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CAUTIONARY NOTE ON SCIN'S

— by Neil E. Harl*

The concept of self-cancelling installment notes or SCIN's grew out of a 1980 Tax Court decision¹ holding that an arrangement involving the cancellation at the death of the seller of the remaining payments due on an installment obligation would not be treated as a transfer with a retained life estate.² The publication in 1986 of *Rev. Rul. 86-723*³ essentially validated the concept and provided guidelines for classifying arrangements as private annuities, SCIN's or conventional installment sales.⁴ Since 1986, SCIN's have come to be viewed as a useful planning device in some settings. In particular, many view SCIN's as superior to private annuities in that SCIN's permit the seller under the obligation to retain a security interest in the underlying property without adverse income tax consequences. Retention of a security interest by an annuitant under a private annuity runs the risk of causing the transaction to be treated as a sale with recognition of gain in the year the obligation became effective.⁵

Rules on cancellation of principal

Until *Estate of Frane*⁶ was decided by the Tax Court earlier this year, no decision had faced directly the issue of the relationship of the rules governing SCIN's to the provisions enacted in 1980 requiring recognition of gain on cancellation or forgiveness of principal payments due under installment obligations.⁷ The rules on cancellation or forgiveness of principal were enacted to combat the practice of annual forgiveness of principal payments, typically to family members. The solution was to require cancelled or forgiven principal payments to be reported as though constructively received by the seller. The calculation of gain, however, differed depending upon whether the parties were related or unrelated.⁸ If related, the calculations were to use the face value of the obligation;⁹ in the event the parties were unrelated, the fair market value of the obligation was to be used.¹⁰ While the statute did not distinguish cancellation or forgiveness of principal for purposes of wealth transfer from cancellation or forgiveness of principal to help a financially troubled buyer, the Internal Revenue

Service had ruled that cancellation or forgiveness of principal to help a financially troubled buyer would not trigger the provisions requiring the recognition of gain.¹¹

Estate of Frane v. Commissioner

In the 1992 case of *Estate of Frane*,¹² a taxpayer sold stock in a wholly-owned corporation to four children in an installment transaction with payments over twenty years. The promissory notes specified that the obligation would be "cancelled and extinguished as though paid" in the event of the taxpayer's death.¹³ At the time of the sale, the seller's life expectancy exceeded the twenty-year term of the notes. However, the seller died two years later with cancellation of the remaining principal balance of \$136,238 owed by each child.

The Internal Revenue Service took the position that the seller's death constituted a taxable disposition of the notes. The Tax Court upheld the IRS, noting that the statute required any cancellation of an installment note to be treated as a disposition of the note.¹⁴ Thus the difference between the seller's basis and the face amount of the obligation was included in the seller's final income tax return inasmuch as the transaction involved related parties.¹⁵ Five Tax Court judges dissented on the grounds that an obligation that had not matured could not be considered cancelled.

Lesson of *Estate of Frane*

The majority opinion in *Estate of Frane*¹⁶ noted that the taxpayer's problem was in using the word "cancel" in the agreement. While one could justifiably note that the majority opinion in *Frane* elevated form over substance, it is clear that, until otherwise resolved, drafters should avoid using the terms "cancel," or "forgiveness" in self-cancelling installment obligations. Language requiring the seller to be alive in order to receive payments under the obligation would seem preferable to a provision referring to cancellation or forgiveness of the remaining principal balance under the obligation. Only time and more decisions will tell whether even that will be successful.

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FOOTNOTES

- ¹ Est. of Moss v. Comm'r, 74 T.C. 1239 (1980), *acq.*, 1981-1 C.B. 2.
² See Harl, "Self-Cancelling Installment Notes," 1 *Agric. L. Dig.* 137 (1990).
³ 1986-1 C.B. 253.
⁴ *Id.*
⁵ Est. of Bell v. Comm'r, 60 T.C. 469 (1973); 212 Corp. v. Comm'r, 70 T.C. 788 (1978).
⁶ 98 T.C. No. 26 (1992).
⁷ See I.R.C. § 453B.
⁸ I.R.C. § 453B(a), (f).
⁹ I.R.C. § 453B(f)(2).
¹⁰ I.R.C. § 453B(a),(f)(1).
¹¹ Ltr. Rul. 8739045, June 30, 1987.
¹² 98 T.C. No. 26 (1992)
¹³ *Id.*
¹⁴ I.R.C. § 453B(f).
¹⁵ See I.R.C. § 453B(f)(2).
¹⁶ 98 T.C. No. 26 (1992).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL

