Self-Canceling Installment Notes (SCINs) — IRS Guidance and Pending Tax Court Case; CCA 201330033 and *Estate of William Davidson*

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IRS Chief Counsel Advice Regarding IRS Approach to SCIN Transactions If Seller Dies Soon After Sale Transaction; Pending Tax Court Case Will Address Huge Alleged Deficiency in SCIN Case

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General Background

1. *General Description of SCINs.* A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion in the seller's estate of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling any future payments amounts upon the death of the holder.

   If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includible in the estate of the holder. This feature can also be useful if the seller does not want to burden the purchaser with the continued obligation to make payments after the seller's death. If the seller lives to full life expectancy, the seller will receive more payments than if a standard note had been used. If the seller dies before the note is paid, the IRS maintains that the seller's estate will recognize the amount cancelled as income on the estate's first income tax return.

2. *Risk Premium to Account for Cancellation Feature.* For the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and thus not receive the full purchase price. Since such a feature must be bargained for at arm's length to be respected, the seller must be compensated for the risk associated with the potential cancellation either by an increase in the purchase price or by a higher interest rate. To calculate the premium, an advisor must determine what stream of payments are required, taking into consideration the possible death of the seller, to have the same present value as the principal amount of the promissory note. There is not universal agreement on how payments under a SCIN are properly valued, for there is no clear answer concerning which mortality tables should be used and which discount rate should be applied to value the payments. Many, if not most, practitioners are using the higher of the §7520 rate (which is 120% of the mid-term applicable federal rate) or the applicable federal rate (AFR) for the actual term of the note; the estate tax risk of using a rate that is too low is simply too great.

   The risk premium can be structured using a higher than "normal" interest rate, a higher principal face amount of the note, or a combination of the two. A principal risk premium should be treated as a capital gain to the seller and increase the basis of the property in the hands of the purchaser. Using a higher interest rate will result in higher interest income to the seller (taxed as ordinary income and subject to the 3.8% tax on net investment income) and a higher investment interest deduction for the buyer.

3. *Impact of Note Term.* A SCIN term which is too long may raise debt/equity concerns, especially when the sale is to a trust with comparatively few other assets. The mortality component of the SCIN increases as the term of the SCIN increases, for a greater risk premium must be added to the SCIN to compensate the seller for the higher probability that the seller will die prior to the expiration of the longer term.

Seminal Case—Estate of Moss

Planning with SCINs followed the seminal case of *Estate of Moss v. Commissioner.* 74 T.C. 1239 (1980), *acq. in result,* 1981-1 C.B. 2. The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under §2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note." In *Moss*, the parties stipulated that the SCIN sale transactions were bona fide transactions for full and adequate consideration and that the cancelation provision was part of the bargained for consideration for the purchase price of the stock. (The case involved a sale to unrelated parties; the president and largest shareholder of a funeral home sold his stock to the corporation for a SCIN; the remaining shareholders were employees of the funeral home.) In that case, "there was nothing to indicate that his life expectancy would be shorter than the approximate 10 years of life expectancy which was indicated by generally accepted mortality tables." (The notes had varying terms, but one of the notes had a term of 9 years and 7 months, so the term of note was very close to the seller's life expectancy.)

Recognition of SCIN Transaction as Bona Fide Transaction to Treat Note As Providing Value

The premium feature of SCINs was addressed in *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo. 2001-128. In that case, the decedent sold real property to his son in exchange for a SCIN that was fully secured by the real property. The note was payable over 11 years. The interest rate increased by one-half percent every 24 months, beginning at 6.25 percent and ending at 8.75 percent the last 12 months of the note. The decedent died unexpectedly five months after the note was issued, after payments had been made for only three months. (He had heart disease but medical experts testified that his life expectancy at the time of the SCIN transaction was between 5 and 13.9 years.) The Tax Court concluded that the sale was not a bona fide transaction and that the SCIN provided **no consideration**. The Sixth Circuit stated that "a SCIN signed by family members is presumed to be a gift and not a bona fide transaction." *Id.* at 597. However, the presumption could be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness. The court concluded that, on the facts of the case, the estate "rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness." The Sixth Circuit remanded the case to the Tax Court to determine the value of the note and whether the SCIN constituted a bargain sale with some gift element. The parties settled.

In *Costanza*, the IRS interestingly argued that the parties entered into the SCIN transaction because they presumed the father would die prior to the note being fully satisfied. "If they had thought [the father] would outlive the final payment due under the SCIN, … there would have been no reason to have signed the SCIN, as opposed to an unconditional promissory note." The Sixth Circuit rejected this argument, reasoning that it effectively would invalidate all SCINs, but SCINs have been recognized (*Estate of Moss*).

