A PRIMER ON THE SELF CANCELING INSTALLMENT NOTE

“In everything one must consider the end.”
Jean de La Fontaine

By George Chamberlin

Financial and tax professionals continually work to develop techniques that may be used by clients to achieve a variety of goals. Most prominent among these goals are the desire to avoid unnecessary income and transfer taxation, to ensure business continuity and to provide for an orderly transfer of wealth or its application to particular ends. The broad variety of techniques available allows advisors, clients and other professionals to create the most appropriate advice depending on the particular mixture of goals, assets and needs at issue. When a client is interested in transferring assets while minimizing taxation, one particularly appealing strategy is the self-canceling installment note (SCIN). This article will discuss the structure and implementation of the SCIN as well as the advantages and disadvantages of the strategy.

What Is a SCIN?

The SCIN is an installment note representing the obligation of the purchasers of designated client assets to pay the client seller over time for the assets purchased. The installment payments include both interest and principal and provisions of the Internal Revenue Code govern the transaction.¹ The initial value of the note is based on the fair market value of the assets sold while the interest rate should be a market rate loan.² A special feature of the SCIN - and the one underlying its name - is the self-canceling provision. This provision operates to terminate the note and any obligation on the part of the purchasers to make further installment payments when the client seller dies. Naturally, such a provision has value and the value of this feature is included as a premium in the installment note. The premium may be reflected by a higher initial principal value in the note, a greater interest rate payable by the purchasers or a combination of increased interest and principal. Thus, it may be that the purchasers pay a higher than fair market price for the assets purchased.

With the addition of the premium, why would a client choose to use the SCIN and why would a purchaser wish to participate? First, from the standpoint of the client seller, the sale of assets freezes their value for purposes of the client’s estate.
Any future appreciation in those assets is not going to be subject to transfer taxation on the client’s death. The SCIN provides a means of transferring the assets to the desired persons - typically heirs - during the client’s lifetime and without any transfer taxes on the transaction because it is a sale and not a gift. Finally, if the client seller were to die during the installment term, the client’s estate will not include the future payments as they are forgiven under the self-canceling feature. The cancellation of the remaining indebtedness is not a gift to the purchasers. Thus, there is a great potential for significant reductions in the client’s taxable estate using this technique.

Among the attractions from the standpoint of a purchaser is the immediate right to the use and enjoyment of the assets, including the potential of funding the installment payments through leveraging the property purchased. The amount of assets transferred to the purchasers may be larger because there is no reduction of the client seller’s total assets for transfer taxes on this sale. The purchasers will be entitled to take an income tax deduction for the interest portion of the payments they make - the client seller being taxed on the interest received. The purchasers also stand to benefit from the value of the self-canceling feature which will terminate their obligation on the death of the client seller during the installment term. Of course, if the client lives out the entire term, the purchasers will be required to pay all of the installments for the property.

The SCIN also offers some other advantages that may be important. For example, in a properly executed SCIN, the gain on sale of the property is deferred upon the sale and will not be recognized until and to the extent that the purchasers make payments. This is so despite the fact that the purchasers get a basis stepped up to fair market value at the time of the purchase. The purchasers may prepay installments if that is desirable and there is a great deal of flexibility in establishing the installments themselves. Payments may be in variable amounts and at different times based upon what works best for the parties.

Potential Pitfalls with the SCIN

What are the potential problems in using a SCIN? Probably the central issue is avoiding a characterization of the transaction as a gift instead of a bona fide sale. When a SCIN is entered into between family members, there is a rebuttable presumption that the transaction is a gift and therefore subject to transfer taxation. The taxpayers may refute the gift argument by establishing that at the time of the sale and installment note the client creditor had a real expectation that the purchasers would pay the installments agreed upon and that the creditor intended to enforce collection of the installments. This might be shown, for example, through evidence that the debtor purchasers made timely payments of the installments prescribed in the note and that the debtors acted at the direction of the creditor and in accor-
dance with instructions in remitting such payments. Failure to make the required payments would, of course, support a claim that the transaction was not at arms-length and should be subject to gift taxation.

There are several subsidiary issues that play into how the transaction is viewed for tax purposes. For example, determining an appropriate term for the SCIN may be critical to whether the transaction is treated as a gift, and therefore taxable, or as a bona fide sale. For the greatest protection, the term of the note should be equal to or shorter than the remaining life expectancy of the client creditor. This is because a term that exceeded the client creditor’s life expectancy would suggest inadequacy of consideration or an expectation that not all installments would be paid. This in turn would undermine the preferred characterization of the SCIN as an arms-length transaction instead of as a gift.

