GOT PREMIUM? COSTANZA V. COMMISSIONER AND THE TAX TREATMENT OF SCINS CANCELLED BY DEATH

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I. INTRODUCTION

This article hopes to accomplish one goal for the practitioner who is essentially unfamiliar with self canceling installment notes and another for the seasoned practitioner who is more versed in their use. In the first instance, the article seeks to introduce a practitioner to the basics of the self canceling installment note (SCIN) along with some general considerations regarding their use in practice. A SCIN, usually executed between family members, is different from other notes in that a person's death (usually the note's holder) immediately terminates any future obligations to pay on the note. The primary purpose of a SCIN is to get property (typically a closely held business) out of the donor's estate without incurring transfer taxes.

A basic illustration follows. Mother, seventy-five years old and in average health, owns an auto dealership with a fair market value of $5,000,000. She sells the dealership to Daughter in exchange for a SCIN. The $5,000,000 note matures in eight years, is payable quarterly and accrues interest at a rate of AFR + 5%. Keep in mind that at this point, Mother could live for three years, in which case the note, if respected by the IRS, avoids transfer tax consequences (income tax consequences are discussed below). If Mother lives long enough for the note to mature, she has essentially imposed de facto transfer tax consequences to daughter who paid full price plus a high interest rate for the dealership while Mother paid income taxes on the payments. Moreover, whatever is left of the payments in Mother's estate is subject to estate taxes. Thus, one can take from this example that a SCIN is only advantageous if the holder dies before maturity.

The SCIN must be an objectively bona fide transaction. Because two unrelated business people would not likely consider such a deal, the "objectivity" of the SCIN exists within the world of SCINs entirely. A simple way to conceive of the objectively bona fide transaction is by asking what the reasonable parent actually selling (as opposed to a sham sale) the business to her child would do. Also, a SCIN must be a subjectively bona fide transaction in which the parties manifest a subjective intention of creating a debtor-creditor relationship. Also, the SCIN must be exchanged for full and adequate consideration in order to be effective.

Whether analyzing for a bona fide transaction or for full and adequate consideration, the author argues that the crux of the SCIN is the risk premium: an enhancement in either interest rate or principal balance accounting for the fact that a person's death may cancel the obligation to pay on the note before its maturity date. After all, if one exchanges a straight installment note, the note holder gets guaranteed payments, but if one exchanges a SCIN, the holder knows that payments stop at the holder's death. It follows that full and adequate consideration, therefore, would have to include a premium for the potential death cancellation of what otherwise would be a simple term installment note. The author argues, moreover, that the same premium is the strongest evidence of an objectively bona fide transaction as well as a subjectively bona fide transaction. A variation of the car dealership example appears in Section II, *infra*, to illustrate the point.

For the seasoned practitioner, this article cautions against the lure of reliance upon a pro-taxpayer case, *Costanza v. Commissioner of Internal Revenue*,[1] as a guide to one's execution of SCINs. The trickery of the SCIN is that there are no hard and fast rules to what is considered bona fide, or full and adquate consideration. For example, there is no life expectancy table the IRS expressly recognizes as a guide for SCINs. The practitioner may use the Ordinary Life Annuities Table of Treas. Reg. § 1.72-5, and the IRS is free to reject the use of that table. With such a treacherous roadmap for a tool that by design is a suspect transaction, practitioners need to exercise care in creating SCINs that will muster IRS scrutiny, and reliance on *Costanza*, as will be argued below, is not the care a prudent practitioner should exercise if that practitioner wants to avoid costly Tax and Appeals Court trials with unpredictable outcomes. There are other aspects of estate planning and administration, such as valuation of non-cash property in determining its fair market value, for which there are no hard and fast rules. This is to say, the fact that SCINs lack a clear regulatory roadmap is not in and of itself problematic. Rather, like the issue of valuing non-cash property for transfer tax purposes, practitioners should exercise appropriate prudence in navigating with such a treacherous roadmap.

