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SELF-CANCELLING INSTALLMENT NOTES

— by **Neil E. Harl***

Until 1980, it was generally believed that an installment contract set up with remaining payments cancelled after the death of the contract seller would be treated as a transfer with a retained life estate.[1] That was sufficient to discourage use of such a concept.

In the 1980 Tax Court case of *Estate of Moss*,[2] the remaining balance due under an installment note (which was cancelled at death) was not includible in the transferor's gross estate. That case cleared the way for development of the self-cancelling installment note (SCIN). It was not until 1986, however, when IRS released a General Counsel's Memorandum[3] and a revenue ruling[4] that the SCIN came to be viewed as a viable estate planning and retirement planning concept.[5]

Principles for characterizing transactions. SCINs bear some resemblance to installment sale obligations,[6] used widely for the sale of farmland, and some resemblance to private annuities.[7] Therefore, one of the important planning features of using SCINs is to distinguish among the three concepts in setting up the transaction. IRS has provided principles for characterizing transactions as SCINs, installment obligations or private annuities.

• If the transferor receives a right to periodic payments for the remainder of the transferor's life, with no monetary limit imposed, the transaction should be characterized as a private annuity.

Example (1): X transfers farmland to Y in return for Y's promise to make annual payments of $15,000 to X until X's death. The transaction is properly a private annuity.

• If the terms of the transaction provide for a stated maximum payment that will be achieved in a period less than the transferor's life expectancy, the transaction should be characterized as an installment sale.[8]

Example (2): X transfers farmland to Y in exchange for Y's promise to make annual payments of $15,000 to X until $150,000 is paid or until X's death, whichever occurs first. X's life expectancy at the time of transfer is 11 years. The transaction should be treated as an installment sale with a SCIN provision.

• If the life expectancy of the transferor is equal to or less than the maximum payment period, the transaction should be treated as a private annuity.

Example (3): X transfers farmland to Y in exchange for Y's promise to make annual payments of $15,000 to X until $150,000 is paid or until X's death, whichever occurs first. X's life expectancy at the time of the transfer is 9.1 years. The transaction should be characterized as a private annuity.

Tax consequences. As noted above,[9] the value of an obligation cancelled at death under a SCIN characterization is not included in the gross estate.

For federal gift tax purposes, a gift could arise if the SCIN transaction fails to include an appropriate premium (in terms of principal payment or interest rate) because the seller may not collect the full amount of the principal due under the transaction. No objective guidelines have been provided for establishing the magnitude of the premium. The premium amount should relate to the relationship of the seller's life expectancy to the term of the obligation and the amount of principal involved. A gift could also occur if the stated interest rate is excessive (gift to the transferor) or insufficient (gift to the transferee).[10] The IRS position has been that utilization of an interest rate below the market rate for installment obligations produces a gift as to the present value of the difference even though the rate of interest actually used is acceptable for federal income tax purposes.[11] Some courts have agreed,[12] although the Seventh Circuit Court of Appeal in 1988 held that purchase of property with the interest rate set below the market rate of interest was not a gift where the transaction was acceptable from an income tax perspective.[13] In a 1990 case,14 the Tax Court has once again upheld the IRS position in finding a gift in a family transaction where the interest rate used was below a market rate. Thus, outside the Seventh Circuit Court of Appeals area, the IRS position is still an important consideration.

For federal income tax purposes in dealing with SCINs, the major concern is that the deferred gain which is cancelled at death must be recognized on the seller's estate's initial income tax return.[15] Some commentators have argued that the deferred gain should be recognized on the decedent's final return.[16]

For income tax reporting purposes, a SCIN is treated as a contingent installment sale with gain calculated under the assumption the maximum stated selling price will be received by the seller.[17] Each payment is divided into return of basis, gain and interest income.[18] Apparently, the full face value of the SCIN is included in the

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buyer's income tax basis for the property even though a part of that amount may be cancelled in the event of the seller's death. It appears that a SCIN is subject to the usual unstated interest rules (and original issue discount provisions where applicable)[19] although that is not completely clear. Apparently, the buyer does not have discharge of indebtedness income from cancellation of the remainder of the obligation at the death of the seller.[20] It would appear that SCIN transactions could be subject to the penalties for valuation overstatement (more than 150 percent over the correct amount).[21]

Conclusion. Self-cancelling installment notes may be preferred over private annuities, primarily because the seller can retain a security interest in the property conveyed. With private annuities, retention of a security interest causes the transaction to be treated as a sale.[22] That is not a problem with SCINs; security interests can be retained in the same manner as with installment sales.

