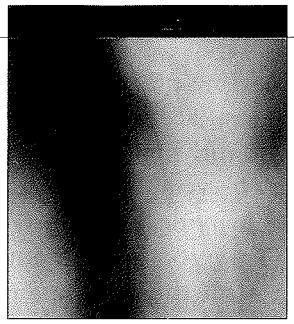


IRS Position Puts More Skin In the Game of Using SCINs

Self-cancelling installment notes have been an effective estate planning tool for individuals with shortened actual life expectancies, but the IRS limits how ill the individual may be.

KENNETH J. CROTTY, JEROME M. HESCH,
EDWARD P. WOJNAROSKI JR., AND ALAN S. GASSMAN, ATTORNEYS

Individuals in poor health who are not expected to survive to their predicted life expectancy may use estate tax planning techniques that are based on the assumption that they have a normal life expectancy. Some of these techniques can produce advantageous estate planning results for those unhealthy individuals.

For example, an individual age 70 has an actuarial life expectancy of 14.2 years based on the mortality tables the IRS is required to use.[1] The 70-year-old person could sell an asset to a junior family member, or to a trust for the benefit of junior family members, receiving from the buyer a deferred payment obligation that would cease upon the seller's death. If the purchaser's deferred payment obligation is a private annuity treated as adequate consideration (i.e., the private annuity has a value equal to the value of the asset sold in exchange for the private annuity), then the sale does not have gift tax consequences. In determining whether the annuity is adequate consideration, the annuity payments are assumed to be made for a term equal to the seller's 14.2-year life expectancy—even though the seller's poor health makes it unlikely that he or she will live that long.

Example. Senior, age 70, desires to sell an asset valued at $1 million to Junior in exchange for a level payment private annuity. If the Section 7520 rate for the month of the sale is 2.0%, Section 7520 assumes the purchaser will pay 2.0% interest on the outstanding principal under the deferred payment obligation. The annual annuity payment, with the first annuity payment due 12 months after the sale, is $84,245.29, and the entire principal will be completely paid over the 14.2 year life expectancy period. In effect, for the private annuity sale to be treated as a sale for adequate consideration, using the required Section 7520 rate and the seller's life expectancy under the 2000CM mortality tables, the seller-annuitant is assumed to receive 14.2 annual payments. Because the annuitant can be expected to receive the predicted annuity payments, the private annuity obligation is presumed to have a value equal to the asset sold.

When the seller who is to be the measuring life for the private annuity is not expected to receive all of the predicted annuity payments, the courts and the IRS may take the position that there is a gift

KENNETH J. CROTTY is a partner of Gassman, Bates & Associates, P.A., in Clearwater, Florida, and is Florida Board Certified in Tax Law. JEROME M. HESCH is of counsel at Berger Singerman in Miami, Florida. He is also the Director of the Notre Dame Tax & Estate Planning Institute and is a Fellow of the American College of Trust and Estate Counsel (ACTEC). EDWARD P. WOJNAROSKI JR. is a partner with Williams Coulson in Pittsburgh, Pennsylvania, and is a Fellow of ACTEC. ALAN S. GASSMAN is a partner of Gassman, Bates & Associates, P.A. and is a Florida Board Certified Wills, Trusts and Estates Lawyer. The authors thank Daniel B. Evans for his feedback on this piece and Kylie Caporuscio, for her drafting assistance.

at the time of the sale to the extent the value of the asset sold exceeds the present value of the payments the seller/annuitant is expected to receive.

Example. The facts are the same as in the previous example, except Senior is not expected to survive for more than one year at the time of the private annuity sale. In fact, immediately after receiving the first annual annuity payment, Senior dies, and Junior's obligation to make all further annual annuity payments is cancelled. If, upon examination of Senior's health at the time the private annuity sale occurred, the trier-of-fact finds that Senior was not expected to survive beyond the first year, then Senior will be treated as having made a gift at the time the private annuity sale occurred equal to the value of the asset sold over the present value of the annuity payment received using Senior's actual life expectancy.[2]

Background

Under the Section 7520(b) delegation of rule-making authority, the IRS promulgated a Regulation that adopted the "terminal illness" test for private annuities. This test is used to determine if the assumption that the annuitant will receive annuity payments over the annuitant's life expectancy can be ignored and, based on the annuitant's actual health, the expected payments can be used instead.[3] Under this standard, the life expectancy assumption under the mortality component may not be used if an individual is *terminally ill* at the time the private annuity sale takes place.

This Regulation goes on to provide that the individual (the measuring life for the annuity payments) is presumed to be *terminally ill* if, at the time of the private annuity sale, the individual is known to have an incurable illness or other deteriorating physical condition, and there is at least a 50% probability that the individual will die within one year. This Regulation further provides that if the individual survives for 18 months or longer after the private annuity sale, that individual is presumed to have not been terminally ill.

Until 8/5/2013, the estate planning profession generally assumed that the terminally ill test also applied to self-cancelling installment notes.

Until 8/5/2013, the estate planning profession generally assumed that the terminally ill test also applied to self-cancelling installment notes (SCINs) because SCINs are similar to private annuities in that the SCIN obligation is cancelled if the measuring life dies during the note term. Prior to this date, the IRS gave no official or unofficial indication that it would not apply the terminally ill test to SCINs.