An earlier case had agreed with the IRS position under the facts of that case that the SCIN was not recognized as providing any value to the seller. In *Estate of Musgrove v. United States,* 33 Fed. Cl. 657 (1995) a demand SCIN transaction was not recognized as a bona fide transaction because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds and the seller declared that he was not likely to demand payment on the note), and the SCIN was included in the decedent's gross estate.

Chief Counsel Advice 201330033

The IRS Chief Counsel Office weighed in on the treatment of SCINs in Chief Counsel Advice 201330033. A CCA memo merely states the litigating position of the IRS for a case, the the memo gives guidance regarding the IRS's position regarding SCINs. The taxpayer entered into various estate planning transactions including transfers of stock in exchange for preferred stock, stock transfers to GRATs, and sales of stock for notes. The CCA addresses the sale transactions. The sale transactions included some "standard" note transactions and some SCIN transactions.

1. *Facts—Note Transactions.* CCA 201330033 relates to the estate tax audit of the estate of William Davidson. The following fact summary is the description of facts in the CCA. The more detailed facts involving the *Estate of Davidson* are discussed following this summary of the CCA.

   - One sale was to grantor trusts for notes providing interest-only annual payments with a balloon principal payment at the end of a fixed term.
   - A second sale was to grantor trusts for SCINs, providing for interest-only payments during the note term, with a balloon principal payment at the end of the note term. The face of the note was almost double the value of the stock that was sold. "The higher value of the notes supposedly compensated the decedent for the risk that he would die before the end of the note term and neither the principal nor a significant amount, if not all, of the interest would be paid."
   - Within six months, a third sale transaction was to grantor trusts for SCINs, requiring interest-only payments during the note term, with a balloon principal payment at the end. These SCINS had an interest premium rather than a principal amount premium to account for the self-canceling feature.
   - On the same date as the third sale transaction, seller also funded a GRAT. The CCA does not describe the GRAT term. (Obviously, if the grantor died during the GRAT term most if not all of the GRAT assets would be included in the grantor's estate. Presumably, the grantor thought he would live throughout the GRAT term--or else he was being sneaky and created the GRAT just to make it look like he thought that he would live that long.)

   The decedent was diagnosed with a serious illness "very shortly after" the third sale transaction and GRAT formation and died less than six months after the sale transactions, having received no payments at all on the notes. The CCA does not address the decedent's life expectancy at the time of the transactions in relation to the terms of the notes, but did note that "[b]ecause of the decedent's health, it was unlikely that the full amount of the note would ever be paid." (Based on the description in the CCA, it is not clear whether the decedent merely had some health issues, but would have satisfied the requirement in the §7520 regulations of having a greater than 50% likelihood of living at least one year. However, the *Estate of Davidson* facts [discussed below] appear to indicate that medical consultants selected by the IRS agreed that the decedent had a greater than 50% probability of living at least one year at the time of the sale transactions. The IRS maintains, however, that is irrelevant because §7520 does not apply at all to SCINs.)

2. *Issues.* The CCA addresses three issues.

(1) Does a portion of the transfers for the SCINs constitute a gift?

(2) How should the fair market value of the SCINs be determined?

(3) What are the estate tax consequences of the SCINs at the seller's death?

3. *Gift Element and Valuation of SCINs.* The CCA observes that the exchange of property for a promissory note is not treated as a gift "if the value of the property transferred is substantially equal to the value of the notes." [Observation: This is helpful to have an acknowledgement from the IRS, albeit not guidance that can be relied on, that a sale in return for notes "substantially equal" to the value transferred is not a gift. In light of the inherent uncertainties in valuing property and notes, an acknowledgement of a "substantial equality" standard is comforting.]

The analysis primarily is a comparison to the facts in the *Costanza* case. The CCA distinguishes the facts from the facts in *Costanza* on several grounds.

- In *Costanza*, the seller-decedent needed the note payments (of interest and principal, so they were substantial periodic payments) for retirement income and therefore "had a good reason, other than estate tax savings, to enter into the transaction."
- Under the CCA facts, the payments during the term of the note were interest-only payments and a steady stream of income was not contemplated. Also, the seller-decedent had substantial assets and did not need cash flow from the sale to cover daily living expenses.
- An indicia of genuine debt is that there must be a reasonable expectation of repayment, and the CCA suggests that the estate has not demonstrated that the grantor trusts-purchasers have the ability to repay the notes. This is particularly concerning for the SCINs that are about double the value of the stock transferred to the trusts in return for the notes (but is also a concern for the SCINs with the interest-rate premium). However, the CCA acknowledges that the estate might argue that the grantor trusts have enough seed money to cover the note payments.
- The analysis of the estate tax issue also discussed similarities with the *Musgrove* case (which held that the SCIN was included in the decedent's gross estate). The facts of the CCA were similar to the facts of *Musgrove* because the seller-decedent "was in very poor health and died shortly after the note was issued." [Observation: A distinction between *Musgrove* and the CCA facts may be that the seller may have been unaware of his serious health issue at the time of the sale transactions, even though he died within six months, because he was diagnosed after the sale transactions.] Also, there is a legitimate question as to whether the note would be repaid in each case.