AVOIDABLE LIENS. The debtor sought to avoid a consensual nonpurchase money security interest in fishing rods, sleeping bags, tents, tools and a camera as household goods. The court held that the lien was not avoidable because the items were not household goods. *In re Wheeler*, **140 B.R. 445 (Bankr. N.D. Ohio 1992)**.

The debtor sought to avoid a consensual nonpurchase money security interest in two television sets, various tools, a VCR, and videotapes as household goods. The court held that only one television set, the VCR and the tapes were household goods against which the lien could be avoided. *In re Brubaker*, **140 B.R. 460 (Bankr. N.D. Ohio 1992)**.

EXEMPTIONS.

CONVERSION. The debtor had filed a Chapter 13 case in which the plan was confirmed. The debtor had claimed, as exempt, interests in two IRA's. The debtor converted the case to Chapter 7 and the trustee objected to the exemptions for the interests in the IRA's, arguing that a recent state case had declared the exemptions unconstitutional prior to the conversion. The court held that the debtor was not entitled to the exemptions because as of the date of the conversion, the exemptions were not allowed. *In re Marcus*, **140 B.R. 803 (D. Colo. 1992)**, *aff'g*, **128 B.R. 294 (Bankr. D. Colo. 1991)**.

PENSION PLANS. Prior to filing for bankruptcy, the debtor elected to receive a lump sum payment from an ERISA qualified pension and profit-sharing plan. The distribution was made by cashier's check made out to the debtor's attorney. The checks were not cashed but a judgment lien holder sought to attach the lien to the checks. The debtor claimed the checks as exempt pension plan funds. The court held that because the checks were cashier's checks, the funds were no longer part of the pension plan and were no longer exempt. The debtor also argued that because the bankruptcy case was filed before the period

allowed for rollover of the funds to an IRA, the funds remained exempt. The court held that the rollover period applied only as to the federal tax liability of the debtor and did not affect the exempt status of the funds. *In re Toone*, **140 B.R. 605 (Bankr. D. Mass. 1992)**.

WAGES. The debtor operated a grain hauling business and hauled grain for two companies as an independent contractor. The debtor claimed payments from these companies as exempt wages under Iowa Code § 627.6(9)(c). The court held that because the payments were received for services performed by the debtor, the payments were exempt as wages. *Matter of Sexton*, **140 B.R. 742 (Bankr. S.D. Iowa 1992)**.

CHAPTER 12

AUTOMATIC STAY. The debtor was the executrix of the deceased spouse's estate. The deceased spouse's parent, a creditor of the debtor and the deceased spouse's estate, filed a petition in the probate case seeking to remove the debtor as executrix. The court held that the probate petition violated the automatic stay under Section 362(a)(1) and could be enjoined. *In re Panayotoff*, **140 B.R. 509 (Bankr. D. Minn. 1992)**.

NOTICE TO CREDITORS. The FmHA filed a proof of claim in the debtor's Chapter 12 case and requested that notices be sent to the state office. The debtors sent notice of their proposed plan and confirmation hearing to the state office of the United States Attorney and the FmHA national office. The FmHA did not appear at the confirmation hearing and argued that sufficient notice was not sent. The court held that the notice was not sufficient and ordered a new confirmation hearing. *In re Miller*, **140 B.R. 499 (Bankr. E.D. Ark. 1992)**.

CHAPTER 13

PLAN. The debtor's Chapter 13 plan provided that the mortgage against their residence would be divided into a secured portion, to the extent of the fair market value of the house, and an unsecured portion for the remainder. The mortgagee argued that Section 1322(b)(2) prohibited modification of liens secured solely by the debtors' residence. The court held that Section 1322(b)(2) applied