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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2230

Date: 03-Jun-14
From: Steve Leimberg's Estate Planning Newsletter
Subject: Alan Gassman & Ken Crotty: SCIN, SCRAM, Annuity, or SCGRAT- Planning for Clients with Short Life Expectancies after Davidson and CCA 2013-30-033

"Since the Tax Court decision of Estate of Moss v. Comm'r in 1980 and the issuance of Treasury Regulation § 1.1275-1(j) in 1998, estate tax planners have used self-cancelling installment notes (SCINs) to save millions of dollars of estate taxes for taxpayers whose life expectancy may be shorter than that assumed under the 2000CM Mortality Table promulgated by the Treasury Department under Publication 1457. In the recent CCA 2013-30-033, the IRS has taken the position in the Davidson case that clients with shorter than average life expectancies may not rely on the 2000CM Mortality Table to determine their life expectancy for the purpose of valuing the SCIN and may make taxable gifts when the sale occurs if they do rely on the 200CM Mortality Table.

To reduce the possible gift tax exposure for clients, practitioners using SCIN with clients who have reduced life expectancies may want to use the SCGRAT technique. Utilizing a SCGRAT may be the best choice for practitioners who would like to use SCINs with a client who has a reduced life expectancy.

If the Service successfully challenges the transaction and reduces the face value of the note by applying the willing buyer willing seller standard, by using the SCGRAT the value of the GRAT formed by the client should be increased. If the value of the GRAT is increased, then the payments from the GRAT to the client will be increased. As a result, there should not be any additional gift tax liability for the client."

Alan Gassman and **Ken Crotty** provide members with their commentary on the benefits of using the "SCGRAT" planning technique.

Alan S. Gassman, J.D., LL.M. practices law in Clearwater, Florida. Each year he publishes numerous articles in publications such as BNA Tax & Accounting, Estate Planning, Trusts and Estates, The Journal of Asset Protection, and Steve Leimberg's Asset Protection Planning Newsletters. Mr. Gassman is a fellow of the American Bar Foundation, a member of the Executive Council of the Tax Section of the Florida Bar, and has been quoted on many occasions in publications such as The Wall Street Journal, Forbes Magazine, Medical Economics, Modern Healthcare, and Florida Trend magazine. He is an author, along with Kenneth Crotty and Christopher Denicolo, of the BNA Tax & Accounting book Estate Tax Planning in 2011 and 2012. He is the senior partner at **Gassman Law Associates, P.A.** in

Clearwater, Florida, which he founded in 1987. His email address is agassman@gassmanpa.com. Alan S. Gassman, Esq. and Christopher J. Denicolo, Esq. are the co-authors of the The Joint Exempt Step-Up Trust Legal Document Form, which is available from The Ultimate Estate Planner, Inc. Mr. Gassman has also co-authored *Florida Law for Tax, Business and Financial Advisors, Gassman and Markham on Florida and Federal Asset Protection Law* and *A Practical Guide to Kickback and Self-Referral Laws for Florida Physicians.* You may contact Alan Gassman at agassman@gassmanpa.com to order these books.

Kenneth J. Crotty, J.D., LL.M., is a partner at the Clearwater, Florida law firm of Gassman Law Associates, P.A., where he practices in the areas of estate tax and trust planning, taxation, physician representation, and corporate and business law. Mr. Crotty has co-authored several handbooks that have been published in BNA Tax & Accounting, Estate Planning, Steve Leimberg's Estate Planning and Asset Protection Planning Newsletters and Estate Planning magazine. He, Alan Gassman and Christopher Denicolo are the co-authors of the BNA book Estate Tax Planning in 2011 & 2012. His email address is ken@gassmanpa.com.

Before we get to their commentary, members should take note of the fact that a new **60 Second Planner** by **Bob Keebler** was just posted to the **LISI** homepage. In his commentary, Bob reports on U.S. v. Zwerner, where a federal jury found that an 87-year-old Florida man owes the U.S. government civil penalties amounting to 150 percent of the value of his Swiss bank account. You don't need any special equipment - just click on this link.

