THE UNEXPECTED CURVE – THE ESTATE OF COSTANZA AND ITS IMPACT ON SELF CANCELING INSTALLMENT NOTES

By: Richard F. Roth

I. CREATIVE FINANCING

A. The future of estate tax in question.

B. The future of gift tax is secure.

C. What is a SCIN?

D. Why are we discussing SCINs?

E. SCINs allows taxpayers to escape both estate and gift tax.

F. I hate complex schemes – what is a SCIN?

G. SCINs:

1. A note should be issued to cover the value and should have a term shorter than the expected death based on the mortality tables.

2. The note should contain a premium for cancellation provisions, either in interest rate or face amount.

3. Provides retirement income for the seller.

4. Eliminates estate tax on death, because note becomes worthless.

5. Seller may have a gain on installment sale upon death unless sold for cost.

KEY: Upon death of the first spouse, surviving spouse has stepped-up basis and can sell without gain.

II. Estate of Costanza

(91 AFTR 2d 2003-476, 2003 WL 354836; CA-6 2/19/03)

A. A father and his son enter into a SCIN in February 1992; the two sold a restaurant and a retail/office space in Flint for total price of $830,000 in exchange for a SCIN over an 11-year term.

B. The Note was secured by a Mortgage.

C. The Note canceled if the father died.

D. SCIN was dated December 15, 1992.

E. The father died on May 12, 1993, following bypass surgery.

F. The father had severe coronary disease since April 1991.

G. Decedent's health was a factor in tax court, not appellate court.

H. Tax court held that SCIN was not a bona fide sale.

1. Documents were back-dated to December 15, 1992.

2. Documents were not executed until after January 6, 1993, when the first payment was to be made on January 1, 1993.

3. Son signed all documents in his capacity as Trustee of both trusts.

4. Payments for monthly installments were not made as required by the Note.

5. In March 1993, son made three (3) checks for January, February and March.

6. He changed dates on checks to show they were written for the appropriate month of payment.

7. He made no further payments.

I. In rejecting tax court, Sixth Circuit stated that:

1. Father and son intended to satisfy all payments due pursuant to the SCIN.

2. A gift was never intended, since the payments were needed for retirement.

3. The delay in execution of papers was needed in order to pick a date upon which to base the amortization schedule.

4. The fact that all documents were signed within several weeks was inconsequential.

5. Son testified that his father wanted to be paid quarterly instead of monthly.

6. Appellate court for the Sixth Circuit remanded the case to determine whether it was a bargain sale that will increase the estate's adjusted taxable gifts.

7. **Note**: This is a valuation issue to determine whether the SCIN equals the value of the property given in exchange for the transferred property.

8. Court rejected IRS's assertion that the transfer was a revocable transfer under Section 2098.

9. There was no evidence decedent retained such a power or son violated his duties as Trustee.

III. <u>SUMMARY</u>

A. The transaction must be properly documented both as to intent and instruments.

1. Documents should be correctly dated.

B. The transaction must be carried out with same formality as is required for transactions with unrelated entities.

C. The intent of the parties to create a debtor/creditor relationship must be shown.

(See attached example of calculations)

Transfer Date:	5/2005
Discount Rate:	5.20%
FMV of Property:	$3,500,000
Cost Basis:	$1,200,000
Recapture (Sec. 1245 or 1250):	$600,000
Initial Down Payment:	$250,000
Age(s):	60
Term of Note:	10
Type of Note:	Level Principal
Annuity Valuation:	Complete
No-Risk-Premium Market Interest Rate:	5.20%
Payment Period:	Annual
Amortization or Principal-Recovery Period:	20
Balloon Payment	Yes

	Risk Premium	
	Principal	**Interest**
Mortality Risk Premium (Principal):	$339,644.56	N/A
Total Sale Price:	$3,839,644.56	$3,500,000.00
Principal Amount of Note:	$3,589,644.56	$3,250,000.00
Mortality Risk Premium (Interest):	N/A	1.6530%
Total Interest Rate:	5.2000%	6.8530%
Annual Principal Payments:	$179,482.23	$162,500.00
Annual Interest Payments:	Varies	Varies
Total Annual Payments:	Varies	Varies
Balloon Payment at the End of Note:	$1,794,822.28	$1,625,000.00
Total Interest to be Paid:	$1,446,626.76	$1,726,099.37
Total Capital Gain:	$2,039,644.56	$1,700,000.00
Profit Percentage (Capital Gain / Sale Price):	53.12%	48.57%
Capital Gain Recognized in Year of Sale:	$132,801.65	$121,428.57
Basis Recovery in Year of Sale:	$117,198.35	$128,571.43