This article may be bifurcated into 1) a primer on self canceling installment notes, and 2) a comment on a case that the author feels is bad law despite the allure of its taxpayer-friendly holding. Section II, below, starts with a primer on SCINs. In addition to introducing a practitioner to when SCINs may or may not be appropriate, the section addresses the negative consequences of a failed SCIN. Section III briefly summarizes the *Costanza* case and asserts why the author thinks it was poorly decided on appeal. Section IV discusses the risk premium. The author weaves in the *Costanza* facts along with some analogous facts from other cases in his attempt to demonstrate the central role of the risk premium to SCINs. Section V uses *Costanza* as a vehicle for discussing the possibility that even where a SCIN is deemed a bona fide transaction, the practitioner risks gift tax treatment where the Tax Court finds less than full and adequate consideration. Section VI, again using *Costanza* as a jumping off point, discusses the income tax treatment of SCINs cancelled before maturity. Finally, Section VII concludes with a synopsis of this work.

II. INTRAFAMILY SCINs: A PRIMER

A SCIN is a hybrid of an installment sale and a private annuity.[2] Typically, SCINs are used to transfer a family business or other valuable assets to lower generations without incurring gift or estate tax liability. Often, a parent sells assets to a child in exchange for a note entitling her to regular payments (at least annual) of a certain sum over a fixed number of years. The "self-canceling" part of the transaction comes from a note provision which cancels the obligation of the child to continue making payments on the note upon the death of the parent. The SCIN has no value at death and, thus, neither the property nor the note is included in the gross estate.[3] SCINs have a ghoulish taint: the SCIN is financially advantageous only if the parent dies prior to the expiration of the note's term. If the parent outlives the SCIN's term, she pays income taxes on the installments and estate taxes on the accumulated SCIN payments remaining in her estate at death.[4]

SCINs are usually intrafamily transactions. As such, they must be objectively bona fide transactions due to their potential as a tool for evading estate or gift taxes. The following example is a twist on the example given in the introduction of the auto dealership. Imagine Father selling his auto dealership to Son for $5,000,000 (current fair market value) in exchange for a SCIN with a twenty-year term at four percent interest, payable in equal yearly installments. Now imagine that the Applicable Federal Rate for long-term loans at the time of the transaction is eight percent, that Father is eighty-five years old and that he suffers from advanced terminal cancer. If effective, such terms would constitute an end-run around the gift and estate taxes – allowing the parent to reduce his taxable estate by disguising a sizeable gift under the cloak of the SCIN.[5]

A SCIN may escape transfer tax inclusion if the transaction is deemed to be bona fide and for adequate and full consideration.[6] One of the most important factors in assessing whether the SCIN represents a bona fide transaction is determining whether the value assigned to the note reflects an appropriate premium for such factors as the time value of the money (the longer the note, the higher the premium should be) and the age and health of the person whose death cancels the note.[7] The premium charged (often referred to as a "risk premium") on the note can come in the form of an above-market interest rate, or an increase in the principal.[8] As mentioned in the introduction, there are no hard and fast rules as to what an appropriate risk premium would be. It is the author's opinion that courts should give much weight to the risk premium in determining whether an intrafamily SCIN was a bona fide exchange, because appropriate pricing is the crux of a bona fide business transaction.

A. When Is an Intrafamily SCIN Appropriate?

Even if the sale for a SCIN can be arranged to satisfy the bona fide transaction requirement, an intrafamily SCIN does not always make estate planning sense. After all, the holder of the SCIN must pay income taxes on the payments received over the term of the note. Moreover, as discussed in section VI, below, the decedent's estate realizes any deferred gain upon the cancellation of the SCIN. Thus, one must ask if the income tax liability attached to the note is worth the estate and gift tax savings offered by the note.