As to how the note should be valued, the CCA states that the SCINs were valued "based upon the § 7520 tables." Presumably that means they were valued using the § 7520 rate as the *discount rate* to determine the present value of the future payments, and that the *mortality tables* of § 7520 were used in determining the principal and interest premium amount to account for the self-canceling feature. The CCA gives the following conclusion regarding how the notes should be valued:

> "We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986)."

The IRS position may be based in part on the general understanding that § 7520 applies to annuities, interests for a life or term of years, remainders and reversions—but does not govern debt instruments. (Section 1274—which refers to the applicable federal rate rather than the § 7520 rate and which makes no reference to mortality tables—specifically applies to "certain debt instruments issued for property.")

The IRS's conclusion that the § 7520 tables do not apply "to value the notes in this situation" raises various questions.

- The paragraph says that § 7520 applies only to value an annuity, interest for life or a term of years, or a remainder. Are the principles of § 7520 (in particular the mortality tables of § 7520) never applicable for valuing notes?
- Is the primary concern that the decedent's life expectancy was unduly short, making the valuation using the mortality tables of §7520 inappropriate? What if the decedent was in good health? Would §7520 then be applicable in valuing SCINs (i.e., using the §7520 rate as the discount rate to value future payments and using the §7520 mortality tables)? As a practical matter, the commercial programs that value SCINs (including the "Numbercruncher" program and Larry Katzenstein's "Tiger Tables") use the §7520 approach to value SCINs. (Some commentators suggest using the AFR, rather than the §7520 rate to value SCINs; using the AFR for short-term or mid-term notes produces a higher value than using the §7520 rates. *See* Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,

  1601.3.B(1)-(2) (2000).)
- The CCA cites a prior GCM taking the same position that §7520 does not necessarily apply in valuing notes for an installment sale (although that GCM predated §7520). GCM 39503 ("unlike the private annuity, there is no requirement that the actuarial tables are to be used in determining the gift taxation of an installment sale. Thus, the taxpayer's particular health status may be considered.") In that respect, the position in the CCA is basically consistent with prior position statements from the IRS. Various commentators have noted this position of the IRS. Esperti et al., IRREVOCABLE TRUST: ANALYSIS WITH FORMS (WG&L), ¶16.06[4][A]; BNA TAX MANAGEMENT PORTFOLIO 805, ¶III(C)(3)("there is no requirement that the actuarial tables are to be used in determining the gift taxation of SCINs," quoting GCM 39503). However, other commentators have concluded that the IRS's citation of

GCM 39503 is overstated as support for the proposition that § 7520 does not apply for valuing SCINs but that the decedent's actual medical history should be considered.

> As the language clearly shows, the GCM is not rejecting the use of the mortality tables at all. The memo simply acknowledged that Revenue Ruling 80-80 required taxpayers to use the mortality tables in Treasury Regulation § 20.2031-10 to value private annuities, and reiterated that no such requirement existed for SCINs. The fact that the use of the § 7520 tables is not required, does not mean that these tables do not offer the most practical valuation system for SCINs as well. An again, this GCM was released in 1986. The subsequent Rev. Rul. 96-3 deemed Rev. Rul. 80-80 to be obsolete. Yet the CCA characterizes the GCM for the proposition that mortality tables should not be used and the willing buyer willing seller standard should be used instead. Simply put, the CCA mischaracterizes the GCM for standing for a much broader principle than it actually does.
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> …
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> By changing the valuation of a SCIN, the IRS is abandoning a mechanical valuation system for a system that practitioners can only speculate about. The need for subjective valuation was a reason for the enactment of § 7520. Congress recognized that in intra-family transactions there frequently are no comparable arm's-length transactions which could be relied on to establish the value of the transaction.

Ken Crotty, Jerry Hesch, & Alan Gassman, *Chief Counsel Advice 201330033: IRS Puts SCINs in the Sunlight, Will Taxpayers Get Burned?*, LEIMBERG INFORMATION SERVICES ESTATE PL. NEWSLETTER #2147 (SEPT. 24, 2013).

- Other commentators have suggested that the §7520 actuarial tables should apply unless there are serious health issues. See Zaritsky & Aucutt, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS (WG&L),

  12.02[3](2d ed. 1997 & Supp. June 2013). This treatise provides an excellent extended analysis of this issue.