Another advantage is that the buyer under a SCIN is entitled to an interest deduction; an obligor may not claim an income tax deduction for interest in a private annuity.[23]

Finally, in the event of default by the purchaser, a seller under a SCIN can repossess the property under the special relief provisions of I.R.C. § 1038. Such is not possible with a private annuity because the property does not stand as collateral for the debt obligation as is required.[24] Therefore, reconveyance of property by the obligor under a private annuity to the annuitant does not appear to come within the relief provisions of I.R.C. § 1038.

FOOTNOTES

1 See generally 5 Harl, **Agricultural Law** § 43.02[6] (1990).

2 74 T.C. 1239 (1980), *acq.*, 1981-1 C.B. 2.

3 GCM 39503, May 7, 1986.

4 Rev. Rul. 86-72, 1986-1 C.B. 253.

5 See generally Banoff & Hartz, "Self-Cancelling Installment Notes: New IRS Rulings Expand Opportunities," 65 J.Tax. 146 (1986).

6 See 6 Harl, *supra* note 1, § 48.03.

7 See 6 Harl, *supra* note 1, ch. 49.

8 See Ltr. Rul. 8906002, September 11, 1988 (sale of stock in exchange for 10-year promissory note was installment sale where seller had life expectancy of 12.1 years).

9 See notes 2-3 *supra* and accompanying text.

10 See I.R.C. § 7872. See also Blackburn v. Comm'r, 20 T.C. 204 (1953).

11 E.g., Ltr. Rul. 8804002, Sept. 3, 1987 (installment sale of stock to shareholder's children at below market rate was gift unless and to extent purchase price included premium sufficient to increase effective interest rate); Ltr. Rul. 8512002, Nov. 28, 1984 (promissory notes for purchase of stock with interest rate of 2.355 percent below interest rate of equivalent United States Treasury obligations constituted gift unless purchase price of stock contained premium for reduced interest rate).

12 See Fox v. U.S., 88-1 U.S.Tax Cas. (CCH) ¶ 13,770 (W.D. Va. 1988) (transfer of real property in exchange for promissory note was gift to extent fair market value of property exceeded amount of note).

13 Ballard v. Comm'r, T.C. Memo. 1987-128, *rev'd*, 854 F.2d 185 (7th Cir. 1988) (sale of property at below market interest rate was not gift to extent interest rate below market rate; for federal gift tax purposes market rate of interest equal to interest rate established in regulations under I.R.C. § 483 which applied to all tax treatment of installment sales).

14 Krabbenhoft v. Comm'r, 94 T.C. No. 56 (1990) (farmland sold to sons at 6 percent; IRS used 11 percent to calculate gift).

15 GCM 39503, May 7, 1986; Rev. Rul. 86-72, 1986-1 C.B. 253. See I.R.C. §§ 691(a)(5), 691(a)(2).

16 See Banoff & Hartz, note 5 *supra*.

17 GCM 39503, May 7, 1986. See Temp. Treas. Reg. § 15A.453-1(c).

18 See 6 Harl, *supra* note 1, § 48.03[4].

19 See I.R.C. §§ 483, 1274. See 6 Harl, *supra* note 1, § 48.03[7].

20 Cf. Terminal Investment Co. v. Comm'r, 2 T.C. 1004 (1943).

21 See I.R.C. § 6659.

22 See Est. of Bell v. Comm'r, 60 T.C. 469 (1973); 212 Corp. v. Comm'r, 70 T.C. 788 (1978).

23 Bell v. Comm'r, 668 F.2d 448 (8th Cir. 1982), *aff'g*, 76 T.C. 232 (1981). See Garvey, Inc. v. U.S., 83-1 U.S. Tax Cas. (CCH) ¶ 9163 (Ct. Cl. 1983), *aff'd*, 726 F.2d 1569 (Fed. Cir. 1984).

24 Treas. Reg. § 1.1038-1(a)(1).

CASES, REGULATIONS AND STATUTES

ANIMALS

CATTLE. The defendant had borrowed a bull for breeding and had placed the bull in a fenced area. The bull escaped from the fenced area into another pasture which was similarly fenced. The defendant did not capture the bull and place it back in the original fenced area and the bull escaped from the pasture. The bull was later captured in a fenced in state park by park rangers but the bull escaped again and caused an accident with a truck owned by the plaintiff. The court denied summary judgment for the defendant and held that actions of the state park rangers was not a sufficient intervening cause by law to absolve the defendant of any negligence which a jury may find. **T. M. Doyle Teaming Co., Inc. v. Freels, 735 F.Supp. 777 (N.D. Ill. 1990)**.

HORSES. A summary judgment for the defendant was upheld in an action involving injuries received by the plaintiff when a horse provided to the plaintiff by the defendant fell while the plaintiff was riding it. The court held that the plaintiff failed to allege any specific evidence as to the cause of the horse's fall other than to allege that the horse was sick. The court held that the doctrine of res ipsa loquitur by itself was insufficient because the