We are already approaching a point where potential tax benefits may not obviate a SCIN, again, depending on the potential taxpayer's specific situation. In 2009 the highest marginal personal federal income tax rate was thirty-five percent[9] and the estate and gift tax rate was forty-five percent.[10] President Obama has proposed to restore the highest marginal income tax rate to 39.6%,[11] exceeding the current (temporary?) gift tax rate of thirty-five percent and approaching his proposed estate and gift tax rate of forty-five percent.[12] Given record-breaking projected federal deficits, one should note that at times individual personal income tax rates at the highest bracket reached as high as seventy percent (1980) and even ninety-four percent (1945).[13] When income taxes rise above seventy percent, it makes no sense to expose oneself to income tax when the estate and gift taxes are significantly lower.

What is less clear (given the uncertainty of the estate tax exemption going forward) but important for a practitioner to compute, is the breaking point at which the income tax approaches the estate and gift taxes so as to create a *de minimis* benefit unworthy of the costs and efforts of creating an intrafamily SCIN. Such a computation needs to be made on a case-by-case basis where the economic realities of the potential estate and gift taxpayer do not readily indicate a benefit from an intrafamily SCIN.

B. Consequences When a SCIN is Deemed Not to be a Bona Fide Transaction

There are two possible negative outcomes in cases where intrafamily SCINs are deemed not to be a bona fide transaction: the property "sold" may be pulled back into the estate, or the sale may be deemed to be a gift of the entire asset.

In cases like *Estate of Musgrove*,[14] where the decedent retained control, the entire property may be drawn back into the gross estate via IRC sections 2036 or 2038.[15] On the other hand, if there is no potentially offending right of ownership but a court finds that a bona fide transaction is lacking, it may invoke IRC section 2512 and deem the transfer a gift for less than adequate and full consideration.[16] In the former case, the full fair market value of the property "sold" is included in the decedent's gross estate.[17] Therefore, any consideration that may have been exchanged for the property has no affect on the valuation of the amount to be included in the gross estate for estate tax purposes. If the transaction is deemed a gift, the amount of the gift is the fair market value at time of transfer reduced by the amount of consideration furnished.[18] Thus, construed ownership may result in a significant difference in the transfer tax treatment of the property if a transaction is deemed by a court as not bona fide.

III. COSTANZA V. C.I.R.

As previously noted, *Costanza* is attractive to practitioners who may naturally picture themselves representing the taxpayer against the Service in Tax Court. The author hopes that the discussion below will convince such practitioners that *Costanza's* allure is a Siren that is more likely than not to lead practitioners and their clients into a costly shipwreck. First, as presented below, the author thinks the Sixth Circuit opinion is at best the exception that proves the rule, because the appeals court ignored the absent risk premium and misapplied the "clearly erroneous" standard of review. Second, accepting *Costanza's* findings, arguendo, California practitioners should keep in mind that the Tax Court, not bound by *Costanza* in the Ninth Circuit, is more likely to apply Judge Laro's analysis in *Costanza's* Tax Court memorandum. Thus California practitioners creating a SCIN modeled after the Costanzas' SCIN expose their client to costly and uncertain appeals litigation.

A. A Brief Synopsis of the Costanza Case

In 1993, Duilio Costanza died of complications following heart surgery.[19] One result of his death was the cancellation of a SCIN signed by his son, Michael Costanza, in favor of the the decedent as payment for commercial real property. The Costanza estate valued the SCIN at zero on the return, and the Internal Revenue Service ("IRS" or "Service") assessed a $297,062 deficiency corresponding to the value of the note, based on its assertion that Duilio Costanza had actually made a gift of the property to Michael.[20] The United States Tax Court agreed with the IRS, and deemed the transfer a gift, finding insufficient evidence that a bona fide, arm's length transaction occurred between Duilio and Michael.[21] The estate appealed and the Sixth Circuit reversed, finding sufficient evidence in the record to overturn the Tax Court regarding whether the SCIN constituted a bona fide transaction.[22] The Sixth Circuit remanded the case for further proceedings regarding the issue of whether the SCIN constituted a bargain sale exposing the estate to possible gift tax liability.[23]

