THE LATEST WORD ON **SELF-CANCELLING INSTALLMENT NOTES***

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Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003), *rev'g and remanding* T.C. Memo 2001–128, blesses the use of a self-cancelling installment note (SCIN) as a valid estate planning tool. The Sixth Circuit opinion accepts a planning technique approved in *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), but it leaves the valuation of the note as an open issue. The opinion also fails to discuss the recognition of gain issues raised in an earlier decision, *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993), *rev'g* 98 T.C. 341 (1992).

BACKGROUND

Because it involves a series of payments, a SCIN has some of the characteristics of an annuity and some of the characteristics of an installment sale. If an annuity provides for payments so long as the seller lives, the seller may ultimately receive substantially more than the value of the property transferred. A SCIN, on the other hand, terminates on the earlier of the seller's death or payment in full. Because the seller may die before receiving payments equal to the property's value, the Service may assert that the SCIN is not full and adequate consideration for the property being transferred, thus triggering adverse tax consequences for the seller or the seller's estate. For the SCIN to constitute full and adequate consideration, the payment terms must reflect not only the value of the property transferred but also a premium. The premium compensates for the risk that a premature death may result in the seller receiving less than the value of the property transferred. The premium can be reflected in a higher interest rate (SCIN–INT) or a higher purchase price (SCIN–PRIN).

For federal estate tax purposes annuities are taxable under section 2039, which includes in the gross estate the value of any annuity or other payment receivable by any beneficiary by reason of surviving the decedent, under any form of contract or agreement. Annuities must be valued using the Service's tables. See *Estate of Cullison v. Commissioner*, T.C. Memo 1998–216, which involved the sale of farmland for a private annuity. The estate valued the annuity by reference to market interest rates for real estate. The Tax Court held that section 7520 controlled and that therefore the federal tables for annuities must be used.

For the SCIN to avoid a Service challenge that it is an annuity, its terms should be structured so that full payment of the note is anticipated to occur within the holder's actuarial lifetime. If the life expectancy of the holder is less than the timeframe set for the final installment, the Service will treat the installments cancelled at death as an amount taxable under section 2039. *See* GCM 39503 (June 19, 1986).

But, does this mean that section 7520 must be used in valuing the SCIN, bringing into play the presumptions in the regulations defining "terminal illness?" GCM 39503 (May 7, 1986), in discussing whether a SCIN should be taxed under section 72 (annuities) or section 453 (installment sales), states that the monetary limit tends to dilute the annuity nature of the transaction. Therefore, the income tax treatment will depend upon whether or not the stated maximum payout will be achieved in a period less than the life expectancy of the transferor. The GCM goes on to say (citing S. Banoff and M. Hartz, *Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete?*, 59 TAXES 499 (1981), and E. Schnee, *Cancelling a Debt Correctly Can Give Rise to Estate and Gift Tax Advantages*, 8 EST. PLAN. 276 (1981)) that in analyzing an installment sale there is no requirement that the actuarial tables be used to determine if the transaction included a gift element, and the taxpayer's particular health status may be considered.

MOSS AND *FRANE*

In *Estate of Moss*, the decedent sold his stock in a funeral home for a note (SCIN) calling for monthly payments of principal and income for a set term. The note also provided for the cancellation of the remaining payments should he fail to survive the term. Although he was not in poor health when he entered into the transaction, the decedent failed to survive the term. The Service argued that the transaction was equivalent to one of two situations: (1) the decedent retained control of the debt until death and then forgave it by will; or (2) the decedent made an assignment of the note to be effective on his death. The Tax Court disagreed and held that the SCIN did not represent anything of value to the decedent at death. It rejected the Service's argument that the note was includible under section 2033. *Estate of Moss* thus made the SCIN a legitimate estate-planning vehicle.

The parties in *Estate of Moss* had stipulated that the decedent's sale of stock was a bona fide sale for adequate and full consideration. As a result, the taxpayer avoided the adverse gift and estate tax consequences that arise if the SCIN does not constitute full and adequate value for the property transferred. If the value of the property transferred exceeds the value of the SCIN on the date of the transfer, the excess amount will constitute a gift under section 2512. Unless the holder of the note survives the term, the SCIN may also be subject to tax as an annuity under section 2039 or as a transfer taking effect at death under section 2037. If the estate tax applies, the value of the property at the date of death, rather than the value at the date of gift, may control.