Now, here is Alan and Ken's commentary:

EXECUTIVE SUMMARY:

Since the Tax Court decision of *Estate of Moss v. Comm'r* in 1980 and the issuance of Treasury Regulation § 1.1275-1(j) in 1998, estate tax planners have used self-cancelling installment notes (SCINs) to save millions of dollars of estate taxes for taxpayers whose life expectancy may be shorter than that assumed under the 2000CM Mortality Table promulgated by the Treasury Department under Publication 1457. In the recent CCA 2013-30-033, the IRS has taken the position in the *Davidson* case that clients with shorter than average life expectancies may not rely on the 2000CM Mortality Table to determine their life expectancy for the purpose of valuing the SCIN and may make taxable gifts when the sale occurs if they do rely on the 200CM Mortality Table. To reduce the possible gift tax exposure for clients, practitioners using SCIN with clients who have reduced life expectancies may want to use the SCGRAT technique described below.

FACTS:

The industry practice for most well versed practitioners has been that the 2000CM Mortality Table can be used when the taxpayer has a better than 50% chance of living at least one year at the time that the SCIN or private annuity arrangement is entered into.[i]

In order to avoid incurring income tax on the sale of assets for a SCIN or private annuity, most arrangements have entailed having an irrevocable trust established to be separate and apart from the taxpayer for federal estate tax purposes, while being disregarded for income tax purposes so that there is no income on the sale and no interest or Internal Code Revenue § 72 income recognized by the taxpayer as payments are received by the taxpayer from the trust during the taxpayer's lifetime.

Treasury Regulation § 25.7250-3(b)(2)(i) was enacted to implement the "probability of exhaustion test" which generally provides that if the entity purchasing assets for a private annuity is not capitalized with sufficient assets to enable the trust to make the scheduled private annuity payments until the Grantor reaches age 115, assuming a market rate equal to what is known as the 7520 rate which is equal to 120% of the Federal midterm rate in effect under § 1274(d)(1) for the month when the transaction is entered into, rounded up to the nearest 2/10ths of 1%.

Because of the difficulty of satisfying the probability of exhaustion test, especially in periods of low interest rates, most estate tax planners have recommended the use of SCINs, which are not subject to that test. A commonly used planning industry rule of thumb has been that a trust purchasing assets from a Grantor in exchange for a SCIN should have a positive net worth equal to 10% or more of the value of the assets purchased in order to be considered a separate and viable entity for estate tax planning purposes.

When trusts do not have sufficient assets to pass the probability of exhaustion test or the "10% rule of thumb" described above then it is common to have beneficiaries or affiliated entities guarantee the note or the private annuity in order to meet the applicable test,[ii] the 10% test for a SCIN or the probability of exhaustion test for a private annuity.

Treasury Regulation § 25.7520-3(b)(3)(I), which states that the 2000CM Mortality Table can be used when the person whose life controls the document has better than a 50% chance of living at least one year, applies explicitly to private annuities.

Many leading commentators, including **Howard Zaritsky** and **Ronald D. Aucutt**, have concluded that most likely this regulation applies to SCINs, because in form and content a SCIN constitutes a series of payments over time that can in substance be exactly the same as a private annuity contract.

The Service has strongly disagreed with this approach, but has waited over 18 years since the enactment of the above-referenced Treasury Regulation and notwithstanding annual and continuing industry and leading treatise literature to the contrary, on the occasion of the death and estate tax return audit of William M. Davidson to challenge this approach, whereby over $1,000,000,000 of estate tax is being assessed by the Service (constituting over 25% of the total estate taxes that the U.S. government would receive for a given calendar year) as the result of Mr. Davidson having sold a large percentage ownership in the Detroit Pistons basketball team and other assets in exchange for multiple SCINs when Mr. Davidson is said to have been in failing health.

The Service further threw the gauntlet down in front of the estate tax planning industry by publishing CCA 2013-30-033 on August 5, 2013, as an IRS Chief Counsel Advice which concludes that a SCIN will be worth substantially less than its face amount if a willing buyer would pay a willing seller less than the face amount if there was open market negotiation for the note.

In other words, if Mr. Davidson sold $1,000,000,000 worth of assets for a $1,000,000,000 SCIN then the trust that sold the note would only be able to receive $300,000,000 pursuant to an auction of the note at an event where every willing buyer received notice of the auction. Mr. Davidson would then have made a $700,000,000 gift and he would be subject to $280,000,000 worth of estate tax, enough to purchase two F-35 fighter jets.

What is a planner to do now when a wealthy client has a short life expectancy – SCRAM, go flat or SCGRAT?