The difference between the two courts' opinions reflects an interpretation of facts and not an interpretation of law. Both courts recognized that where SCINs are used between family members there is a rebuttable presumption that the transaction is a gift; the courts also recognized that to overcome this presumption, the taxpayer must clearly demonstrate that there existed an intent to create a debtor-creditor status.[24]

Surprisingly, neither court expressly addressed the lack of a risk premium. The paramount role of the risk premium in SCINs is taken up in more detail below in section IV. For now, suffice it to reiterate that the author believes risk premium analysis should be the *primary* threshold courts address when evaluating contested SCINs.[25] Further, the Sixth Circuit overstepped its standard of review, substituting its reasonable factual inferences for the Tax Court's reasonable factual inferences, where the standard of review for factual findings was "clear error." Given the two courts' representations of the facts as applied to the Costanzas' SCIN, the *Costanza* cases present a unique opportunity to examine the risks inherent in any SCIN transaction, illustrating the fine (and moving) line between sham and legitimacy.

B. Relevant Costanza Facts: Tax Court v. Sixth Circuit, and the Sixth Circuit's Misapplication of the Clearly Erroneous Standard of Review

The *Costanza* Tax Court memorandum decision cited several facts to support its conclusion that the transaction failed the bona fide sale exception, among them: 1) Michael Costanza altered the check dates on his SCIN payments; 2) all payments were late; 3) only one payment was made in five months on a SCIN that was payable monthly; and 4) Michael, as trustee of both his own revocable trust *and* his father's revocable trust, executed all of the documents in connection with the land sale transaction between the two revocable trusts.[26] Thus concluding, the Tax Court applied IRC section 2512(b), which provides that in a transaction like the Costanzas' exchange, the difference between Michael's consideration of $26,130 and the value of the real property constituted a taxable gift.[27]

The Sixth Circuit, unlike the Tax Court, accepted the estate's contentions that the decedent had orally changed the terms of the SCIN from monthly to quarterly payments[28] and that Duilio's life expectancy was between 5 and 13.9 years.[29] The Sixth Circuit based its finding of a bona fide transaction primarily on the testimony of Michael Costanza and the lawyer who structured the SCIN.[30] For example, regarding the dispositive issue of whether there was an intention of repayment, the Sixth Circuit cited Michael's and the attorney's testimony that there was such an expectation.[31] Accepting such facts and testimony over the trier of fact's conclusions steps beyond the parameters of the clearly erroneous standard of review, where an appeals court must use stipulated or otherwise uncontroverted facts as its basis for overturning the Tax Court, but may not substitute its own reasoned opinion for the Tax Court's conclusions of fact.[32] Here, the Sixth Circuit claimed that it was merely satisfied with one party's representations of disputed facts in its overturning the Tax Court.[33] This is not a basis for overturning the trier of fact when applying the clearly erroneous standard.

As the Eighth Circuit once noted, "the [Tax Court] is not bound to accept testimony at face value even when it is uncontroverted if it is improbable, unreasonable or questionable."[34] Thus, so long as the Tax Court was acting from a reasonable basis and there existed questionable circumstances, there was no obligation for the Tax Court to accept Michael Costanza's testimony.

Finally, the Sixth Circuit seized upon the security provided for the SCIN, opining that "the fact that the SCIN was fully secured by a mortgage on the properties further refute *any* inference that the sale was not bona fide."[35] Here, the Sixth Circuit weakened its opinion by avoiding the fact that the petitioner, standing on both sides of the transaction, executed all the transaction documents. The mortgage was executed by Michael Costanza as trustee of his revocable trust and held by him as trustee of his father's revocable trust. What if Michael were to default on his mortgage by missing 10 monthly payments for a deficiency of $87,000 plus interest, and then his father died? It would have been up to Michael Costanza as executor of the estate to join with Michael Costanza as trustee of his father's trust in a cause of action against Michael Costanza as purchaser of the property.[36] It is difficult to see how the mortgage further refutes *any* inference that the sale was not bona fide when examined under the totality of the circumstances.