> "The IRS may attempt to reject the use of the actuarial tables under Section 7520 IN VALUING THE PREMIUM ON A SCIN, BUT The tables appeAR TO BE THE BEST WAY TO VALUE A SCIN premium. In GCM 35903 (May 7, 1986), the IRS stated that, when the term of a SCIN is less than the transferor's life expectancy (determined at the time of the transaction in accordance with Regulations Section 1.72-9, Table I), then the transaction will be characterized as an installment sale with a contingent sales price and will be treated in accordance with the installment sale rules, rather than the private annuity rules. …
>
> It should be noted, however, that GCM 35903 predated Section 7520, which states that actuarial tables must be used to value an "annuity, any interest for life or a term of years, or any remainder or reversionary interest." Section 7520 states that it must be used to value "an interest for life or a term of years," which precisely describes the payments under a SCIN. Furthermore, the IRS publication "Actuarial Values, Alpha Volume," which implements the IRS actuarial tables under Section 7520, includes an example that uses the tables to determine "the present worth of a temporary annuity of $1.00 per annum payable annually for 10 years or until the prior death of a person aged 65. . . ." This, too, appears to describe precisely the calculation of the premium for a SCIN. Thus, Section 7520 appears to apply to the valuation of a SCIN premium.

Also, GCM 35903 only cites two articles [citing S. Banoff & 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)] as authority for using actual life expectancies rather than actuarial life expectancies to value a SCIN. The Banoff and Hartz article provides no authority for preferring the use of actual life expectancy over actuarial life expectancy, and merely describes it as "one equitable way" of determining the SCIN premium. The Schnee article does not refer to the computation of the SCIN premium at all but states, also without authority, that the payments on a SCIN must continue for no longer than the "taxpayer's life expectancy based on mortality tables and taxpayer's health at the time of sale."

Furthermore, it should be noted that a GCM is expressly not a binding precedent. A GCM is issued solely for internal agency use. As the Court of Appeals for the D.C. Circuit has explained:

> 'GCMs are memoranda from the Chief Counsel to the Commissioner written originally for the purpose of guiding the Assistant Commissioner (Technical) concerning substantive issues on proposed revenue rulings, private letter rulings, and technical advice memoranda. The . . . same qualities that make these memoranda useful to the Assistant Commissioner (Technical) recommend the memoranda to agency lawyers for legal research and to agency field personnel in need of guidance in dealing with the public on certain tax liability issues. Moreover, the fact that earlier GCMs are constantly updated to reflect the current status of an issue within the Office of Chief Counsel, . . . combined with the "reconciliation" of positions taken by the Chief Counsel in GCMs with those ultimately adopted by the decisionmaker in the formal rulings, eliminates whatever deliberative character these documents may have had prior to their being "updated" or "reconciled." In essence, after a decision has been reached, a completed GCM becomes an expression of agency policy.'

…

Practitioners should, therefore, generally use the actuarial tables under Section 7520 to calculate the premium on a SCIN. They should, however, be aware of the possibility that the IRS may challenge this calculation to the extent that the seller's actual life expectancy is significantly different from his or her actuarial life expectancy." Id.

- The Zaritsky and Aucutt treatise also points out that a fairly recent case, *Dallas v. Commissioner*, T.C. Memo. 2006-212 appears to have used §7520 in valuing a SCIN. Zaritsky & Aucutt, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS (WG&L),

  12.02[3] at n.19.8 (2d ed. 1997 & Supp. June 2013):

  "It is not possible to replicate this calculation perfectly from the facts reported in the court's opinion and in the pleadings available online. It is, however, possible to get close enough to believe strongly that the Section 7520 tables were used by the IRS in its determination of the value of the SCIN in this case."

- If the concern is that the seller-decedent in the CCA was in poor health and "unlikely" to receive the full note payments, and if § 7520 can apply if there are no health concerns, how does one determine when the poor health threshold has been crossed? Do the principles of Treas. Reg. § 1.7520-3(b)(3) apply? (Under the regulation, the §7520 tables may not be used if the person who is the measuring life has a "terminal illness" and for these purposes, "terminal illness" means that the individual has an "incurable illness or other deteriorating physical condition" which results in at least a 50% probability that he or she will die within one year. If the person lives for 18 months or longer after the relevant valuation date, he will be presumed not to have been terminally ill at the time of the transaction, unless the existence of a terminal illness can be established by clear and convincing evidence.)

- An alternative interpretation of the CCA's conclusion may be that the decedent's actual medical history must be taken into account in all SCIN valuations, even if the taxpayer has at least a 50% probability of living at least one year. For example, if an individual is in perfectly good health, but has a family history of cancer, would the "decedent's medical history" indicate that the mortality tables in §7520 could not be used? What if an individual is in outstanding good health, suggesting that he or she will have a longer than normal life expectancy. Would the SCIN be valued taking into account "the decedent's medical history" in that case as well to provide a higher value to the SCIN than the §7520 mortality tables would suggest?
- Does the CCA mean that §7520 cannot be used in valuing "standard" notes without a self-canceling feature? The facts of the CCA give rise to some confusion about that issue, because the transaction involved the sale for standard note as well as for SCINs and this conclusory sentence does not make a distinction for the standard notes. However, the context of the statement clearly suggests that it is referring to the SCINs. The sentence refers to the "notes in this situation" and the immediately preceding paragraph was clearly addressing the SCINs.