COMMENT:

Door Number 1

A private annuity arrangement could be entered into with family members, such as occurred in the 2012 *Estate of Kite v. Commissioner* case. If a private annuity is entered into where the parent sells assets to children, the children's basis in the assets will be equal to the annuity payments made by the children. If the parent dies before receiving any annuity payments, such as what happened in the *Kite* case, the children would have a zero basis in the assets received and would face a 23.8% capital gains tax on the full value of the assets when they were sold.

Alternatively, the planner must face the probability of exhaustion test if a grantor trust is used that would quite possibly allow a stepped up basis for the assets.

The probability of exhaustion test may not apply, as discussed in the University of Miami Heckerling presentation by **Lawrence Katzenstein**[iii], but there is a significant risk that the probability of exhaustion test will apply.

Door Number 2

Go with a SCIN, but understand the risk posed by CCA 2013-30-033 and the *Davidson* case that the Grantor could be making a significant taxable gift at the time the transaction was entered into.

Door Number 3

Do nothing, but accelerate planning with charitable donations, discounting, and other methods.

Door Number 4

The box where Carol Merrill is now standing. [iv]

Door number 4 is the bread slicer – or at least what we think is better than sliced bread – a SCIN arrangement that would allow any gift element to not be subject to gift tax and to instead be repayable to the Grantor by use of a grantor retained annuity trust arrangement.

Instead of selling the assets to a typical irrevocable grantor trust the taxpayer first establishes a limited liability company owned 100% by the Grantor and places the assets that are being "sold" into the LLC and also receives a SCIN from the LLC while verifying that the taxpayer has a better than a 50% chance of living at least one year.

The taxpayer also executes a grantor retained annuity trust agreement (GRAT) which provides that a percentage of the value of the Day 1 GRAT assets will be paid back to the Grantor each year for two years on the anniversary date of the GRAT being established.[v]

The Grantor then transfers ownership of the LLC to the GRAT and hires a valuation firm to determine the value of the assets owned by the LLC.

If the valuation firm opines that the assets in the LLC are worth less than the face amount of the SCIN, then the LLC will be considered to have a negligible value, and the payments owed back to the Grantor will be very small. There should be some positive value even if the assets in the LLC are worth less than the SCIN because the owner of the LLC has no downside and at least some limited upside potential that the assets will grow in value and yield a net return exceeding the amount owed on the SCIN.

If the assets have a value exceeding the value amount of the SCIN then assuming the 7520 rate is 2.4%, then the excess amount multiplied by approximately 51.8% will be the amount of the annual payment that the GRAT will make to the Grantor, which may be in cash that the LLC can distribute to the GRAT or in the form of assets equal in value to such amounts that the LLC may distribute to the GRAT each year.

After the second annual payment, the LLC will be owned by the GRAT or an irrevocable "remainder trust" that the GRAT pours into after the second year.

The SCIN will typically be an interest only SCIN with a balloon payment at the end of the term of the note which will normally be just before the standard life expectancy of the individual on whose life the note is based as determined under 2000CM Mortality Table or the mortality table under Treasury Regulation § 1.72-9, Table V.

The 2000CM Mortality Table will typically have a shorter life expectancy and it is therefore safer to use it. For example, for a 78 year old the life expectancy under the 200CM Mortality Table is 9.44 and the life expectancy under Treasury Regulation § 1.72-9, Table V is 10.63.

To determine the value of the SCIN, either the interest rate of the SCIN will be increased, the face amount of the SCIN will be increased, or the interest rate and the face amount of the SCIN can both be increased to the extent appropriate to satisfy actuarial assumptions which make the note equal in value to the assets sold so that the seller is compensated to take into account that the note will vanish on death. This can be determined based upon standard life expectancies under actuarial tables using software programs like **Steve Leimberg's Number Cruncher** and **Larry Katzenstein Tiger Tables**. The links to obtain these programs are as follows.

- http://www.leimberg.com/products/software/numberCruncher.html
- http://www.tigertables.com/

The need to value the assets held under the LLC is a substantial reason to use the GRAT when assets are hard to value or discounts will be applicable.

A GRAT must be funded in a single transfer and there is no authority for the ability to sell assets to a GRAT in exchange for a note at the time of funding.

This is why well respected commentators have suggested that an LLC that is disregarded for income tax purposes will first be funded by the Grantor and that the Grantor can receive a note back from the LLC in order to provide appropriate financial leverage for the arrangement.

