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Short-Term Estate Tax Planning

A recent federal court decision has given renewed vigor to a powerful estate tax planning strategy: the self-cancelling installment note ("SCIN"). A SCIN strategy can result in a substantial transfer of assets to younger generation family members at no transfer tax cost. Thus, a family could save a significant portion (or all) of the estate tax that would otherwise be paid to the IRS. Technically, a SCIN is a promissory note where the payor and payee agree that payments need be made only while the payee, or a third party, is living. If desired, the note can be structured so that payments during the term of the note consist of only interest. A single principal payment is then made at the end of the note's term and then only if the payee is alive. If the payee does not survive to the maturity date, the estate may argue that the entire principal balance is excluded from the payee's taxable estate.

The decision, *Costanza v. Commissioner*,¹ held that: (1) a SCIN transaction results in the exclusion of the unpaid note balance from the estate of the seller, and (2) the SCIN transaction in the case at issue was a bona fide sale. The transferred assets were not included in the seller's estate, as the IRS desired.

The appellate court in *Costanza* found that the lower court had erred in concluding that the SCIN was not a bona fide transaction. Three issues in the original case had troubled the lower court. First, it believed the SCIN sale document had been backdated. Second, it was concerned that the SCIN payments had been made after the specified due date in the agreement. Finally, there was an alteration in the written date of the checks for the monthly SCIN payments.

As to the first issue, the appellate court found the date was acceptable under circumstances where the attorney in the original sale transaction needed to pick a date in order to create an amortization schedule for the property. The appellate court also noted, as to the second issue, that the quarterly payments were in sufficient compliance with the sale arrangement, where the seller verbally agreed that payments could be made on a quarterly basis, instead of on a monthly basis, notwithstanding the written agreement. Finally, the appellate court found that the purchaser's alteration of the dates on the checks did not jeopardize the bona fide nature of the transaction, where checks were sent quarterly but altered to show monthly remittance dates.

The bottom line is that even with egregious facts - the proverbial i's not dotted and t's not crossed - the appellate court was willing to bless the SCIN sale. Moreover, the court reaffirmed the beneficial estate tax implications, i.e., the unpaid note balance in a SCIN transaction will not be included in the estate of the seller. This potential benefit of the SCIN should be considered in the current estate tax environment.

Short-Term Planning

The repeal of the estate tax in 2010, with the concomitant phase-out period, poses a quantifiable paradox for planners.² The increase in the estate tax liability for a decedent who dies this year versus during 2006 is significant. Although Congress seemed unable to articulate a policy reason for the phase-out (revenue issues come to mind here) and an immediate repeal could have been enacted, the tax will now strike unevenly depending upon the year of death.

The differences in the estate tax for a decedent passing away this year versus during 2006 are shown in Table 1. For example, a \$5 million dollar estate will owe half a million dollars less in estate tax if the individual lives just two and a half years longer. On the surface, it

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might appear that the simplest (but not least expensive) way to hedge this risk is with life insurance. But it is not so.

First, underwriting is going to play a factor and some individuals are not insurable at any premium. Second, a SCIN is a substantially more efficient hedge that can be implemented for a cost that is a fraction of what the insurance premiums would be. Moreover, a SCIN can be implemented with an otherwise uninsurable seller.

The Risk Premium

A SCIN requires a premium to be added to the note balance to compensate the payee for the risk that (i) not all interest payments will be received over the maximum term and, (ii) if the payee is not alive at the end of the term of the note, i.e., no part of the principal will be received. Alternatively, the interest rate on the note can be increased to compensate the payee for these risks.

In a typical scenario, a surviving spouse (who would otherwise be subject to the estate tax) could sell an asset to her children. Rather than paying cash, the children would issue an interest-only promissory note with a self-cancellation feature. The note would provide that if the seller (the surviving spouse) is not alive at the end of the term of the note, then the principal balance is forgiven. The children would be obligated to make interest payments during the term of the note. But, as shown in the example that follows, these interest payments can be made from the transferred asset itself. So, the children would need no cash initially and no cash during the term of the note either.

At the end of the note term, if the surviving spouse is not living, the children own the asset sold with no further payments. For estate tax purposes neither the asset nor the note balance is included in the seller's estate. If she is living, the children must pay back the principal balance on the note. However, they can use the purchased asset for this purpose and can possibly even make the payment in kind.

Use of a Grantor Trust

The above scenario is straightforward but ignores the income tax issues. Unless further steps are taken, the interest or dividends paid on the transferred asset generate taxable income to the children. More importantly, the interest paid on the note signed by the children generates taxable income to the surviving spouse. As in the relatively common installment sale technique, a grantor trust can be used as the purchaser. If such a grantor trust is established for the children and used as the purchaser, the two income tax issues are solved. The income of the transferred asset is taxed to the seller (the surviving spouse grantor), as it would have been without the sale, and the interest paid on the note is not taxable to anyone.

