SCIN the Tax Man

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An installment sale is one in which at least one portion of the payment is made in a tax year later than the one in which the sale took place.[i] For example, you sell your Star Wars figurine collection for $15,000, payable $5,000 now and $10,000 after the first of next year.

If you have an installment sale, you report the profit *as received*, rather than all in the year of sale. Continuing the Star Wars example, if your cost basis is $1,500, you recognize and pay tax on the profit in two separate years: this year it is $4,500 ($5,000 less one-third of basis, or $500) and next year it is $9,000 ($10,000 less two-thirds of basis, or $1,000).

Subject to certain exceptions, disposition of the installment note requires recognition and income taxation of the remaining profit. Cancellation of the note obligation is treated as such a disposition.[ii]

If you sell the collection to someone who is a natural object of your bounty (a child, for example), you might set it up as an installment sale evidenced by a promissory note under which any balance owing at your death is extinguished. If the installment sale becomes taxable as a *private annuity*. The result is that no part of it is taxed to your estate at your death for either income or estate tax purposes.[iii] Such notes are called "self-cancelling installment notes." (SCINs)

IRS has sometimes challenged this result, claiming that it is not a *bona fide* transaction and that the remaining value of the SCIN should be included in the seller's gross estate for federal estate tax purposes. Earlier this year, IRS lost that argument in *The Estate of Duilio Costanza vs CIR*[iv]
In 1992 and during his lifetime, the decedent sold some income property to his son. The purchase price of $830,000 was paid entirely with a SCIN having a term of 11 years. Payments were to be made quarterly. The father then retired to Italy. The son paid the first installment in March 1993. The father underwent surgery in May 1993 and died unexpectedly from a toxic reaction.

The note balance remaining unpaid and extinguished at the father's death was excluded from the gross estate when the estate tax return was filed. IRS audited and challenged its exclusion, arguing that the transaction presented was not the *real* deal made between father and son, and that the balance should be reported and taxed. An alternative IRS argument was that it was a "bargain" sale; *i.e.*, for less than fair market value and the bargain element should be included and taxed. The U.S. Tax Court where the issue was tried looked at some disorganized records for the transaction and agreed that the transaction was not conducted at arm's length. It ruled that it was not a *bona fide* sale, and did not rule on the alternative argument.

On appeal, the Sixth Circuit Court of Appeals reversed the Tax Court. It found that the son adequately explained the record-keeping discrepancies. Moreover, the medical evidence presented at the trial showed that the father had a life expectancy of five to 13.9 years at the time of the 1992 sale. Therefore, his death could not have been anticipated by the parties, so it could not have led them to make a deal other than that which was evidenced by the records. This view

was buttressed by the fact that the note was secured by a deed of trust on the property, something the parties would not have done if some slight of hand was in mind at the time; *i.e.*, the father intended to be paid the full amount during his lifetime.

The case was remanded to the Tax Court for a ruling on the alternative argument of bargain sale, the present posture of the case. The alternative argument will turn on expert testimony as to the 1992 market value, but the point of interest here is that a properly-documented transaction will withstand IRS scrutiny, serving to move large amounts of property from the estate without forfeiting income and without the payment of gift tax.

Endnotes

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[i] *IRC* §453(b).

[ii] *IRC* §453B(a), B(f)(1) and B(c). Subdivision (c) provides that, *except as provided in Section 691*, the disposition rules of Section 453 do not apply to extinguishment of the balance at death.

Under Section 691(a)(2), death of the note holder and its transfer to the whomever inherits it brings about income taxation of that balance to the note holder's estate. Subdivision (a)(5) provides that, for purposes of applying (a)(2), any cancellation of the obligation on death of the note holder is treated (and taxed) as a transfer.

[iii] *General Counsel Memorandum* 39503 presents these issues:

_ When property is sold in exchange for installment payments where those installments continue until the obligation is fully satisfied or until the death of the note holder, whichever first occurs, and the note holder dies when a balance remains unpaid, is the installment obligation an annuity under *IRC* §72 (no estate tax), or is it an installment sale under *IRC* §453 (balance subject to estate tax)?

_ When property is sold in exchange for installment payments where those installments continue until the obligation is fully satisfied or until the death of the note holder, whichever first occurs, and the note holder dies when a balance remains unpaid, does the estate of the note holder realize income in respect of a decedent (income tax) under *IRC* §691?

IRS' General Counsel states the governing rule as follows:

_ If the installments are to continue for the remaining lifetime of the note holder and cease on his or her death, it is an annuity.

_ If the installments are to continue until the note is fully paid or death of the note holder, whichever first occurs, it is an annuity, *except* that if the

note balance will be paid before expiration of the life expectancy of the note holder, it is an installment sale.

Thus, a SCIN will be classified as an annuity (the tax features we seek), only if the note term is longer than the life expectancy of the note holder when the sale takes place. If treated as an annuity, there is no estate or income tax on the (canceled) balance remaining at the death of the note holder.

[iv] Number 01-2207 (6th Cir. February 19, 2003).