IRS litigation position. The August 2013 Chief Counsel Advice (CCA) 201330033 (8/5/13 release date; sent by the IRS to district counsel's office on 7/26/2013) declaring the IRS's litigation position in a recently filed Tax Court petition regarding SCINs came as both a surprise and disappointment to the estate planning community. The IRS Chief Counsel's Office rejected the traditional practice of valuing SCINs using the actuarial tables promulgated under Section 7520 and using the terminally ill test as applied to a SCIN, apparently even if the note holder had more than a 50% chance of living past one year after signing the note. Instead, the CCA provided that a SCIN valuation must account for the amount a willing buyer would pay a willing seller upon the execution date of the SCIN. The CCA went on to state that the valuation must incorporate the note holder's "actual" life expectancy based on factors that include the seller's medical history and what arm's-length parties consider the note to be worth pursuant to the Reg. 25.2512-8, willing buyer/willing seller valuation test.

As of now, this CCA seems to prohibit the use of the Reg. 25.7250-3(b)(3) terminally ill test in deciding whether to disregard the standard mortality tables.[4] While CCAs are issued to assist IRS personnel in administering their functions, they are not to be used or cited as prece-

1 Pursuant to the specific mandate under Section 7520(a)(1), the IRS and the taxpayers must use the mortality tables to value any annuity, any interest for life or a term of years, or any remainder or reversionary interest.

2 Using a 2.0% interest factor for the $1 million of principal, the interest portion for the first $84,245.29 annuity payment is $20,000. Because the principal portion of the first annuity payment is $64,245.29, the gift is $935,754.71 (the excess of $1 million over $64,245.29).

3 Regs. 20.7520-3(b)(3)(i) and (4), Example 1 and 25.7520-3(b)(3) and (4), Example.

4 This Regulation's terminally ill test provides as follows: The mortality component prescribed under Section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the decedent's death. For purposes of this paragraph (b)(3), 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% probability that the individual will die within one year.

5 A Chief Counsel Advice lacks precedential authority because Section 6110(k)(3) provides that a written determination may not be used or cited as precedent unless the Secretary otherwise establishes by regulations.

6 See 100-2nd T.M., Federal Tax Research, for a discussion of whether agency pronouncements, including CCAs, carry persuasive authority and offer penalty protection.

7 Docket 13748-13 (U.S. Tax Court).

8 Zaritsky and Aucutt, *Structuring Estate Freezes: Analysis With Forms* (Thomson Reuters/WG&L, 2013), ¶ 12.03[3].

9 According to our calculations, the gift and estate tax notice of deficiency, including penalty and interest, totaled $2,787,159,406.

10 CCA 201330033.

dent.[5] However, a CCA represents the probable litigation position of the IRS.[6]

This leaves the estate planning community uncertain as to how to value a SCIN properly and will almost certainly lead to increased litigation. Hopefully, the IRS will apply the terminally ill test to SCINs where the measuring life survived for at least one year. (The IRS, in its answer in *Davidson*,[7] found the terminally ill test irrelevant.) If not, we hope that the Tax Court, and eventually the applicable courts of appeal, will do so. Author and leading authority, Howard Zaritsky, among others, observed that Section 7520 requires that taxpayers use the actuarial tables to value "an interest for life or a term of years" and that SCIN payments should also fall under this parameter.[8]

The IRS had never previously suggested that it is abandoning the terminally ill test and that the willing buyer/willing seller standard should apply to SCINs. In all of the court cases and pronouncements the IRS published regarding SCINs, the IRS never suggested the application of the willing buyer/willing seller standard instead of the "terminally ill" test. In fact, the authors are not aware of any time that the IRS has ever taken such a position prior to this CCA. The authors feel that using the terminally ill test is appropriate for private annuities, based on the annuitant's health and a reasonable expectation of repayment, then the terminally ill test should be used instead of the CCA's willing buyer/willing seller standard to determine a SCIN's value.

Facts of the Chief Counsel Advice. CCA 201330033 addressed a situation where the individual used for the measuring life died within one year. It involved a decedent who entered into five separate transfers during the last period of his life. Although the CCA was redacted for personal information, a recent Tax Court petition indicates that the decedent was William M. Davidson, owner of the NBA Detroit Pistons. The stakes in *Davidson* are very large. Mitchell Gans and Jonathan Blattmachr suggested in LISI Estate Planning Newsletter #2135 (8/28/2013) that the IRS proposed a deficiency in excess of $2 billion in gift, estate, and generation-skipping transfer tax, including penalties and interest.[9]

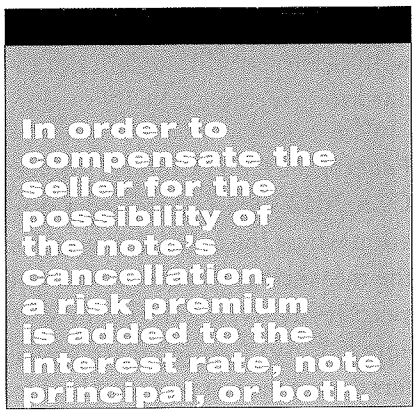
Specifically at issue were several sales of closely held stock to grantor trusts in exchange for SCINs. Shortly after these transactions were made, the decedent was diagnosed with an unspecified health condition and died within six months of the diagnosis.