An additional question is the identity of the appropriate taxpayer for

* For an excellent, and more detailed explanation of SCINs, readers should refer to S. Banoff, M. Hartz and V. Famparska, *Appellate Court Upholds SCIN as Bona Fide Sale: Planning Opportunities Enhanced*, 98 J. TAX'N 292 (2003).

income recognized as a result of death before the end of the SCIN term. In *Estate of Frane*, the Tax Court held that the decedent's final tax return should report income equal to the excess of the face value of the SCIN over the basis of the property that had yet to be fully recovered. The Eighth Circuit reversed and taxed the income to the decedent's estate. The Tax Court finding is the more favorable for taxpayers, as it would produce an estate tax deduction under section 2053 and would also allow an offset for passive activity losses on the final income tax return.

COSTANZA

In *Estate of Costanza*, the decedent sold his interest in a restaurant and commercial real estate to his son in exchange for a SCIN. The SCIN provided for monthly installments over an eleven-year period and included a cancellation on death provision. The son made the first three monthly payments by backdated checks and made no further payments during the decedent's lifetime. The decedent died five months after the SCIN was issued.

The SCIN provided for an initial interest rate of 6.25%, increasing in stages, every two years, until it reached 8.75% for the final 12 months of the term. In January 1993, the first month of the SCIN, the Applicable Federal Rate was 7.63%. The Tax Court decision does not specifically indicate whether this SCIN involved an interest-rate or purchase price premium.

The Tax Court held that the SCIN was not a bona fide transaction and should be treated as a taxable gift. The Sixth Circuit disagreed, ruling that the estate provided satisfactory explanations for the backdated checks and the failure to make the final two payments. The Sixth Circuit also ruled that the testimony of medical experts that the decedent had a five to 13½ year life expectancy was sufficient to show that, at the time the transaction was entered into, the decedent had a real expectation of repayment. GCM 39503 would impose a gift tax unless the value of the property transferred is equal to or less than the value of the obligation, considering the taxpayer's particular health status. The testimony regarding the five to 13½ year life expectancy would not appear to be sufficiently precise to meet the exception, and was not, in fact, mentioned in the Tax Court opinion.

Although it ruled in the taxpayer's favor regarding the bona fide transaction issue, the Sixth Circuit remanded the case to the Tax Court for consideration of the government's alternative argument, that the transaction was a bargain sale subject to gift tax.

CONCLUSION

In summary, a SCIN may be a feasible estate-planning tool, but it must be used carefully!

THE RISING SIGNIFICANCE OF **STATE DEATH TAXES**

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The 2001 federal legislation "repealing" the estate tax included, as a revenue-raising feature for the federal fisc, the phased-out repeal of the federal credit for state death taxes. Section 2011(c) had provided a sliding-scale credit against federal estate tax for "the amount of any estate, inheritance, legacy or succession taxes actually paid to any state or the District of Columbia, in respect of any property included in the gross estate," with the maximum credit equal to 16% for adjusted taxable estates of $10,040,000 and higher. That credit is now being phased out in 25 % increments over 2002-2004, and in 2005 will be replaced with a federal deduction for state death taxes. For decedents dying after 2004, therefore, there is no federal credit, only a deduction against the ultimately-to-be-phased-out federal tax. I.R.C. § 2011(g).

Prior to the 2001 federal legislation, virtually every state had some form of death tax designed to maximize the utility of the federal credit. This uniformity in the state tax treatment of death taxes was the product of an historically significant compromise, brokered in the 1920s, through which the federal government and the states arrived at a mutually agreeable allocation of death tax revenues. Specifically, the federal credit for death taxes represented, at its enactment, a solution to federal-state wrangling over death tax monies that began in the nineteenth century. The federal credit was a compromise that recognized the encroachment of the federal government on traditional sources of state revenues, and sought to compensate the states, in some comprehensive and efficient manner, for the federal incursion. It was conceived, not as a federal stipend to the states, but as a form of revenue sharing, and had the salutary effect of eliminating state-to-state competition in death tax regimes, and of making state death taxes all but invisible to taxpayers and tax planners. (This early history of death taxes in America is recounted in a fascinating article by Eugene E. Oakes, a professor of economics at Yale at the time of its publication, *Development of American Death Taxes*, 26 Iowa L. Rev. 451 (1941).)

With the repeal of the federal credit, however, a variety of new state death tax patterns have emerged. In some states, such as Connecticut, the state estate tax was pegged by statute to the amount of the federal death tax credit. In such states, the federal legislation had the immediate effect of reducing the state tax rate (and taking those additional monies in as federal estate tax revenues). Other states, such as New York, had an estate tax that was drafted to match the federal credit but was not directly derivative of the federal Code. In New York the federal legislation did not affect the amount of the state estate tax, meaning that New York decedents continue to pay the same state tax as before, but get a smaller credit against their federal taxes. Indeed, after the "repeal" of the federal estate tax, the total estate tax rate for New York taxpayers can be as high as 60 %. And some states, such as Florida, are constitutionally prohibited