The Sixth Circuit was correct to reject the Service's argument that Michael and Duilio Costanza entered into the deal expecting Duilio to predecease the term of the SCIN, and that this expectation evinced the lack of a bona fide transaction.[37] Ultimately, the parties to a SCIN are betting that one party will die before the note terminates – this is expected with SCINs.[38] However, none of the Sixth Circuit's reasonable arguments are significant enough to overcome the fact trier's findings under a "clearly erroneous" standard of review.

IV. THE RISK PREMIUM IN INTRAFAMILY SCINs

The Sixth Circuit cited an article by Banoff & Hartz for its proposition that there is no inherent tax problem caused by family members essentially betting that one of them will predecease the term of the SCIN.[39] However, both the Sixth Circuit and the Tax Court missed an important issue prominently featured in the Banoff & Hartz article with regard to whether the intrafamily SCIN is a bona fide transaction: the *risk premium*.[40] While the centrality of the risk premium is not binding law per se, and neither court was obligated to consider it, the premium issue would hopefully be addressed on remand regarding the bargain sale issue, or in similar future cases.

The Banoff & Hartz article asserts that a valid SCIN *must* include a risk premium to compensate the seller for the risk of cancellation by death.[41] The risk premium comes in two forms: an elevated interest rate or an inflated principal.[42] Banoff & Hartz point out that the risk premium differentiates a SCIN from a traditional installment note, which does not terminate until the term of years is completed.[43] In his article, Drake cites *Estate of Musgrove* for the proposition that the risk premium must take the "terminating life's"[44] health into account in order to constitute a bona fide transaction.[45]

Let us take a moment to harken back to the example in Section 1, *supra*, of Mother selling her auto dealership in exchange for a note. Recall that the fair market value of the dealership was $5,000,000, Mother was seventy-five years old and in average health. That example hypothesized an eight year note with a mid-term quarterly AFR + 5%. Another option might have been to leave the interest at the proper mid-term quarterly AFR on, say, a $6,000,000 note – inflating the principal. Assuming this risk premium would pass muster with the Service, one would, in simplistic terms, add to or subtract from the interest and/or principal in concert with shifting facts. Thus, if Mother has a chronic illness, a risk premium in the interest rate could be AFR + 7.5%. Alternatively, adding the risk premium to the principal might cause the principal to be $6,500,000. The basic concept is essentially analogous to many accepted instruments, such as life annuities or term life insurance policies.

One would like to have seen this issue directly addressed by either the Tax Court or the Sixth Circuit in *Costanza*. Neither the courts nor the parties noted any risk premium built into the *sale price* of the property. Therefore, the risk premium should have been reflected in the *interest rate* charged. The Costanza SCIN interest rate started at 6.25% and increased by one-half percent over the eleven-year period, to average out at 7.392% over the term.[46] The Applicable Federal Rates for long-term monthly and quarterly loans at the time were 7.61% and 7.66% respectively[47] Yet, only the Tax Court, in passing, noted the lack of a risk premium.

A. Estate of Musgrove v. U.S.—Lack of Risk Premium Poster Child

Musgrove[48] illustrates just about everything one could do wrong with an intrafamily SCIN transaction. The primary players in *Musgrove* were the decedent, Sebe Musgrove, his son and executor, Stanley Musgrove, and Sebe's predeceased daughter, Naomi Ruth Stevens.[49] Stanley Musgrove was also Naomi's estate's personal representative.[50] After learning that Naomi's estate would owe some $300,000 in estate taxes, Sebe and Stanley Musgrove desired to pay the taxes without selling property in Naomi's estate.[51] On September 5, 1980, father and son entered into an *interest-free* promissory note in favor of Stanley for $300,000 with a cancel-upon-death clause.[52] On December 16, 1980, after becoming aware of the actual estate taxes owed on Naomi's estate, Sebe Musgrove arranged the availability of $251,540 pursuant to the note to allow Stanley to pay the estate taxes.[53] Sebe died on January 2, 1981.[54] The Service included the full $251,540 in Sebe Musgrove's estate and the estate, having paid estate taxes on that inclusion, brought action in the Court of Claims to recover $99,381.94 overpaid taxes.[55]