Of great importance in the CCA's analysis is whether the terminally ill test should be disregarded in the determination of the fair market value of a SCIN. Since their adoption in 1994, the Section 7520 regulations have been the traditional measure for taxpayers to determine a SCIN's value. However, the Chief Counsel's Office determined that the terminally ill test can be disregarded because "[b]y its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder."[10] The CCA cites to General Counsel Memorandum (GCM) 39503, discussed in detail below, as authority for valuing the notes in a manner that accounts for the willing buyer/willing seller standard, but does not offer further explanation or detail.

SCIN terms. Payments under a conventional installment note end upon the expiration of the stated term. The seller's death has no bearing on the buyer's obligation to pay under a conventional installment sale, and the beneficiaries of the decedent noteholder inherit the buyer's obligation.[11] In contrast, payments under a SCIN end on the earlier of the stated term or the seller's death. Death extinguishes the seller's interest in remaining SCIN payments. Because of this bargained-for cancellation feature, the buyer has to provide additional consideration to rebut a bargain sale characterization. This early termination risk results in the note providing for higher payments to account for the potential cancellation of future payments upon the death of the noteholder.

SCINs are predominantly used in intra-family property transfers because they can eliminate estate taxes on the value of the note received for the property sold. When a sale using a SCIN is made to a grantor trust, the SCIN is outside the realm of income tax rules for annuities, debt obligations, and installment sales so that no gain or loss is realized for income tax purposes.

SCIN transactions offer significant estate tax benefits if the seller dies before the due date for payment of note principal. If the noteholder survives past the maturity date of the SCIN, the total payments received will be greater than the value of the assets sold in the transaction (unless the asset sold is a rapidly appreciating asset sold at a deep valuation discount). If a noteholder dies before the maturity date of the note, the self-cancelling provision becomes operative and cancels the remaining note balance. Because the assets purchased are owned by the buyer, and because the note cancels, nothing is included in the gross estate of the seller. Since a SCIN is only advantageous if the noteholder dies before the maturity date of the note, the ideal candidate is "someone in poor health, but whose death is not imminent, or someone with a very poor family health history."[12]



SCINs may also be established *per autre vie*, meaning "for the life of another." Thus, the risk premium added to the note can be valued based on the life expectancy of someone other than the noteholder. This is an interesting technique, as described by T. Randolph Harris in a Heckerling publication:

> This technique (which is not strictly speaking wealth transfer planning for the terminally ill, but rather wealth transfer planning using the terminally ill) falls somewhere between ghoulish and grotesque. However, it would appear to work, and perhaps should be suggested to certain selected clients.[13]

Similar to an annuity, the measuring life for a SCIN may be someone "who is relatively young, and so has a long actuarial life expectancy, but who is actually suffering from an incurable disease that is certain to shorten his or her life expectancy significantly."[14] Use of a life other than the grantor for a charitable lead annuity trust arrangement (a "ghoul trust") was prohibited after 4/4/2000 by Reg. 1.170A-6(c)(2)(i)(A) and (ii)(A), but this does not apply to SCINs or private annuity agreements.

In order to compensate the seller for the possibility of the note's cancellation, a risk premium is added to the interest rate, note principal, or both. The maturity date is set when the note is created. The note may be an interest-only note with payment of all principal at the end of the note term, or a note with amortizing principal payments over the note term. Typically, the note term is based on the individual's life expectancy on the date of the sale. A SCIN's term is usually shorter than the seller's life expectancy.

Debt or annuity. Interestingly, in accordance with the suggestion found in GCM 39503, the IRS concluded that a SCIN would be considered a debt obligation if the note term was shorter than the seller's life expectancy.[15] Otherwise, the SCIN would be treated as an annuity. However, the 1998 amendment of Reg. 1.1275-1(j) indicates that even a SCIN with a term greater than the seller's life expectancy should be treated as a debt obligation (i.e., an installment note), rather than an annuity.

11 When the seller dies during the note term, ownership of the fixed payment installment note is transferred by will, trust, or intestacy to the new holder consistent with the terms of the will or the trust.

12 Akers and Hayes, "Estate Planning Issues With Intra-Family Loans and Notes," The Forty-Seventh Annual Heckerling Institute on Estate Planning (Lexis Nexis, 2013), Chapter 5.

13 Harris, "Techniques Based on Using the Actuarial Tables," The Thirty-Second Annual Philip E. Heckerling Institute on Estate Planning (Lexis Nexis, 2013), Chapter 6.

14 Zaritsky, "Annuities Per Autre Vie," The Thirty-First Annual Philip E. Heckerling Institute on Estate Planning (Lexis Nexis, 2013), Chapter 14.

15 GCM 39503, 5/19/1986, addressed an income taxable sale. Its purpose was to determine if the gain realized on the sale of an appreciated asset was to be reported under the Section 453 installment method or the Section 72 annuity method. The GCM went on to provide that if the note term was greater than life expectancy, the SCIN would be treated as an annuity, and if the note term was less than life expectancy, the SCIN would be treated as a debt obligation.