A risk premium is added to the note balance to compensate the payee/seller (the surviving spouse) for the risk that not all payments will be received. The risk premium involves a complex calculation. Each year, the probability that the payment will be received must be determined, i.e. the probability that the seller will be living. Additionally, each such future payment must be discounted to its present value. The payments, discounted to their present value, and discounted for their probability of receipt, are aggregated. That total is equal to the principal amount of the note (including the risk premium).

Example of SCIN Sale

Even for elderly sellers, a relatively short-term SCIN does not add a significant risk premium to the principal balance on the note. For example, a 77-year-old selling an asset

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for a three-year SCIN would need only a 17% increase in the note balance (as the risk premium) to compensate her for the risk of mortality in that period. Accordingly, an asset valued at \$2 million for sale purposes would require interest payments of about \$93,000 per year for three years. A combination of dividends, interest and sales of grantor trust property could provide the cash for such payments. Assuming a discounted asset was used in the transaction (such as a partnership interest), an assumed growth rate of only 5% would provide a transfer tax benefit even after the principal was repaid. Thus, assuming a 33% discount on the asset sold, an asset worth \$3 million would be valued at \$2 million for purposes of the sale. At the end of the term, even after the payment of the note principal, over half a million dollars goes to the children transfer-tax free. If the seller is not living, over three million dollars is transferred. (See Table 2.)

Conclusion

The upshot is that for no transfer tax cost, a family can effectively hedge the short-term economic risk of mortality. If the seller outlives the note term, she receives her property back at the end of the term (and with some transfer tax benefit to the kids). If she does not survive the note term, a transfer tax windfall is achieved for the family. But as time goes on, the benefit of the increase in the unified credit offsets, to an extent, the estate tax detriment. In essence, the SCIN attempts to smooth out the playing field.

Taxable Estate	Estate Tax 2003	Estate Tax 2006	Difference
3,000,000	925,000	460,000	465,000
5,000,000	1,905,000	1,380,000	525,000
7,000,000	2,885,000	2,300,000	585,000
10,000,000	4,355,000	3,680,000	675,000

Assumptions:				
Sale Price of Interest				2,000,000
Age at Time of Sale (4/17/26)				77
IRS Actuarial Life Expectancy				9.9
Interest Rate for Note Payment				4%
Calculated Principle Risk Premium				\$336,123
Assumed Growth Rate of Transferred Asset				5%
Year	Interest Payment	Principal Payment	Growth of Asset Less Payment	If Seller Not Living at End of Note Term
2004	93,445	0	2,906,555	
2005	93,445	0	2,958,438	
2006	93,445	2,336,123	676,791	\$3,012,915

Endnotes

- 1 2003 WL 354836 (6th Cir.), rev'g *Costanza v. Commissioner*, T.C. Memo 2001-128.
- 2 The phase-out of the estate and generation-skipping transfer taxes was implemented as part of the Bush tax-cut package (H.R. 1836; Public Law 107-16) signed into law on

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June 7, 2001. In order to comply with reconciliation procedures, the tax-cut bill included a “sunset” provision, under which the law expires at the end of 2010.

- 3 The balance on a SCIN arguably does not generate estate taxes at the death of the transferor. When considering SCINs, the Tax Court has held that if the installment obligation instrument itself contains a cancellation provision as part of its agreed upon terms negotiated at arms’ length for adequate consideration, there is no estate tax inclusion of the note at the death of the transferor. Estate of Moss, 74 TC 1239 (1980); Estate of Costanza, 2003 WL 354836 (6th Cir.); General Counsel Memorandum 39503 (June 28, 1985).

A \$1 million term policy for a 77-year-old, for example, could cost about \$90,000 for three years.

- 4 There is no definitive authority on the required mortality table to use when calculating the risk premium for a SCIN. However, if the mortality table under IRC section 7520 is used, the Treasury Regulations require only that the measuring life not be terminally ill. Under Treas. Reg. section 20.7520-3, an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year. However, if the individual survives for eighteen months or longer, that individual is presumed not to have been terminally ill unless the contrary is established by clear and convincing evidence.
- 5 See fn.3
- 6 Original principal plus risk premium = $\$2,000,000 \div ('7520' \text{ interest rate} \times \text{probability of receipt} \times \text{discount for time value of money [for each year of the SCIN]})$. Original risk premium plus risk premium \times note interest rate = interest payment.