4. *Estate Tax Effects*. The *Moss* case held that the SCIN remaining payments were not included in the decedent's gross estate and the *Musgrove* case concluded that the SCIN was included in the gross estate. The CCA noted similarities with *Musgrove*: (a) the decedent's health made it unlikely that all payments would be made; and (b) there is a legitimate question as to whether the note would be repaid. There was no further conclusion as to whether the SCINS would be included in the estate, other than the analysis treating this situation as being closer to the *Musgrove* facts than the *Moss* facts.

ESTATE OF WILLIAM DAVIDSON, TAX COURT CAUSE NO. 013748-13 (FILED JUNE 14, 2013)

1. *General Background*. William Davidson was the President, Chairman, and Chief Executive Officer of Guardian Industries Corp., one of the world's leading manufacturers of glass, automotive, and building products. Before various gift and sale transactions in December of 2008, he owned 78% of the common stock of Guardian. He is a prior owner of the Detroit Pistons NBA team. The decedent (age 86) entered into various gift and sale transactions in December 2008 and January 2009, include large sale transactions for self-canceling installment notes. Soon after these transactions, he was diagnosed with a serious illness and he died on March 13, 2009 (before he received any payments on the notes). The IRS Notice of Deficiency alleges gift, estate, and GST tax deficiencies of well over **$2.6 billion (**although the IRS acknowledges in its answer that it "did not calculate certain deductions and credits to which [the estate] may be entitled."). The case involves a wide variety of issues, but the major issues are the valuation of the Guardian stock and whether the self-canceling installment notes constituted bona fide consideration that is considered as providing any value whatsoever, or if they are bona fide, whether they provide consideration equal in value to the stock transferred in return for the notes. The following brief summary of facts only addresses the SCIN transactions. The decedent sold about $600 million worth of Guardian stock (using the taxpayer's valuation) to trusts for SCINs and sold about $530 million of Guardian stock for "standard" notes. This

summary is based on the estate's petition (filed June 14, 2013) and the government's answer (filed August 9, 2013).

2. *Valuation.* The stock sale and gift transactions were based on a value of $2,750 per share for the common stock and $531 per share for the preferred stock of Guardian. After the date of death, the estate obtained an appraisal indicating a value of $2,300 per share for the common stock at the date of the gift/sale transactions and $1,900 at the date of death.

   The IRS maintains that the value of the Guardian common stock was $4,400 at the gift/sale dates and $2,999 at the date of death, and that the Guardian preferred stock was approximately $750 per share. (The government's appraiser was Francis X. Burns, who has also been the government's valuation expert in various other transfer tax cases.)

   The primary difference between the taxpayer's and the government's appraisals is that the taxpayer's appraisal was based primarily on a "market analysis" whereas the government's appraisal was based 25% on a market analysis and 75% on a discounted cash flow analysis of estimated cash flows for the corporation.

3. *Gift and Sale Transactions.* There were gift, sale and substitution transactions on three dates. All of the sales were for notes providing annual interest payments and balloon principal payments after 5 years. The SCINs were secured by more Guardian shares than just the shares transferred in return for the SCINs. The summary of transactions below describes the value of Guardian shares transferred in each of the sale transactions; these values are based on the taxpayer's valuation of the stock.

   - December 22, 2008.
     - There were gifts to various trusts of common and preferred stock of Guardian, valued at over $150 million (using the IRS's values).
     - There were substitutions of stock with trusts that had been created in 1995 and 1997 (increasing the percentage of common stock owned by the trusts), which the IRS alleges also included a gift element.
   - January 2, 2009.
     - Guardian stock was sold to trusts for the decedent's two children and his step-daughter for 5-year balloon "standard" notes, with annual interest payments at a rate of 2.06% (the AFR)(combined transfers of $210 million of stock for $210 million face value unconditional 5-year notes).
     - Guardian stock was sold to GST exempt and non-exempt trusts for six grandchildren for standard notes (combined transfers of $322 million of stock for $322 million face value, 5-year unconditional notes with annual interest payments at a rate of 2.06% [the AFR]).
     - Guardian stock was sold to six grandchildren's trusts for SCINs (combined transfers of $162.3 million of stock for $305.9 million face value, 5-year balloon SCINs, with annual interest payments at a rate of 2.4% [the §7520 rate]). The SCINs reflected a risk principal premium of about 88% over the stock value.
     - Guardian stock was contributed to a 5-year GRAT. The IRS answer clarifies that any unpaid annuity amount following the decedent's death and the remaining

assets in the GRAT at the end of its 5-year term pass to a family foundation that is exempt under §501(c)(3).

– Further substitutions of stock were completed with the 1995 and 1997 trusts.