Howard Zaritsky discussed the importance of deriving a premium from the Section 7520 tables as follows:

> All of the cases upholding SCINs stress that the self-canceling feature was a bargained-for consideration between the parties and that the buyers paid a distinct premium for that feature. This is a critical feature for transfer tax purposes. The failure to pay a premium for a self-canceling feature in a SCIN strongly suggests that the transaction is, at least in part, a gift with a retained life estate includable in the decedent's gross estate under § 2036(a).[16]

In the past, the IRS has acquiesced in court decisions upholding the cancellation provision of a SCIN as part of the bargained-for consideration, and to some extent, has even recognized the principle.[17] A SCIN sale where the transaction is bona fide should not be subject to gift tax.[18] To qualify as bona fide, a seller needs to have a reasonable expectation of repayment, and the transaction needs to have an established payment schedule. In several cases, the courts denied IRS challenges where no repayment occurred.[19]

Also, in the CCA, the IRS recognized, but easily dismissed, the estate's potential argument that "sufficient seed money" qualified the SCINs as bona fide debt in the fourth set of transactions. The estate in *Davidson*, in its petition in Tax Court, argues that each buyer held more trust assets than the value of stock exchanged for the SCINs.[20]

Analysis

The issue at the heart of the CCA turns on whether the terminally ill test should be ignored for a SCIN, and if so, under what circumstances or conditions. The IRS has not provided any clear guidance as to what test can be used to make this decision. The current IRS Regulations treat all SCINs as debt obligations.[21] Although, the terms of Section 7520 do not apply to debt obligations, practitioners traditionally use the terminally ill test under Section 7520 to value SCINs.

Interestingly, all of the commercially available software for SCIN valuations use the Section 7520 rates and the 2000CM mortality tables, tacitly adopting the Section 7520 "terminally ill" test. In fact, Robert Held and Charles Newlin support this approach, stating that "[w]hile Section 7520, by its terms, applies only to the value of an annuity, term interest, remainder or reversion, there seems little reason (beyond semantics) not to apply its rationale and consistency to the SCIN."[22] Howard Zaritsky also advocates for Section 7520 application. He puts forth that:

> Section 7520 states that it must be used to value 'an interest for life or a term of years,' which precisely describes the payments under a SCIN. Furthermore, the IRS publication 'Actuarial Values, Alpha Volume,' which implements the IRS actuarial tables under Section 7520, includes an example that uses the tables to determine 'the present worth of a temporary annuity of $1.00 per annum payable annually for 10 years or until the prior death of a person aged 65....' This, too, appears to describe precisely the calculation of the premium for a SCIN. Thus, Section 7520 appears to apply by its terms to the valuation of a SCIN premium.[23]

Terminal illness. Reg. 25.7520-3(b)(3)(i) limits the use of the valuation tables if the seller suffers from a terminal illness.[24] For these purposes, "terminal illness" means an incurable illness or other deteriorating physical condition such that the transferor has at least a 50% probability of dying within one year from the date of the transaction.[25] What may be particularly important for transactions in-

16 Zaritsky, *Tax Planning for Family Wealth Transfers*, 4th ed. (Thomson Reuters/WG&L, 2002) ¶ 12.04[3].

17 Estate of Moss, 74 TC 1239 (1980), *acq. in result only* 1981-1 CB2; See Cain, 37 TC 185 (1961), *acq.* 1962-2 CB 4.

18 See Estate of Moss, *supra* note 17 (respecting the sale and declining to apply Section 2036 as a trust substitute).

19 See Estate of Moss, *supra* note 17, and Costanza, TCM 2001-128, *rev'd and rem'd* 320 F.3d 595, 91 AFTR2d 2003-988 (CA-6, 2003); But see Estate of O'Reilly, 973 F.2d 1403, 70 AFTR2d 92-6211 (CA-8, 1992).

20 Davidson, *supra* note 7.

21 See Reg. 1.1275-1(j).

22 Held and Newlin, "Hedging Death and Taxes," 143 Trust & Estates 56 (January 2004).

23 Zaritsky, *supra* note 16 at ¶ 12.8.19.

24 Regs. 1.7520-3(b)(3), 20.7520-3(b)(3)(i), and 25.7520(b)(3). For estates of decedents dying prior to 12/14/1995, the regulations do not apply. Rather, the question of whether a particular interest must be valued based on the tables was resolved based on applicable case law and Rev. Rul. 80-80, 1980-1 CB 194.

25 Regs. 1.7520-3(b)(3), 20.7520-3(b)(3)(i), and 25.7520-3(b)(3). See also Regs. 1.7520-(3)(b)(4), Example 2; 20.7520-3(b)(4), Example 1; and 25.7520-3(b)(4), for examples of terminal illness.

volving SCINs is that the regulation sets forth a 12-month rule for a terminally ill individual:

> The mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the transaction. For purposes of this paragraph (b)(3), 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.[26]

The regulation also provides for an 18-month *rebuttable* presumption, known as the safe-harbor provision:

> [if] the individual survives for eighteen months or longer after the [effective date of the note], 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.* [Emphasis added.][27]

The IRS may still challenge the use of the Section 7520 mortality tables in situations where the noteholder survived the sale by 18 months or more, but the IRS will have the more difficult task of providing clear and convincing evidence that these tables would not be applicable. According to T. Randolph Harris, "it is hard to imagine a situation where the IRS could succeed in rebutting the presumption."[28]

Practically speaking, using the Section 7520 terminal illness test for SCIN holders has meant that the taxpayer should provide a letter from his or her doctor before entering a SCIN. In the typical situation, the letters have stated that the individual has a better-than-50% chance of surviving for one year after the note was signed. The authors recommend, especially in light of the IRS's position in the CCA, that *the doctor's letter should confirm that the noteholder has better than a 50% chance of outliving the note's maturity date.* This demonstrates a realistic probability at the time of the transaction that repayment of the entire note was likely.