Repayment Schedule for Level-Principal SCIN with Principal Risk Premium

Actual Periodic Interest Rate: 5.2000%

Year	Balance of Note	Interest	Principal Gain	Principal Basis	Principal Total	Total Principal and Interest
1	$3,589,645	$186,662	$95,342	$84,140	$179,482	$366,144
2	$3,410,162	$177,328	$95,342	$84,140	$179,482	$356,811
3	$3,230,680	$167,995	$95,342	$84,140	$179,482	$347,478
4	$3,051,198	$158,662	$95,342	$84,140	$179,482	$338,145
5	$2,871,716	$149,329	$95,342	$84,140	$179,482	$328,811
6	$2,692,233	$139,996	$95,342	$84,140	$179,482	$319,478
7	$2,512,751	$130,663	$95,342	$84,140	$179,482	$310,145
8	$2,333,269	$121,330	$95,342	$84,140	$179,482	$300,812
9	$2,153,787	$111,997	$95,342	$84,140	$179,482	$291,479
10	$1,974,305	$102,664	$95,342	$84,140	$179,482	$282,146
Totals:		$1,446,627	$953,421	$841,401	$1,794,822	$3,241,449

Repayment Schedule for Level-Principal SCIN with Principal Risk Premium

Actual Periodic Interest Rate: 5.2000%

Year	Balance of Note	Interest	Principal Gain	Principal Basis	Principal Total	Total Principal and Interest
Balance:	$1,794,822					

Repayment Schedule for Level-Principal SCIN with Interest Risk Premium

Actual Periodic Interest Rate: 6.8530%

Year	Balance of Note	Interest	Principal Gain	Principal Basis	Principal Total	Total Principal and Interest
1	$3,250,000	$222,722	$78,929	$83,571	$162,500	$385,223
2	$3,087,500	$211,586	$78,929	$83,571	$162,500	$374,086
3	$2,925,000	$200,450	$78,929	$83,571	$162,500	$362,950
4	$2,762,500	$189,314	$78,929	$83,571	$162,500	$351,814
5	$2,600,000	$178,178	$78,929	$83,571	$162,500	$340,678
6	$2,437,500	$167,042	$78,929	$83,571	$162,500	$329,542
7	$2,275,000	$155,906	$78,929	$83,571	$162,500	$318,406
8	$2,112,500	$144,770	$78,929	$83,571	$162,500	$307,270
9	$1,950,000	$133,634	$78,929	$83,571	$162,500	$296,134
10	$1,787,500	$122,497	$78,929	$83,571	$162,500	$284,997
Totals:		$1,726,099	$789,286	$835,714	$1,625,000	$3,351,099
Balance:	$1,625,000					

How Is the Risk Premium Determined?

If the buyer and seller are not close family members and the transaction is at arm's length by an informed seller and informed buyer, neither of whom is under any obligation to sell or buy, the negotiated sales price and note terms can generally be presumed to reflect an adequate premium for the cancellation feature. However, the tax laws essentially presume transactions between close family members are not at arm's length. Therefore, it is critical to establish the adequacy of the risk premium for the cancellation feature. Since a risk premium can only be measured relative to fair market value or the market rate of interest, it is equally critical to properly substantiate the fair market value of the property being sold and the appropriate market rate of interest.

In the case of property such as listed stocks and bonds where there is an established, well-functioning market, fair market value is simply the price at which it could be sold outright based on market prices when the installment sale commences. (Although installment sales of listed stocks are not generally recommended because of the requirement to recognize all gain in the year of sale.) For other types of property, such as closely held stock, artwork, or certain real estate, a professional appraisal may be required to establish fair market value.

The mortality factors used for computing the risk premium for the cancellation feature typically are the same as those used for valuing annuities, life estates, and remainders for gift and estate tax purposes as provided in Table 80CNSMT or Table 90CM.

Note: For May or June of 1999, you have the choice of using the Mortality Table 80CNSMT or the Mortality Table 90CM. For any dates prior to May 1, the program will automatically use the 80CNSMT mortality table. For any dates after June 30, the program will automatically use the 90CM mortality table.