- January 21, 2009.

  – Guardian stock was sold to trusts for the decedent's children and step-daughter for SCINs (combined transfers of $432 million of stock for $432 million face value, 5-year balloon SCINs, with annual interest payments at a rate of 15.83% [reflecting an interest rate premium of 13.43% over the §7520 rate]). (Interestingly, the IRS answer "denies any allegations that such transfers were sales," but did not make that same statement regarding the SCIN transactions with the grandchildren's trusts on January 2.)

  – Older trusts were merged with newly created trusts for the decedent's children and step-daughter.

  – Additional Guardian stock and the SCINs from these January 21 transactions were contributed to a 5-year GRAT. The IRS answer clarifies that any unpaid annuity amount following the decedent's death and the remaining assets in the GRAT at the end of its 5-year term pass to a family foundation that is exempt under §501(c)(3).

  – Further substitutions of stock were completed with the 1995 and 1997 trusts.

4. *Mortality Information.*

   a. *Section 7520 Tables.* The mortality tables under §7520 indicate that the life expectancy was 5.8 years at the time of the sale transactions (based on Table 90CM, which applied to transactions from May 1999-April 2009 [Table 2000CM applies to transactions from May 2009 forward]). The taxpayer's appraiser used life expectancies from Table 90CM and the 2000 National Vital Statistics Life Expectancy table to assume that the decedent had a life expectancy of about five years.

   b. *Decedent's Doctors*. The decedent's primary physician wrote a letter in October 20, 2008 stating: "Mr. Davidson continues an active exercise schedule, and is routinely working at home or in the Guardian Headquarters Office. Based on regular medical assessments and oversight, I believe that Mr. Davidson is in good health commensurate with his age group, and participates in a healthy lifestyle, exercise regimens, and activities which require keen mental rigor. He has no current conditions which will impact his actuarial life expectancy."

   In December 16, 2008, the primary physician wrote another letter stating that he had completed a routine medical assessment of the decedent the prior week. He concluded that "there are no changes in his health and he has no current conditions which would impact his actuarial life expectancy and continues to work in his usual capacity."

   A specialist in physical medicine and rehabilitation examined the decedent in early January 2009 and wrote a letter stating: "I considered [Mr. Davidson's] prognosis for return to standing and short distance assisted ambulation within 6 months to be good." [Observe, this letter indicates that the decedent had significant ambulatory limitations in January 2009.]

The government's answer in the case alleges that the estate did not offer any evidence demonstrating that these physicians were qualified to estimate the decedent's life expectancy.

c. *IRS's Medical Expert.* One of the IRS's medical experts estimated that the decedent had a significantly shorter life expectancy, 2.5 years. He estimated that the decedent had only a 19.3% probability of surviving for five years. The expert never personally examined the decedent but based his estimates on the decedent's medical records as well as prognostic studies and statistical studies. The IRS's valuation of the SCINs was based on this medical expert's life expectancy estimate.

d. *Four Medical Consultants' Review of Medical Records—Greater Than 50% Probability of Living At Least One Year.* In connection with the estate tax audit the decedent's medical records were reviewed by four medical consultants, two of whom were selected by the estate and two of whom were selected by the IRS. All four medical consultants concluded that the decedent had a greater than 50% probability of living at least one year in January 2009.

5. *Possible Tax Court Guidance Regarding Valuation of SCINs*. If the *Davidson* case is not settled, the Tax Court opinion may provide the first guidance in any reported case regarding the valuation of SCINs. The IRS makes two arguments regarding the SCINs. First, the SCIN transactions are not bona fide and the notes provide no consideration. Second, in the alternative, if the SCINs are bona fide, they should be value under a hypothetical willing buyer test, not under §7520.

   One possible outcome is that the court determines that the SCINs were not bona fide loan transactions (perhaps based on whether there was a reasonable expectation of repayment-and one factor in that decision will be that the SCINs are secured by more Guardian stock than just the shares transferred in return for the SCINs), and the SCINs may be valued at zero if they are determined not to represent bona fide loan transactions. The government's answer in the case states that the burden of proof is on the estate to prove that the SCINs were bona fide debt, that the decedent intended or expected to collect all payments due under the SCINs, and that the trusts would be able to make payments on the SCINs when due.

   If the court gets beyond the "bona fide transaction" issue, because all of the medical consultants agree that the decedent had a greater than 50% probability of living at least one year on the date of the sale transactions, the court presumably will be squarely faced with addressing whether §7520 applies in valuing SCINs. The IRS maintains that §7520 applies only in valuing annuities and life estates. The estate maintains that §7520 applies in valuing "any interest for life or a term of years," and that a SCIN requires valuing an interest that involves both a term of years and an interest for life. If §7520 applies in valuing SCINs, Treas. Reg. § 1.7520-3(b)(3) indicates that the §7520 mortality tables can be used "to determine the present value of an annuity, income interest, remainder interest, or reversionary interest" even if the individual who is a measuring life is in poor health as long as he or she is not terminally ill, defined to mean the person has a greater than 50% probability of living at least one year. The government's position in the answer is that "whether or not the decedent was terminally ill within the meaning of Treasury Regulation §1.7520-3(b)(3) is not relevant." Therein lays the dispute that may be squarely before the court.