The issue at the heart of the CCA turns on whether the Section 7520 terminally ill test should be ignored for a SCIN, and if so, under what circumstances or conditions.

Case law guidance. If the SCIN is to be treated as an annuity, then *Estate of Kite*[29] offers some guidance. In this case, Mrs. Kite used three separate private annuity agreements to sell her beneficial interest in one of her trusts to her children. The first annuity payments were not due until ten years after the sale occurred. If Mrs. Kite died within the ten-year deferral period, the annuity interest would terminate. Mrs. Kite's survival of the ten-year term would make her children personally liable for annual payments of $1,900,679.34 every year until her death.

Mrs. Kite died approximately three years into the deferral period, and the annuity payment rights were not included for estate tax purposes. At the time of the sale, Mrs. Kite, who was 74 years old, had received a physician letter stating that there was at least a 50% probability that she would survive for at least 18 months. The IRS argued that the Section 7520 tables were not applicable because her "deteriorating health in 2001 made her death within 10 years foreseeable." Citing *McLendon*,[30] the Tax Court stated that "[r]espondent, as the party seeking to depart from the actuarial tables, bears the burden of proving that the circumstances justify the departure [from using the Section 7520 tables]."

The IRS then claimed that Mrs. Kite's reliance on 24-hour medical care and her high medical costs of over $100,000 annually at the time of the annuity transactions, indicated that her death was foreseeable within ten years. The Tax Court rejected the argument, stating that the costs "merely demonstrate that Mrs. Kite was a wealthy, 75-year-old woman who, when faced with certain health problems, decided to employ health care aids at her home." The Tax Court's final determination was that the annu-

26 Reg. 20.7520-3(b)(3).

27 *Id.*

28 Harris, "Techniques Based on Using the Actuarial Tables," The Thirty-Second Annual Philip E. Heckerling Institute on Estate Planning (Lexis Nexis 2013), Chapter 6.

29 TCM 2013-43.

30 TCM 1996-307.

31 See Section 7491(a) where the burden shifts to the Service when the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the tax liability, assuming that other conditions outlined in Section 7491(a)(2) apply. See also Estate of O'Reilly, *supra* note 19 (in determining gift tax inclusion value of transferred remainder, IRS "bore the considerable burden" of proving tables inapplicable); Continental Illinois National Bank & Trust Co. of Chicago. 34 AFTR2d 74-6329, 504 F.2d 586 (CA-7, 1974) (government failed to carry burden); Estate of Fabric, 83 TC 932 (1984) (same); Weller, 38 TC 790 (1962) (taxpayers' use of tables "must be sustained unless it is shown" that tables resulted in "unrealistic and unreasonable" valuation); Saltzman, TCM 1994-641, *rev'd on other grounds* 131 F.3d 87 (CA-2, 1997) (IRS conceding that burden shifted after taxpayers "made a prima facie case"); Estate of McDowell, TCM 1986-27 (estate tax deduction under Section 2053(a)(3) for annuity obligation; IRS failed to carry burden of proving inapplicability of tables' mortality assumptions); Mercantile-Safe Deposit & Trust Co., 33 AFTR2d 74-1421, 368 F. Supp. 743 (DC Md., 1974), once stipulated facts were accepted and taxpayer relied on tables, the IRS "assumed the burden of going forward with evidence to show ... the tables should not be applied"); *cf.* Hipp, 11 AFTR2d 1787, 215 F. Supp. 222 (DC S.Car., 1962) (IRS's erroneous calculation of actuarial yield on stock "destroys whatever presumption [its] determination would ordinarily carry"). See also Bogdanski, *Federal Tax Valuation,* 1st ed. (Thomson Reuters/WG&L, 1996), ¶ 5.07[1][c].

ity agreements "constituted adequate and full consideration and consequently were not subject to Federal gift tax."

As an aside, should the IRS seek to depart from the terminally ill test in a SCIN transaction, it would seem that the burden of proof would shift to the IRS to show the transferor's actual life expectancy was less than the SCIN term.[31]

In the *Kite* case, the court rejected the IRS's attempt to disregard the terminally ill test for a private annuity sale where Mrs. Kite survived for three years after the private annuity transaction was entered into, exceeding the 12-month likelihood of survival many advisors feel is adequate when using private annuities or SCINs. In light of the IRS's announcement in the CCA that it intends to convince the courts to adopt a test based on the willing buyer/willing seller standard, it is safest to obtain a doctor's letter confirming that the individual can reasonably (i.e., more than 50%) be expected to survive beyond the term of the note. Additional positive health evidence can help support the estate's claim that under the willing buyer/willing seller conditions the SCIN employed a sufficient risk premium.

Relevance of safe harbor. Unfortunately, if the IRS will not accept Mr. Zaritsky's reasoning described above, then the IRS's treatment of SCINs as debt obligations may cause Section 7520 by its terms to not apply. If all SCINs are debt obligations, this may render the terminally ill safe harbor in the Section 7520 regulations inapplicable to SCINs, because this safe harbor applies to annuities.