These mortality factors are *not* the same as the mortality factors used to compute the life expectancies of Table V of IRC Reg. §1.72-9. However, in contrast with valuations of private annuities and various interests in trust for gift and estate tax purposes, IRS pronouncements indicate that there is some leeway with SCINs to establish that the terms are reasonable. The seller's *actual* health status and life expectancy rather than his or her *actuarial* life expectancy may be considered in designing the terms and the risk premium of the SCIN. This means that higher (but probably not lower) mortality factors than those for the seller's attained age from Table 80CNSMT or Table 90CM may be used to determine the risk premium for the cancellation feature if the seller's health is below average. Whether such adjustment is *required* is uncertain. However, many authorities feel that normal mortality factors based on the seller's attained age may be used even if the seller is in poor health, unless there is at least a 50-percent probability of death within one year.

The risk premium may take one or a combination of two forms. First, the sales price of the property may be increased above the fair market value that would be paid in an outright sale or in an installment sale without the cancellation feature. In this case, the standard AFR would be used to apportion the interest and principal components of the payments. Alternatively, the property may be sold for its fair market value, but an interest rate greater than the standard AFR may be used to apportion interest and principal.

How the principal and interest rate risk premiums are determined is perhaps best explained by example. Suppose your client, aged 60, wishes to sell property with a fair market value of $125,000 to her son in an installment sale. The son will pay $25,000 on the date of the sale and pay off the balance of the note in three equal annual installments. Assuming the applicable federal short-term rate is 6.4

percent, three annual payments of $37,688.17 would be required to pay off the $100,000 balance on a regular non-cancelable installment sale note for 3 years.

This payment is determined by solving the following equation:

$$Pmt = \$100,000 \div \sum_{k=1}^{3} \frac{1}{1.064^{k}} = \$100,000 \div 2.653352387 = \underline{\$37,688}$$

Rearranging terms, the equation can be expressed as follows:

$$\$100,000 = \frac{Pmt}{1.064^{1}} + \frac{Pmt}{1.064^{2}} + \frac{Pmt}{1.064^{3}}$$

Now, assume your client wants to include a cancellation provision in the installment sale and note providing that the sale will be complete and the note will be considered satisfied in full by all payments up to the date of her death in the event she dies before the end of the 3-year term. Assuming she is in normal heath for a 60-year-old person, the note will qualify as a self-canceling installment note, rather than a private annuity, since the Table V life expectancy for a 60-year-old person, 24.2 years, is greater than the 3-year term of the note.

To compute the required payments on the note, the payments must be adjusted for the probability that she is alive to receive the payments when scheduled. Let 60Pk represent the probability that a person age 60 will still be alive k years later. Based on Table 80CNSMT factors, the probabilities for the 3-year term of the note are, respectively,

60P1 = 0.98632

60P2 = 0.97160

60P3 = 0.95578

In addition, assuming your client does not reside in the Seventh Circuit Court's region, the interest-rate factor should be the §7520 rate rather than the short-term AFR. Assume the §7520 rate is 7.6 percent. The required annual payment may be computed using a formula that is analogous to that presented above for the non-cancelable installment note. Specifically,

$$\$100,000 = \frac{{}_{60}P_{1}.Pmt}{1.076^{1}} + \frac{{}_{60}P_{2}.Pmt}{1.076^{2}} + \frac{{}_{60}P_{3}.Pmt}{1.076^{3}}.$$

Or, in the rearranged form:

$$Pmt = \$100,000 \div \sum_{k=1}^{3} \frac{{}_{60}P_{k}}{1.076^{k}} = \$100,000 \div 2.52308 = \underline{\$39,634}$$

The principal risk premium can now be determined by calculating what the face amount would be for a non-cancelable installment note with three annual payments of $39,634.10 using the short-term AFR of 6.4 percent. That is, The $5,163.23 difference between the $105,163.23 is computed and the $100,000 fair market value is the principal risk premium.

$$\text{Face Amount} = \frac{\$39,634.10}{1.064^1} + \frac{\$39,634.10}{1.064^2} + \frac{\$39,634.10}{1.064^3}$$

$$= \$39,634.10 \text{ x } 2.653352387$$

$$= \underline{\$105,163.23}$$

If an interest rate risk premium is preferred to the principal risk premium, the interest rate risk premium may be computed by solving for the interest rate that would equate the discounted value of the 3 annual payments of $39,634.10 with the fair market value of $100,000. That is, solve for the interest rate, I that satisfies the following equation:

$$\$100,000 = \frac{\$39,634.10}{(1+I)^1} + \frac{\$39,634.10}{(1+I)^2} + \frac{\$39,634.10}{(1+I)^3}$$

In this case, I is equal to 9.1826 percent. Therefore, the interest rate risk premium is equal to 2.7826 percent (9.1826 percent minus the 6.4 percent short-term AFR).