The *Musgrove* court provided a well reasoned analysis in its opinion. First, the court pointed out that the Supreme Court has made it clear that common law consideration often illustrated in first-year contract law classes by *Hamer v. Sidway*[56] is not what Congress intended when contemplating transactions like SCINs.[57] The court then held out a "smoking gun" with regard to Sebe Musgrove exercising ownership interests, which resulted in the money being pulled back into the estate via IRC section 2035.[58] The "smoking gun" was a letter written by Sebe's attorney addressing an understanding that the son would "not use any of the monies for any other purpose without prior approval from [the father.]"[59] The *Musgrove* court concluded that there was no subjective intent of repayment citing, among other facts, Sebe's health when the note was executed.[60] Thus, there was no consideration given for the note, the decedent held an interest in the money, and there was never an intent of repayment. These facts epitomize the lack of a bona fide transaction as discussed in Section II, above.

This is not to say that a bona fide transaction was not possible for the Musgroves: by having an adequate risk premium and removing all ownership interests, the Musgroves may have been able to create a bona fide transaction. Instead, the Musgrove SCIN reflected no risk premium. Given Sebe's health, the Musgroves should have added a premium to the loan in order to create an objectively bona fide transaction. On the other hand, Sebe Musgrove's health may have been so poor as to eliminate any reasonable expectation of repayment, in which case there may have been no way for him to avoid gift or estate taxes on the note. However, as *Costanza* illustrates, the fact that Sebe Musgrove happened to have died shortly after executing the transaction is not dispositive regarding the bona fide transaction issue. For the amount of money spent in creating the loan and prosecuting the case against the Service, the Musgroves may have been able to create a bona fide SCIN with an appropriate risk premium and a real expectation of repayment.

B. Lack of Risk Premium in the Costanza SCIN

What stronger evidence is there for a bona fide transaction than the consideration bargained for in a contract? The Sixth Circuit indirectly (and perhaps inadvertently) brought the risk premium issue up by citing the Banoff & Hartz article.[61] The Tax Court in *Costanza* might possibly have avoided a reversal by focusing more on the lack of a risk premium. However, given the Sixth Circuit's liberal interpretation of "clear error" in this case, it is also possible that the Sixth Circuit would have disregarded analysis of a risk premium in the appeal.[62] The Costanzas' SCIN offered no risk premium taking into account the risk that Duilio Costanza would die within eleven years. While the Tax Court did note the interest rate, it failed to mention expressly that the rate was *below-market*.[63] Likewise, while the Tax Court noted that the principal for the SCIN was the approximate fair market value of the properties,[64] it failed to directly note the lack of a risk premium.

Although the presence of full and adequate consideration is not purely dispositive in analyzing bona fide transactions, the nexus between consideration and a true expectation of repayment should be so closely connected that consideration in the form of a risk premium should be pivotal to the determination of whether a SCIN is bona fide. When one looks to objective facts indicating a true expectation of repayment, the fact that family members failed to structure an adequate risk premium consideration into a SCIN should be strong evidence that a bona fide transaction is lacking with regard to other expectations of an arms-length transaction. The Tax Court would have done a service by including such discussion, because it could have forced the Sixth Circuit to address the issue head on.

V. REMAND ON THE BARGAIN SALE DETERMINATION FOR THE COSTANZAS

Because the Tax Court determined in *Costanza* that the transaction was not a bona fide transfer, it never addressed the Service's alternative argument that the sale of property in exchange for a SCIN was a bargain sale. The essence of the Service's alternative argument was that the value of the SCIN was so far below fair market value for the properties as to constitute inadequate consideration pursuant to Section 2512.[65] Whereas the issue in the Tax Court was whether the SCIN was a bona fide transaction between Michael and Duilio Costanza with regard to the expectation of repayment, the issue on remand will be whether the consideration for the SCIN was adequate and full.[66] Thus, the primary difference between the Tax Court's conclusion discussed throughout this paper and its conclusion on remand, should it find that a bargain sale existed, will be the formula used for determining the amount of gift taxes owed on the transfer. For example, if the SCIN is determined to have been worth one-half the value of the properties, the difference (less the money Michael Costanza paid his father) will be taxed as a gift (after deductions and credits are applied).