If the courts consider analogous case law,[32] then they may reject the 12-month "terminally ill" standard in Reg. 25.7520-3(b)(3). In *O'Reilly* the court found that:

> [t]he Tax Court has long followed the rule that the use of the tables "must be sustained unless it is shown that the result is so unrealistic and unreasonable that either some modification in the prescribed method should be made, or complete departure from the method should be taken, and a more reasonable and realistic means of determining value is available."[33]

Despite the IRS's ability to challenge the health of the noteholder when the transaction was entered into, satisfying the "terminally ill" test would still help. This "unrealistic and unreasonable" test can also be negated with a doctor's letter, preferably one that confirms the holder has a 50% or more probability to outlive the term of the note.

Even if life expectancy is used, there is also a disagreement as to the proper discount rate. Several commentators believe that the Section 7872 rate can be used in lieu of the Section 7520 rates, which would make the SCIN risk premium different. Most members of the estate tax planning community have found the Section 7520 rate to be acceptable even though selection of the applicable rate has been a point of contention. There is also a concern over which mortality table is appropriate. Steve Akers and Philip Hayes state that:

> [t]here is not universal agreement on how payments under a SCIN are properly valued, for there is no clear answer concerning which *mortality tables* should be used and which *discount rate* should be applied to value these payments Some commentators use the life expectancies in Table 90 CM for May 1999-April 2009 and Table 2000CM from May 2009 forward and a rate equal to the greater of 120% of the mid-term AFR, assuming annual payments, as prescribed by § 7520, or the AFR for the actual term of the note, as prescribed by § 7872. Others use the annuity tables under Reg. § 1.72-9 Table V and the AFR as prescribed by 7872. Additionally, some commentators have recommended that the actual life expectancy be used.[34]

Elliott Manning and Jerome Hesch believe that when a SCIN is taxed as an installment sale, the AFR prescribed in Sections 1274 and 7872, rather than the Section 7520 rate, should apply,[35] which can result in a lower risk premium.

[32] See also Estate of O'Reilly, *supra* note 19; see also Weller, *supra* note 31.

[33] Estate of O'Reilly, *supra* note 19 (citing Weller, *supra* note 31). Additionally, the recent "lottery" valuation cases all adopted the O'Reilly/Weller test, citing to both O'Reilly and Weller in deciding whether to rely on the actuarial assumptions under Section 7520). See Negron, 103 AFTR2d 2009-634, 553 F.3d 1013 (CA-6, 2009), and its progeny.

[34] Akers and Hayes, *supra* note 12 (citing Covey, et al. Q&A Session I of the Twenty-Seventh Annual Institute on Estate Planning, 27 U. Miami Inst. On Est. Plan. ¶ 216 (1993); Hesch and Manning, "Beyond the Basic Freeze: Further Uses of Deferred Payment Sales," 34 Univ. Miami Heckerling Institute on Estate Planning ¶ 1601.3.[B][1]-[2] (2000); Banoff and Hartz, "Sales of Property: Will Self-Canceling Installment Notes Make Private Annuities Obsolete?," 59 Taxes 499 (1981)).

[35] Hesch and Manning, "Coordinating Income Tax Planning with Estate Planning: Uses of Installment Sales, Private Annuities and Self-Canceling Installment Notes," 36th Annual University of Miami Philip E. Heckerling Institute on Estate Planning, (Lexis Nexis 2013), Chapter 10. Also note that under Section 7872(f)(2)(A), the Section 1274 rate is incorporated by reference.

They claim that because a SCIN is not a term interest under Section 7520, the "same considerations that lead to the conclusion that an installment note is not a retained life estate also lead to the conclusion that it is not a term interest." Manning and Hesch's argument is supported by "(i) the analysis in Reg. § 1.1275-1(j) that a SCIN is treated as a debt obligation subject to the OID rules, including the provisions of § 1274, and (ii) the similar conclusion in GCM 39503 for a SCIN with a maximum term less than the seller's life expectancy is treated under the installment sale rules of § 453."

They find additional support for their position from the Tax Court's decision in *Frazee*,[36] which employed Section 7872 to set the interest rate for a note for income and gift tax purposes. Prior to the 1997 amendment to Reg 1.1275-1(j), the IRS treated a SCIN in a non-grantor trust sale where the term of the SCIN was less than the life expectancy of the individual as an installment sale for income tax purposes. Only a SCIN with a term longer than the life expectancy of the individual received annuity treatment. This position changed with the Section 1.1275-1(j) regulation, which now states that all SCINs, even those with a note term beyond the noteholder's life expectancy, are debt obligations.

