SELF-CANCELING INSTALLMENT NOTES

The Self-Canceling Installment Note (SCIN) is a cross between a private annuity and an installment sale and has many of the advantages and best features of both. A SCIN involves the sale of a business interest, stock, or an interest in real estate or other asset, typically to one or more family members of the owner/seller, or entity that represents them, in exchange for an installment note with a term shorter than the seller's life expectancy.

The SCIN is an estate planning technique that allows an individual to transfer property to his or her heirs at no gift, estate, or inheritance tax cost, while retaining for himself or herself a stream of income for a stated period of time, or until his or her earlier death. The seller will recognize gain on the sale of the asset, but can stretch recognition of that gain out for many years using the installment sales approach.

If the seller lives beyond the period over which installment payments are to be made, the "cancel at death" provision is ignored. If the seller dies during the term of the note, the buyer's obligation to make payments ends on the date of death. The hoped for objectives are two-fold: (1) the exclusion of the unpaid balance of the note from the seller's estate and (2) the avoidance of any gift tax on the transfer.

These notes, by their own terms, become void or canceled, upon some event, usually the death of the seller of the assets. When the death of the holder occurs, the value of such a note is no longer in the seller's estate; no more payments need be made, and the property sold passes to the buyer (usually a child, or someone who is "a natural object of the seller's bounty") free of tax, with a step up in basis equal to the entire purchase price. Such a note must have a higher face value or higher interest rate (or both), than a note that is not self-canceling, to avoid a gift to the buyer at the time of the sale. How much higher or how much more are questions of value that need to be carefully considered with this technique.

Providing "adequate consideration" is an important factor in structuring a SCIN. The best approach is to have value established by an outside party – such as FP Transitions' Comprehensive Valuation – thereby documenting the open market value. Assuming the condition of a sale for "adequate consideration" has been met, the value of the SCIN is removed from the seller's taxable estate, since no asset is transferred to another person as a result of the seller's death.

To meet the adequate consideration requirement, a cancellation feature must be part of the note itself, as opposed to a provision in the seller's will, and the sale must include a risk premium to compensate the seller for assuming the risk that he might die before the note is paid in full. Such a risk premium usually takes the form of a higher than normal interest rate or a higher than normal sales price, and should be supportable in the event of an IRS audit. In addition, the seller's life expectancy must exceed the term of the self-canceling note at the time the sale is consummated.

Generally, the fair market value of any unpaid installment obligation on the date of death is included in the estate of the seller. However, if the note contains a properly designed self-cancellation provision, the buyer is under no obligation to make any further payments after the seller's premature death, which leaves no unpaid balance to be included in the seller's estate. The self-canceling feature can be an effective means of transferring property to family members without estate or gift tax consequences in the event of the death of the seller-transferor before the last potential payment has been made under the terms of the installment note.

CONSIDER THIS EXAMPLE

Bob Smith sold the stock in his closely held financial services practice, with a documented fair market value of $1.3 million, to his son John, accepting a small cash down payment and a 15-year installment note. The sales agreement and the installment note provided that all sums due on the note were automatically extinguished and canceled upon Bob's death. Bob's life expectancy at the time of the sale was longer than 15 years, and the terms included a risk premium to compensate Bob and his estate for the cancellation feature. He reported the gain each year, over time, as he received payments from the sale using the installment method. At the time of Bob's death, halfway through the repayment period, the remaining installment obligations are canceled.

John's basis in the property is the purchase price ($1,300,000), even though all the payments were not made. The cancellation at the seller's death has no effect on the buyer's basis. This step up in basis is an important advantage of using a SCIN.

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