Another potential problem area lies in the valuation of the assets transferred and the selection of an appropriate interest rate for the installment note. These items affect the principal amount included in the SCIN and the face value of the installment payments required by the SCIN at the time of the transaction. Clearly, to avoid an argument that the valuation or interest rate are too low and that the transaction therefore includes at least a partial gift to the purchasers, the principal valuation, interest rate and the resultant note should reflect the current value of the asset transferred as well as an appropriate market interest rate.

A related point is the valuation of the premium paid for the self-canceling feature of the SCIN. The premium may be determined actuarially based on the life expectancy of the client creditor and the probability of the client’s mortality during the term of the SCIN. As noted above, the premium will be reflected in the interest rate and/or principal amount specified in the note. Again, absent a showing of such a premium, the IRS may challenge the transaction on the basis that the overall valuation is improperly low and that a taxable gift element is present.

The underlying property is important quite apart from issues of valuation. For example, the purchasers may use the property transferred as a means of providing security for the installment note. This may be critical where the purchasers do not have substantial assets to back their promise to pay. It is important that the SCIN be based on a transfer of property which the client wishes to sell and in which property the client relinquishes all interest upon the transfer to the purchasers. Continued dominion and control exercised over the property by the client will undermine the status of the transaction as a sale. These additional property issues are relevant when we are evaluating the transaction to determine whether it more closely resembles a gift or an arms-length transaction which is not subject to gift tax.
Modeling the SCIN

As with many other financial strategies, the SCIN may be modeled primarily through the use of specific cash flows reflecting the different phases of the transaction. From the standpoint of the client, the client’s asset base will be decreased by the sale of the subject assets - either through modeling a withdrawal for a future transaction or perhaps by eliminating an asset or account that is the basis of a current transaction. To replace the asset sold in the transaction, the client will receive cash inflows representing the purchaser’s payments on the underlying note. These payments will be calculated using the client’s life expectancy as a starting point for the term of the payments, together with the addition of an appropriate interest rate and a premium for the self-canceling feature. Tax treatment of the payments is important since the client will not pay income tax on that portion of the payment which represents return of the client’s original investment in the asset, although taxes will be due on the interest portion of each installment as well as on long term gains in the property. These funds will be available to meet the client’s lifetime goals and any excess over the client’s current spending needs will be invested in the portfolio.

Separately, we might consider the impact of the transaction on the purchasers, again based on the relevant cash flows. The income tax benefits are significant since the purchasers will get a step up in basis on the assets and will be able to deduct the interest payments from income. The purchasers will have access to the assets transferred and may leverage them immediately. The payouts may be derived from income derived from the transferred assets, a sale of some portion of the assets or another approach. Over time, it is likely that the transferred assets will be expected to appreciate, magnifying the value of the transfer from the client.

Testing the overall strategy by creating scenarios using different life expectancies for the client may prove interesting for the client and advisor. In a scenario where the client dies earlier than expected, the reduction in payments will decrease the amount available to the client for the estate or legacy goal, though year to year spending should not be directly affected. Looking at the transaction from the other side, using the viewpoint of the purchasers, will result in a gain to the purchasers based on the termination of the obligation to continue payouts on the note.

It may be helpful to examine the estate tax implications from the viewpoint of the client since that is one of the reasons for engaging in the sale transaction. Comparing a scenario where the client retains the underlying assets until death with the scenario we built for the analysis of the SCIN transaction will provide differing potential ending values and suggests a decrease in the potential estate tax liability where the SCIN technique is implemented. With the strong likelihood that the federal estate tax will be decreased, though not repealed, this component may be less important than the
business succession and income tax considerations involved.

Summary

The SCIN represents yet another technique for clients who wish to perform business continuity and succession planning in concert with tax planning. The advantages of a carefully planned and implemented SCIN are significant to both the client and the purchasers of the assets in issue. Of course, advisors and clients will wish to engage tax professionals in the discussion and the execution of a goal package which incorporates the SCIN as one of the techniques. The involvement of additional experts in the process will help ensure its meeting IRS requirements and increase the likelihood of the technique providing the desired result. Engaging in advanced modeling permits the advisor to derive a sense of how the technique may play out over time and provides clients with a better notion of their options.

Explaining the SCIN as a financial strategy for clients. This is the future of financial advising.

1 Title 26 US Code, section 453. Full text at http://www.diversifiedexchange.com/Internal_Revenue_Code_Section_453.asp


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