Manning and Hesch also suggest the elimination of the unintended gift issue, stating:

> [t]reating all SCINs ... as installment sales means that the AFR determines the discount rate. If the same valuation principles are used for both income and transfer tax purposes, valuation disparities for the same transaction can be avoided. Therefore, § 7520 does not apply. Consequently, the unintended gift problem and other distortions can be avoided.[37]

The best answer may be found on a case-by-case basis. Akers and Hayes suggest:

> AFRs should not be used by the faint of heart. A conservative planner probably should use the higher of the § 7520 rate or the AFR for the actual term of the note, as recommended by *Covey*. Clearly, many if not most, practitioners are using the higher of the § 7520 rate or the AFR for the actual term of the note; the estate tax risk of using a rate that is too low is simply too great.[38]

Despite differing views as to which rates and mortality tables to employ, the IRS's CCA rejects all of these practices in favor of a new approach: the "method that takes into account the willing buyer willing seller standard in Treas. Reg. § 25.2512-8." The IRS also wishes to consider the medical history of the decedent, but does not offer practical guidance on how to apply this valuation standard, which would make this an extremely subjective process. This may require a combination of actuarial, medical, and investment risk factors, which will certainly be more complex and less precise than using the 12-month "terminally ill" test. The lack of certainty and potential complexity are stripping away the main advantage of using a SCIN—the exclusion from gift tax when the transaction is entered into.

Reasonableness of expecting payment. Others have minimized the importance of the CCA, stating that it should not be given much credence and that the IRS is simply trying to take the best litigation position in the *Davidson* case. It is important to remember that the CCA memo states the litigating position for the IRS in this case. And, the particulars of *Davidson*, according to the IRS, show that the taxpayer had no reasonable expectation of repayment.

It is this lack of expectation of receiving payments that caused the IRS to argue for a different standard than had been traditionally applied in other cases. Because this advice could also be a bargaining tool for the IRS in this instance, the IRS may not have the expectation of applying the standard to other taxpayers, especially those with a reasonable expectation of being repaid in a SCIN transaction.

The petition, filed in *Davidson*, in paragraph (nnnn) states that the decedent's life expectancy is 5.8 years under the tables. Also, paragraphs (aaaa) to (uuuu) of the petition discuss the decedent's health prior to SCINS. The IRS admitted, in its answer (iiii), that four medical consultants, two hired by the IRS and two by the taxpayer, concluded that Mr. Davidson had a greater than 50% chance of living at least one year. If the Section 7520 tables apply to value the SCINs and the terminal illness regulations apply, then the IRS has already conceded the terminal illness issue. The Tax Court may find a way out and rule that no bona fide debt exists and the Section 7520 analysis becomes irrelevant, issuing a memorandum decision, but an appeal is likely given the dollars at stake.

General counsel memorandum. The IRS has permitted the use of the Section 7520 tables for SCINs with a term longer than the life expectancy of the measuring life since 1986,[39] but may now prohibit use of these tables for all SCINs moving forward. A brief reference to GCM 39503, which is a nonbinding memo issued by the IRS in

36 98 TC 554 (1992).

37 Note 34 *supra*.

38 Akers and Hayes, *supra* note 12.

39 GCM 39503, 5/19/86 (This GCM was the basis for Rev. Rul. 86-72, 1986-1 CB 253). TD 8630, 12/12/1995.

1986, is provided as support for this proposition. This Memorandum states:

> Under an installment sale, a gift tax will not be imposed if the sale price and length of payment are reasonable in light of the facts and circumstances of the case. The value of the installment obligation and the property sold must be substantially equal. However, unlike the private annuity, there is *no requirement* that the actuarial tables are to be used in determining the gift taxation of an installment sale. Thus, the taxpayer's particular health status *may* be considered, and there is more room to establish that the terms of the sale are reasonable. [Emphasis added.]

This GCM treated a SCIN as an installment note, provided the note term was shorter than the life expectancy of the noteholder.

The language in the GCM clearly indicates that the GCM is *not* rejecting use of the Section 7520 tables. Rather, the document recognizes that Rev. Rul. 80-80 required taxpayers to use the mortality tables for private annuity valuation in Reg. 20.2031-10 and that SCINs do not have such a requirement. The Section 7520 tables do not have to be used, but they may offer a practical alternative for SCIN valuation. Further, this GCM was issued in 1986, and thereafter, Rev. Rul. 96-3 deemed Rev. Rul. 80-80 obsolete. However, the recent CCA looks to the GCM in its assertion that the willing buyer/willing seller standard should be used in place of the mortality tables. This is a mischaracterization of the GCM, and the CCA represents a much broader principle than the GCM actually describes. Edward Wojnaroski discusses the 1986 GCM in *Tax Management Estates, Gifts, and Trusts Portfolio:*

> While GCM 39503 may give planners substantially more flexibility in structuring SCIN transactions, the reasonableness of the SCIN's terms relative to a private annuity involve a subjective interpretation. In addition to evaluating the seller's health, it is crucial to obtain a realistic value for the property being transferred. To the extent that the property sold is difficult to value, this will compound the probabilities of scrutiny by the IRS.[40]

This 1986 GCM is over 25 years old, and only now has there been movement toward significant changes in the valuation process. Without any real precedent to rely on, semantics seem to be at the heart of the matter. Practitioners can only speculate about the consequences of altering the SCIN valuation protocol, which means the IRS is abandoning an objective valuation system. The purpose behind the enactment of Section 7520 was to provide objective valuations. Congress recognized that intra-family transactions often do not have comparable arm's-length transactions that can be used to establish transactional value. Thus, Section 7520 should be applied broadly to provide greater certainty and reduce disputes in valuations, instead of narrowly like the CCA seems to suggest. With this in mind, the CCA hinders part of the purpose for the establishment of Section 7520.