Planning Implications

1. *SCINs Will be Scrutinized*. The CCA is the first guidance about the IRS's position regarding SCINs since its loss in *Costanza.* The CCA clearly indicates that the IRS continues to view SCIN transactions in a negative light, particularly if the decedent has health issues or dies soon after the SCIN transaction. We can expect to see close examination of SCIN transactions in gift and estate tax audits.

2. *Backloading.* The CCA at various places highlighted that the SCINs called for interest-only payments with balloon principal payments at the end of the note term. "Backloading" SCINs in this manner appears to be a "red flag" that will draw IRS attention. Backloading SCINs raises the valuation risk—because there will be a very large payment at the end of the note term, if the discount rate or mortality assumptions are wrong, the value will be skewed significantly.

3. *SCINs vs. Private Annuities*. Private annuities operate somewhat like SCINs in that no payments are required after the annuitant's death. An early death may result in the seller receiving back far less than the value that was transferred in exchange for the private annuity. The IRS scrutinizes private annuity transactions as well if the seller dies soon after the private annuity transaction. *See Estate of Kite v. Commissioner*, T.C. Memo. 2013-43. However, §7520 clearly applies in valuing private annuities, and if the client has a greater than 50% likelihood of living at least one year after the transfer and will likely live at least 18 months afterward, the actuarial tables in §7520 may be used. Treas. Reg. § 1.7520-3(b)(3). If a client is not in excellent health, but would clearly satisfy the 12-month requirement, the private annuity may be a more conservative approach (even though other tax effects of the private annuity transaction may not be as favorable as a sale for a SCIN). On the other hand, the regulations require that a purchasing trust have sufficient assets to make the annuity payments if the seller lives to age 110. Treas. Reg. §20.7520-3(b)(2)(i). The mortality factor may add such a large premium (particularly for older sellers) that the purchasing trust would be unable to satisfy that requirement. *See e.g., Kite v. Commissioner,* T.C. Memo. 2013-43 (private annuity was bona fide and not illusory; individual purchasers had ability to pay annuity payments for full life expectancy); *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (§2036 applied to a transfer of limited partnership interests to children in return for a private annuity, in part because the parties intended to ignore the agreements, and the children-purchasers did not have assets of their own to make the annuity payments).

4. *§7520 Application.* The CCA raises an ambiguity regarding the manner in which SCINs are valued. The commercial programs (which anecdotal evidence suggests are typically used by IRS agents in audits regarding SCINs where there are no particular health issues) generally use the §7520 discount rate and mortality tables to value SCINs. If §7520 cannot be used at all to value SCINs, those commercial programs may be suspect. What approach should be used?

5. *Ability to Repay.* The CCA at various points emphasized that the ability to repay a note is a central element of recognizing the note as a valid debt instrument rather than as a continuing equity interest of what was transferred in return for the note. In planning SCIN transactions, consider the ability of the obligors on the note to repay the note (as well as evidence suggesting that the seller may not demand payment if payments are not made timely). If sales are made to trusts, consider their ability to make the note payments. The CCA suggests that this concern is exacerbated if there is a large principal premium to account for the cancellation feature, resulting in a note with a face value of almost

double the value of assets transferred. Having the SCINs secured by assets in addition to the assets transferred in return for the SCINs may be helpful in establishing the reasonable expectation of repayment and the ability to repay the note.

This is a particularly problematic issue for older clients, for whom the risk premium (especially for backloaded "balloon" payments) may result in an inordinately large principal premium or interest premium, making it unlikely that the full amount can be paid if the seller lives to a full life expectancy.

6. *Using AFR as Interest Rate for Standard Notes*. While the conclusion of the CCA is somewhat frustrating in light of the confusion of how far it meant to go in saying that §7520 did not apply to the "notes in this situation" (which included about $530 million of standard notes without a cancellation provision), the CCA does not discuss the standard notes at all, other than to note their existence. The CCA raises no concerns about the interest rate that is used on the standard notes. The CCA does not give any indication of the interest rate that was used on the standard notes, and whether the AFR, the §7520 rate or some other rate was used. (As discussed above, the *Estate of Davidson* facts indicate that the AFR was used for the standard notes, but the CCA made no mention of that fact.)

