

An Introduction to Self Cancelling Installment Notes: SCIN Transactions

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SCIN

BEST USES FOR SCINS:

1. Estates with values generally in excess of \$5,000,000 with substantial liquidity.
2. Individuals who are 60 years or older (married couples where at least the youngest spouse is older than 60)
3. Those who have done little or no estate planning.

SCIN

What is a SCIN:

A SCIN is an ordinary promissory note which is payable in installments over the term of years that at the death of the seller, any remaining payments are automatically canceled.

SCIN

EXAMPLE

- Facts:
- The seller, Mr. A, was born on November 1, 1932, and is 78 years old;
- Mr. A is the owner of 100% of the outstanding shares of common stock of XYZ, Inc.;
- Mr. A's tax basis in XYZ is \$500,000;
- As of March 2010, the fair market value of the XYZ shares was \$20,000,000;
- On March 1, 2010, Mr. and Mrs. A established the A Family Irrevocable Life Insurance Trust, (the "Trust");
- Mr. A's trusted advisor, Mr. B was named trustee of the Trust. The Trust was designed to be excluded from Mr. and Mrs. A's estate but also be a grantor trust for federal income tax purposes;

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- Also on March 1, 2010 Mr. & Mrs. A established the SMS limited partnership. SMS has been structured so that it has severe restrictions on transfer as well as other restrictions on distributions that cause the value of the limited partnership interests to have been valued at 75% of their otherwise computed fair market value. Mr. & Mrs. A transferred \$1,000 to SMS for capitalization purposes and in return became the owners of the 1% general partnership interest and the 99% limited partnership interests;
- Mr. A is married to Mrs. A, who is also 78 years old, and they have one child, C, who is 45 years old.
- The A's desire that ownership of XYZ be transferred to C with minimal tax consequences; and
- The total value of Mr. A's federal taxable estate is approximately \$30,000,000, which includes \$5,000,000 in cash.

SCIN

- The A's desire to reduce or eliminate federal estate tax upon their deaths and have undertaken various strategies to achieve that goal. Further, the A's also wish to retain sufficient cash flow to maintain the standard of living to which they are accustomed. The A's have been advised that a SCIN transaction may accomplish most, if not all of their goals. Thus they undertake the following transaction:



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- 1. The A's, in a tax free transaction transfer all of their interest in XYZ to SMS partnership;
- 2. The A's basis in SMS is now \$501,000.
- 3. The Trust enters into a transaction where it purchases the 99% limited partnership interest of SMS from Mr. & Mrs. A for \$14,850,000. This purchase price is computed as follows: (Fair market value of all of SMS is \$20,001,000 times the 99% equals \$19,800,000 which is then reduced by 25% to reflect the discount set forth in paragraph G above.)
- 4. The Trust gives Mr. & Mrs. A a self cancelling installment note ("SCIN") in exchange for the 99% limited partnership interest. The note provides for annual interest only payments of \$1,681,000 over 10 years with a balloon payment of \$14,850,000 at the end of the 10th year. Payments terminate altogether if Mr. & Mrs. A die before repayment has been completed. The interest rate on the note is 11.321%.
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- Consequences of proposed transaction.
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- Mr. & Mrs. A will recognize no gain on the sale of the stock until the payment of principal is made in year 10.
- Mr. & Mrs. A will have annual tax free income over the next ten years of \$1,681,000.
- The entire value of XYZ, Inc. (\$20,000,000) has been removed from the federal taxable estate until the end of year 10.
- The Trust will obtain a step up in basis in the value of XYZ to \$14,850,000 when the loan is completely repaid in year 10.

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- In a properly designed self-cancellation provision, the cancellation provision must be bargained for as part of the consideration for the sale, and the term of the note cannot exceed the seller's life expectancy. In this case sellers are 78 years old and according to the IRS life expectancy tables the sellers are expected to live another 10 years. An exception to a reliance on the IRS life expectancy tables exists where the seller is determined to be terminally ill. As defined by the Service an individual is terminally ill who is known to have an incurable illness or other deteriorating physical condition and there is at least a 50 percent probability that the individual will die within 1 year. Dementia is not a terminal disease under the provisions of the Internal Revenue Code and we are unaware of facts that indicate seller is terminally ill.

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The length of the note, ten (10) years, is long enough to avoid a gifting issue and short enough to incur a mortality risk. In addition, the purchase price must reflect this bargain with either a principal risk premium which is above the market sales price or an interest rate premium which is above the market interest rate. In our example the parties chose to increase the interest rate to account for the mortality risk. The interest rate surcharge was determined to be 7.871% in addition to the IRC § 7520 long term rate for May 2010 of 3.45%, for a total interest rate of 11.321%, rounded up to nearest tenth.

SCIN

The seller may not retain control over the property being sold once the sale has taken place. This issue is addressed by establishing that the Trust is an independent entity and capable to undertake the transaction under review. Most commentators feel that the grantor, in this case the A's, must also "Plant" seed money, typically 10% of the purchase price, to the trust before installment sale is consummated in order to block an attack by the Service that the grantor has retained an interest in the transferred assets which would result in those assets, in this case SMS, being included in the grantor's estate. In this instance, although Trust was established in March 2010, the Trust has not been funded. Therefore, seller/grantor must gift \$1,450,000 (10% of \$14,850,000) to the Trust for such seed money, meeting the 10% threshold suggested above. This establishes that seller has not retained an interest in SMS after the sale, and also that the Trust is creditworthy to sustain the level of debt it will incur as a result of this transaction.

SCIN

- *Estate Taxes:*
- SCINs remove the transferred property from the seller's estate. Therefore, provided all other aspects of a SCIN referenced herein are adhered to, the A's interest in SMS, now valued at \$14,850,000, will be removed from their taxable estate upon transfer. Further, any appreciation in the value of SMS via either equipment appreciation, maturity of insurance investments or the expansion of business activity will be excluded from seller's estate. The payments seller will receive as a result of this transaction are includible in his estate.

SCIN

- *Income Taxes:*
- A grantor or other person who is regarded as the owner of any portion of a trust must include, in computing his taxable income and credits, those items of income, deductions, and credits of the trust that are attributable to the portion of the trust that the grantor is regarded as owning. As stated herein the Trust is an intentionally defective grantor trust and as such the annual income and expenses that are generated within the Trust are to be reported on the grantors'/A's individual income tax return. In this case, the note is interest-only with a balloon payment in year ten. Seller will recognize interest income of \$1,681,000 as being received from the Trust and, via the flow-through of the grantor trust, a corresponding interest expense. The character of the interest deduction will be determined at the trust level. In cases where debt proceeds, in this case the SCIN, are used to purchase an interest in a pass-through entity, in this case SMS, the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using a reasonable method. Reasonable methods of allocating debt among assets of a pass-through entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the pass-through entity or the owner of such assets. Interest expense allocated to trade or business activity will be deductible on seller's income tax return. Interest allocated to investment activities of SMS are still deductible on seller's return, but however will be subject to an investment interest limitation. The most advantageous allocation method for the seller is a matter that is beyond the scope of this correspondence.