Although Hesch and Manning reference the GCM, they still support using Section 7872, which would provide some clarity. Before the CCA was issued, BNA Portfolio Number 805-3rd author, Wojnaroski, noted that the difficulty with a subjective valuation system, by stating the following which is in the Portfolio at Section IV:

> The risk premium for a SCIN does not have to be obtained by reference to the actuarial tables. The planner or client may engage an actuary for this purpose. However, it would appear that relying on the tables provides a greater degree of certainty that the IRS will respect the terms of a SCIN if the assumption about the seller's life expectancy are reasonable and reflect recent mortality data. If the taxpayer chooses to set the terms of a SCIN by looking outside of the tables, it is advisable to consider the amount of the down payment being made, the length of the contract, and the seller's actual health (assuming the measuring life used is the seller's). The IRS has indicated it will not require the value of the consideration paid for the property being transferred pursuant to a SCIN to be identical, but the consideration and transferred property must be substantially equal. The subjective valuation of a SCIN makes the job of satisfying this "substantially equal" test a difficult and perhaps expensive hurdle for the taxpayer with respect to intra-family transactions if the seller's life expectancy is substantially less than what his or her life

[40] Wojnaroski, 805-3rd, *Private Annuities and Self-Cancelling Installment Notes* (Tax Management Estates, Gifts, and Trusts Portfolios, 2013).

expectancy would be under standard actuarial tables. It would appear that there may be a greater risk of a gift tax when working with a SCIN than there would be with a private annuity.

While somewhat radical, the IRS does have a shot at convincing the courts that its position is correct. In part, the IRS already established a subtle change in its position on SCINs in 1998 in Reg. 1.1275-1(j)—a rulemaking regulation.[41] In this regulation, SCINs are considered debt obligations instead of annuities. The IRS made this change in an effort to prevent income tax abuse.

In addition, GCM 39503 has always treated a SCIN with a fixed term that is shorter than life expectancy as a debt obligation. Because Section 7520 does not apply to debt obligations, the *O'Reilly* standard (see text at Note 32) may be considered by a court to be logical and consistent with the IRS position in the CCA.

While a SCIN may possess both annuity and debt obligation characteristics, it cannot be treated as an annuity for some purposes and a debt for other purposes. The winner in all of this, regardless of how SCIN valuation is ultimately determined, is likely to be the IRS. Meanwhile, the estate planning community remains uncertain on SCIN valuation, and clients may face litigation on potential gift taxation.

The reader should keep in mind that the CCA guidelines does not obligate other taxpayers and is perhaps specific in intent with respect to the *Davidson* case, especially since Mr. Davidson died within a year. CCA memos "are legal advice, signed by executives in the National Office of the Office of Chief Counsel and issued to Internal Revenue Service personnel who are national program executives and managers. They are issued to assist Service personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues."[42] Even more importantly, the IRS says that "these documents cannot be used or cited as precedent."[43] The memo is not binding, although it seems to indicate that the IRS's position is that the willing buyer/willing seller standard is applicable to all SCINs.

Planning considerations. As a result, cautious clients may want to seek additional appraisals beyond that of the underlying assets to include a valuation of the note itself, and even a determination of an appropriate interest rate. The IRS may claim that a process similar to the viatical settlement valuation procedure used by arm's-length purchasers of syndicates that buy life insurance policies on unhealthy individuals should somehow be employed as an arm's-length criteria for valuing the windfall that would occur on the death of a named individual. The value of that windfall might be directly comparable to what a viatical settlement company would be willing to pay for an equivalent expected death benefit.

When a note holder dies prematurely, this CCA indicates that the estate had better prepare for litigation. One approach is to have the client's appraiser substantiate the rate chosen, so that the Service is put in the position of having its appraiser need to explain why that rate is inappropriate." Another strategy may be to consider using a shorter life expectancy with a reduced interest rate to lessen the probability that the noteholder will die prematurely.

Many estate planners may forego using SCINs altogether, opting instead for alternative, safer techniques such as private annuities. Again, the all-important doctor's letter should speak to the likelihood that the noteholder will survive past the note's maturity date.

Conclusion

Going forward, estate tax planners will have to wait to see what transpires with respect to the valuation and use of self-cancelling installment notes in the *Davidson* case. Private annuities will no doubt become more popular and widely used in the interim, particularly where planners do not want to rock the boat. But Reg. 25.7250-3(b)(2)(i) imposed the exhaustion test for private annuities, a mechanical formula specifying how much other assets a trust issuing a private annuity must have. Many commentators find the exhaustion requirement to be a draconian standard. In the meantime, practitioners need to keep their eyes and ears open, stay alert, and see how the *Davidson* case is resolved, especially if the case is settled on some sort of compromise. For now, the CCA indicates that even if death occurs after one year, the IRS may still argue to disregard the mortality tables. ■

41 This section provides for a life annuity exception. It states the general rule as follows: "For purposes of section 1375(a)(1)(B)(i), an annuity contract depends (in whole or in substantial part) on the life expectancy of one or more individuals only if (A) the contract provides for periodic distributions made not less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals); and (B) the contract does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants)."

42 IRS, "Legal Advice Issued by Associate Chief Counsel," available at http://www.irs.gov/uac/Legal-Advice-Issued-by-Associate-Chief-Counsel (8/6/2013).

43 *Id.*