WRMarketplace
An AALU Washington Report

Thursday, August 20 2015 **WRM# 15-31**

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Life After Davidson: SCIN Planning – What Now?

MARKET TREND: The IRS has shown a great deal of interest in the use of self-canceling installment notes ("SCINs"), but the recent settlement of the Davidson case has left advisors and clients with little clarity on how to proceed on issues raised by the IRS. At a minimum, clients considering SCINs should understand that they may not be able to rely on the "traditional" approaches to this planning.

SYNOPSIS: The IRS has exhibited a renewed interest in intra-family installment sales, particularly those structured as SCINs. In recent internal guidance and estate tax audits, the IRS has rejected some generally accepted approaches to conducting these transactions, based on the valuation of the notes, the grantor's expectation of note repayment, and the trust's ability to fund the repayment. The settlement in Est. of Davidson v. Commissioner, a recent Tax Court case specifically dealing with these issues, while largely favorable for the taxpayer, provided little additional guidance, making it difficult for advisors and clients to rely on past approaches when contemplating current or future SCIN planning.

TAKE AWAYS: Many questions remain with regard to SCIN planning, given recent IRS activity and the Davidson settlement. In particular, advisors and clients can no longer take for granted the IRS's acceptance of the 7520 mortality tables to determine a SCIN's risk premium or market value. Yet, SCINs may remain a viable plan for clients who appreciate the risks and understand that the traditional planning approaches may need modification. Clients will need to work with a team of skilled advisors who can collaborate to not only implement the SCIN, but assist with proper administration, post-closing. Taking certain steps to establish bona fide debt, evidence the ability of the purchaser to repay the debt, document the seller's health status, comply with all payment terms, and enforce the seller's rights in the event of non-compliance, may help substantiate the plan.

PRIOR REPORTS: *15-9; 14-13.*

MAJOR REFERENCES: **Est. of Davidson v. Commissioner, T.C. No. 013748-13 (July 6, 2015).**

The IRS is showing much greater interest in sale transactions between a grantor and a grantor trust, particularly SCINs, which are commonly used in legacy management and business succession planning. However, a recent settlement in *Est. of Davidson v. Commissioner*,[1] a high profile Tax Court case involving several SCIN transactions, has left advisors and clients without binding guidance on several issues and left open questions on how to proceed with SCINs.

SCINs IN BRIEF

A SCIN transaction is a type of installment sale, often between a grantor and his or her grantor trust, where the grantor sells assets in exchange for an installment note for fixed duration. The SCIN contains a cancellation provision that automatically terminates the repayment obligation if the seller dies before the end of the note term, which arguably removes the note's value from the seller's estate for estate tax purposes.[2] To avoid making a gift, the SCIN's fair market value ("**FMV**") must equal the FMV of the property sold, and the SCIN must include a "risk premium," such as a higher purchase price for the asset, a higher interest rate on the note, or some combination thereof, to account for the possibility of early termination under the cancellation provision.[3] Because of the note's mortality feature, SCIN valuations have traditionally relied on actuarial tables under Internal Revenue Code §7520 ("**7520 tables**") to determine both the risk premium and overall value.

DAVIDSON SETTLEMENT – MORE QUESTIONS THAN ANSWERS

Background. The *Davidson* case involved the decedent's sale of stock in his company to his children and to grantor trusts benefiting his grandchildren in exchange for SCINs. Each SCIN had a five-year term, with balloon payments of principal due at the end of the term. Some of the SCINs included a risk premium based on a higher principal value, while others included higher interest rates. The value of the SCINs and the applicable risk premiums were all determined using the 7520 tables. The decedent died less than six months after completing the transactions.

IRS Challenges. The IRS asserted over $2.6 billion in gift, estate, and GST tax deficiencies in connection with the SCIN transactions, relying in large part on the following challenges:

- ***SCIN Valuation***. The 7520 tables could not be used to value the SCINs. Rather, the parties should have used a "willing-buyer-willing-seller" standard that accounted for the decedent's health and projected life expectancy at the time of the sale.

- ***No Expected Repayment***. There was no real expectation of repayment or intention to enforce collection in this case. The interest-only structure for the SCINs indicated that the decedent did not contemplate or require a steady stream of income to cover his daily living expenses and so it was unlikely he intended to enforce the debt.

- ***Gift of Excess Value***. Based on the SCINs' self-cancelling feature, the balloon payments of principal, and the decedent's poor health, it was unlikely the full amount of the SCINs would be repaid, making them worth far less than their stated amounts and resulting in a gift of the difference between the FMV of the SCINs and the stock sold.

Settlement. In a stipulation of settlement, the IRS and the estate agreed to total deficiencies of almost $388 million dollars ($186.6 million in gift tax, $152.5 in estate tax, and $48.6 million in GST tax), plus $132,912 in gift tax penalties for failure to file. As the settlement amount represented **roughly 15% of the IRS's initial assessed deficiencies of 2.6 billion**, overall, the SCIN planning was likely still a good option for the taxpayer.

Unanswered Questions. Unfortunately, the settlement does not provide any judicial analysis or resolution of the above issues. Further, IRS internal guidance, in the form of CCA 201330033,[4] raised the same challenges based on facts similar to the *Davidson* case. Although the CCA is non-binding and has no precedential value, it provides a clear outline of the IRS's current position of these issues. This leaves advisors and clients with numerous, unresolved questions regarding SCIN planning, including the use of the 7520 tables for valuation purposes and the impact of an interest-only note structure.

WHERE TO GO FROME HERE?