   As a practical matter, many intra-family sale transactions use notes having an interest rate equal to the AFR rather than the higher §7520 rate. Sections 1274 and 7872 were enacted soon after the *Dickman* case and address valuing gifts from below market loans. Those sections (which constitutes the basis for the AFR) seem to contemplate cash loans, but there is authority that AFRs under §7872 can also be used for sale transactions. *See Frazee v. Commissioner*, 98 T.C. 554, 588 (1992)("Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted… We find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept"); *True v. Commissioner*, T.C. Memo. 2001-167 ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004).

   Private letter rulings have also taken the position that using an interest rate that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Private Letter Ruling 9535026 involved an installment sale of assets to a grantor trust in return for a note that paid interest annually at the § 7872 rate (i.e., the AFR), with a balloon payment of principal at the end of 20 years. After summarizing the provisions of § 7872 and the *Frazee* case, the ruling concludes

   > "that, if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that

the notes will not be paid according to their terms; and (ii) the [trust's] ability to pay the notes is not otherwise in doubt."

Private Letter Ruling 9408018 addressed whether redemption of a mother's stock by the corporation for a note, where her son was the remaining shareholder, constituted a gift. The note had an interest rate equal to the greater of (i) 120% of the applicable federal mid-term rate, or (ii) the rate sufficient to provide the note with "adequate stated interest" under § 1274(c)(2) (which is tied to the AFR). The ruling employed reasoning similar Private Letter Ruling 9535026, and concluded that because the interest rate on the note will be at least equal to the AFR for the month during which the note is executed, the fair market value of the note for federal gift tax purposes is the face value of the note. (That ruling similarly was conditioned on (i) there being no indication that the note would not be paid according to its terms and (ii) the corporation's ability to pay the notes is not otherwise in doubt.)

As noted above, in light of the inherent uncertainties in valuing property and notes in sale transactions, an acknowledgement that "substantially equal" values are sufficient to avoid gift consequences is comforting.

7. *Income Tax Consequences of SCINs.* If the seller dies before all payments have been made, the planner must understand that while this may result in a decrease in the amount included in the seller's gross estate, there are factors that may offset some or all of that advantage. If the seller dies before the SCIN matures, the IRS maintains that the deferred gain will be recognized for income tax purposes on the estate's first return. *See Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993). (This reversed the Tax Court's holding that the deferred gain was recognized on the decedent's final return. 98 T.C. 341 (1992).) Some commentators (supported by the Tax Court dissent in *Frane*) maintain that the cancelled gain should not be recognized as income by anyone. There are also uncertainties regarding the purchaser's basis in the purchased assets. In any event, just be aware that there are income tax issues that may offset some of the advantages of avoiding estate inclusion for the cancelled payments. *See generally* Akers & Hayes, *Estate Planning Issues With Intra-Family Loans and Notes,* ¶517-4-517.6, 47th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2013).

8. *Contribution of SCINs to GRAT.* Under the *Davidson* case facts, the SCINs from the January 21 transactions were contributed to a 5-year GRAT in which any unpaid annuity amount following the decedent's death and the remaining assets in the GRAT at the end of its 5-year term pass to a family foundation that is exempt under §501(c)(3). At first blush this may seem to "undo" the effects of the SCIN transaction. The contribution of SCINs to a GRAT, however, may have important economic effects that are based on the anticipation that the decedent will live to his full life expectancy. As mentioned above regarding the general description of SCINs, a possible disadvantage of SCIN transactions is that if the seller lives to (or near) his full life expectancy, the seller will receive more payments than if a standard note had been used (because of the risk premium that is built into the principal or interest payments), this increasing the amount included in the seller's gross estate for estate tax purposes. Contributing SCINs to a GRAT reduces that risk. If the seller dies early, the trust that purchased the assets may experience a valuation increase by reason of having the note liability cancelled. On the other hand, if the seller lives to his full life expectancy and if the SCIN has been contributed to a GRAT, the increased value represented by the risk premium will generally represent the GRAT appreciation that will pass to the GRAT remaindermen. *See* Steven Oshins & Kristen Simmons, *The SCIN-GRAT,* TRUSTS & ESTATES 18 (June 2008).

A further wrinkle in the *Davidson* case is that the beneficiary of the GRAT unpaid annuity payments and remainder is a family foundation. Perhaps the decedent wanted to leave any degree of the excess risk premium actually received to the family foundation, but the amount of that premium that is actually paid by the purchasing trust obviously depends on how long the decedent lives after the sale. Using the GRAT is a way to isolate that amount of risk premium to pass to the family foundation rather than using a formula in the will designed to leave a bequest to the foundation based on the amount of the risk premium actually received by the seller. (But it does seem to be a rather complicated way to achieve that result.) In any event, using a GRAT with a family foundation as the remainder beneficiary is unusual. (It is not a qualified charitable annuity remainder trust; if for no other reason, the *Davidson* facts indicated that the GRAT was not designed with a remainder value of at least 10% of the initial value contributed to the GRAT, which is a requirement for charitable remainder annuity trusts. §664(d)(1)(D).)