Many taxpayers will want to have their remaining assets be under the amount that would require an estate tax return to be filed in order to reduce the paperwork, expenses, and delay in estate administration that results from having to file a federal estate tax return. A SCIN will not be considered to be an asset owned at the time of death for estate tax return threshold filing purposes.

However, in *Estate of Moss v. Comm'r*, 74 T.C. 1239 (1980) , the Tax Court held in favor of the estate....***See: *Cain v. Comm'r*, 37 T.C. 185 (1961)

Where a marital deduction devise or charitable disposition may facilitate avoidance of federal estate tax on the death of the Grantor when used in conjunction with the SGRAT, it can still be advisable to have GRAT assets pass to fund a marital devise or trust and/or a charitable devise as remainder beneficiaries of the GRAT so that a federal estate tax return using it is more clear that the assets passing to fund a marital devise will receive a stepped up basis if held by the taxpayer on death, but the advantage of not having to file a federal estate tax return may outweigh the risk of not receiving a stepped up basis on assets passing to fund a marital or charitable devise.

Another consideration is whether to maximize the use of the taxpayer's generation skipping tax exemption makes the filing of a federal estate tax return worthwhile. Generation skipping tax exemption can clearly be allocated to a marital deduction trust that is funded from the Grantor's estate or revocable trust that receives the payments from the GRAT.

Many clients will prefer to zero out the GRAT in order to avoid the need to file a federal gift tax return for the year that the SCGRAT is implemented. It may therefore be important to be sure that there are no gifts exceeding $14,000 per donee or any gifts that do not qualify for the annual gift tax exclusion for the year in which a gift tax return would be filed, although even if a gift tax return needs to be filed it seems likely that a zeroed out GRAT would not be considered to be a gift that would need to be reported on a gift tax return.

Sample charts demonstrating this SCRAT technique are attached.

Conclusion

Utilizing a SCGRAT may be the best choice for practitioners who would like to use SCINs with a client who has a reduced life expectancy. If the Service successfully challenges the transaction and reduces the face value of the note by applying the willing buyer willing seller standard, by using the SCGRAT the value of the GRAT formed by the client should be increased. If the value of the GRAT is increased, then the payments from the GRAT to the client will be increased. As a result, there should not be any additional gift tax liability for the client.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman

Ken Crotty

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[i] Treasury Regulation § 1.7520-3(b)(3) provides that: an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year. However, if the individual survives for eighteen months or longer after the date of the decedent's death, that individual shall be presumed to have not been terminally ill at the date of death unless the contrary

is established by clear and convincing evidence.

[ii] It has been appropriately noted by many commentators that the 10% rule of thumb described herein is not based upon any specific IRS ruling, court case, or comparable situation. It actually came into being after well respected estate tax planner **Byrle Abbin** delivered a paper at the University of Miami Institute on Estate Planning in 1997, in which he reported that he had conversations with IRS personnel about a comparable situation and concluded the conversation with the mutual non-binding understanding that a 10% net worth should be sufficient to allow a trust entering into such a transaction to be considered as a separate independent entity.

[iii]Larry Katzenstein, “Turning the Tables: When do the IRS Actuarial Tables Not Apply?” 34 Univ. Miami Heckerling Institute on Estate Planning (Miami, Fla. Jan 6-10, 2003).

[iv] In the famous television game show, Let’s Make a Deal, moderator Monty Hall would give contestants the choice of three different doors or the box where Carol Merrill was standing. The box where Carol Merrill was standing was not usually the winner, and Carol Merrill was no Vanna White, but let’s not digress any further here other than to mention that the song “My Whole World Lies Waiting Behind Door Number 3,” by Jimmy Buffett on the A1A album from 1974 is more than worth listening to. “Didn’t Get Rich,” “Son of a _________”, “I’ll be Back Someday, You’ll See,” “My Whole World Lies Waiting Behind Door Number 3.”

[v] We have used two years as an example. Some planners believe that a GRAT can be as short as just over one year, and certainly can be for a longer period of time. If the Grantor dies during the GRAT term then the present value of the GRAT payments that have not yet been paid will be considered to be held by the Grantor’s estate, and can qualify for the federal estate tax or charitable deduction if the GRAT is properly drafted and would then pass to a spouse, a marital deduction trust, or to a private or public charity.

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