Heightened IRS interest in SCINs is likely to continue, particularly if the seller dies early in the SCIN term. This may create more interest in private annuity transactions as an alternative for certain clients. However, even with the IRS's increased sensitivity to SCINs, they may remain a viable plan for clients who appreciate the risks and understand that the traditional planning approaches may need modification. If contemplating a sale to a grantor trust in exchange for a SCIN, clients and their advisors should carefully consider the following:[5]

- **Create a Bona Fide Debt**. Take steps to ensure the SCIN is respected as debt and not re-characterized as a retained equity interest in the transferred assets. Indicia that the sale is bona fide and for full and adequate consideration include: (i) the trust's ability to pay the debt, (ii) the trust has other assets that can be reached in the event of a default, (iii) there is a reasonable expectation of repayment and an intent to enforce collection, and (iv) the term of the note is within the seller's life expectancy.

- **Evidence Ability to Repay**. Ensure the trust is sufficiently capitalized with property in addition to the assets purchased. Options include pre-funding a trust with sufficient assets[6] or using a pre-existing trust with sufficient assets. If these options are not available, the client may consider obtaining personal guarantees from creditworthy individuals who are trust beneficiaries.[7] Further, apart from the seller's death, SCIN payments should not be contingent on other factors, such as the trust's investment performance, and note obligations should be payable from the entire trust principal.

- **Understand Uncertainty in SCIN Valuations**. The IRS has created uncertainty about whether the 7520 tables can be used to value SCINs for gift tax purposes, as opposed to a "willing buyer-willing seller" standard. If relying on those tables, advisors and clients will want to substantiate the seller's health status and probable life expectancy to support the position that the seller was not terminally ill at the date of the transaction. Alternatively, the parties could follow the IRS position and seek a third party appraisal of the SCIN based on the "willing buyer-willing seller" standard. While it increases the transactional costs, it may provide some comfort as a more conservative approach. Clients also may consider adequately disclosing the SCIN transaction on a gift tax return to start the statute of limitations running.

- **Weigh Risks of Backloading**. Delaying payments or accruing interest on SCINs may bolster arguments that there was no expectation of full repayment of the debt.

- **Anticipate Review for Early Deaths**. As SCINs create a "windfall" to trust beneficiaries if the grantor dies early in the SCIN term, anticipate IRS review if the seller dies unexpectedly, especially if within one year of the transaction and/or the seller had known health issues. In this case, the IRS benefits from the fact that hindsight is 20/20.

- **Follow Formalities**. The grantor and the trust must follow all formalities, including documenting and recording property transfers, making timely note payments, assuring proper tax reporting, etc. The grantor should take prompt action to enforce his or her rights if payments are not timely made.

TAKE AWAYS

- Many questions remain with regard to SCINs, given the recent IRS activity and the Davidson settlement. In particular, advisors and clients can no longer take for granted the IRS's acceptance of the 7520 mortality tables to determine a SCIN's risk premium or market value.

- Yet, SCINs may remain a viable plan for clients who appreciate the risks and understand that the traditional planning approaches may need modification.

- Clients will need to work with a team of skilled advisors who can collaborate to not only implement the SCIN, but assist with proper administration, post-closing.

- Taking certain steps to establish bona fide debt, evidence the ability of the purchaser to repay the debt, document the seller's health status, comply with all payment terms, and enforce the seller's rights in the event of non-compliance, may help substantiate the plan.

NOTES

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[1] T.C. No. 013748-13, *filed* June 14, 2013, *answer filed* August 9, 2013.

[2] *See Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result*, 1981-2 C.B. 1.

[3] See Internal Revenue Code § 2512(b); Reg. § 25.2512-8. Also, for a SCIN with a grantor trust, the grantor may need to make a "seed" gift to the grantor trust or find other methods (such as personal guarantees) to capitalize the trust so it can meet its note obligations. For seed gifts, some practitioners suggest a 10% rule-of-thumb for the seed gift (i.e., gift equals 10% of the value of assets sold). If considering personal guarantees, then the use of guarantees should involve an assessment of whether the trust should pay a fee for the guarantee and how that fee should be determined. In addition to supporting the bona fide character of the guarantee, a fee may help avoid triggering a possible gift by a trust beneficiary who provides a gratuitous guarantee, even though the gift may occur only if the guarantee is called. See discussion of seed gifts and guarantees in Martin M. Shenkman, "Role of Guarantees and Seed Gifts in Family Installment Sales," Estate Planning Journal (WG&L), Nov. 2010. See also *Trombetta v. Commissioner*, T.C. Memo. 2013-234 involving a private annuity transaction with a trust, where the court did not recognize the guarantees because the guarantors never paid, and were unlikely to be called on to ever pay, anything on the guarantees and the guaranties only covered the annuity payments but, in this case, the grantor had an implied agreement to retain enjoyment over all trust assets, not just the annuity. Consider, however that this case had numerous "bad facts," including the grantor's retained enjoyment of all trust assets.

[4] *See WRMarketplace No. 14-13* for a more detailed discussion of both this CCA and the *Davidson* case.

[5] See Steve R. Aker's discussion of these issues in *Heckerling Musings 2015 and Current Developments*, February 2015 at http://www.bessemer.com/advisor; "SCINs and Private Annuities: Disappearing Value or Disappearing Strategies?," presented January 13, 2015, and "Planning with SCINs and Private Annuities – Seizing Opportunities While Navigating Complications," presented January 14, 2015, at the 49th Annual Heckerling Institute of Estate Planning, January 2015.

[6] Ideally, any "seed" gift to pre-fund a trust would be separate, in time, from the sale to the trust (30 days at a minimum, but longer is better). This may help avoid a potential argument to collapse the two transfers into a single gift with a retained life interest, which could bring the assets back into the grantor's estate.

[7] See discussion at Note 3 regarding issues to consider when using personal guarantees.

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