Because the SCIN included no risk premium, it fails as full and adequate consideration. This is especially true under the circumstances of Duilio Costanza's age and relatively poor health. As argued above, where the presumption is that the intrafamily SCIN was not a bona fide transaction, the issue of adequate and full consideration impacts whether the transaction was bona fide: the two issues are separate, but they are not unrelated. This is why the Tax Court applied Section 2512(b) after determining that the SCIN was not a bona fide transaction between the Costanzas.[67]

Nevertheless, the Sixth Circuit bifurcated the issues of evaluating bona fide transactions and determining valuation. At its heart, the determination of whether a transaction was bona fide inserts a state of mind element to the transaction, because it requires courts to subjectively determine whether there was an "intrafamilial wink" regarding the deal. On the other hand, an objective bargain sale determination requires no investigation into the parties' state of mind. Following Congress' directive, the court looks at the terms and subtracts the amount of the transaction from the fair market value of the property to arrive at the value of the gift.[68] In *Costanza*, the inadequate consideration is important evidence, *in addition to the circumstances*, of a transaction that was not bona fide. However, one may imagine a situation where the terms and value of an intrafamily SCIN are, say, 10% less than fair market value and the deal had all the other markings of an arms-length transaction. Harkening again to the hypothetical example of the auto dealership in Section I, *supra*, a valuation of $4,500,000 for the dealership may represent an honest and reasonable difference in valuation techniques for a closely held family business. In such a case, it would be unjust to construe the "gift" as the difference between the consideration actually paid and the fair market value of the property, if the "terminating life" happened to end early.

VI. INCOME TAX TREATMENT OF THE SCIN FOR DUILIO COSTANZA'S ESTATE

As *Costanza* stands, Duilio successfully removed the property from his estate in exchange for a SCIN that was cancelled at his death. With his estate reporting the SCIN as having no value, in total he received $26,130 in gross income for his $830,000 worth of properties. Does this mean that Duilio Costanza's estate (or Duilio himself) owes no income taxes on the worthless note? "No!" says Congress as it implements IRC sections 453B and 691. *Estate of Frane v. Comr.*[69] addresses the inquiry of how the cancelled Costanza SCIN will be treated for income tax purposes.

In *Frane* the decedent, at age fifty-three, sold his family business to each of his children in exchange for twenty-year SCINs at 12% interest, payable annually.[70] Mr. Frane died after receiving only two of the annual payments from his children and his estate recognized only the income from the payments themselves on his income tax returns.[71] The Service issued a notice of deficiency, claiming that a gain from the SCINs should have been reported either on the decedent's final income tax return or on his estate's income tax return.[72] The Tax Court concluded that a gain was recognized upon the decedent's death for the notes, and held that Frane (as opposed to the estate) was liable for the income tax owed on the SCINs.[73] The Eighth Circuit agreed with the Tax Court that income was realized on the SCINs, but held that the income should be recognized by the estate, rather than on the decedent's final income tax return.[74] This distinction is important, because income taxes paid by a decedent are deductible against estate taxes under IRC section 2053(a)(3), but income taxes paid by the estate are not so recognized.[75]

The Estate argued that no income was realized as a result of the worthless cancelled note.[76] The Eighth Circuit disagreed, because the "Internal Revenue Code specifically provides that 'if any installment obligation is canceled or otherwise becomes unenforceable,' and the obligee and obligor are related persons, it shall cause the obligee to recognize income equal to the difference between the basis of the obligation and its face value."[77] Thus, the *Frane* court reasoned, income is clearly recognized by statute for the difference between the face value of the SCIN and any remuneration received per the SCIN.[78]

With regard to who should realize the gain (the decedent or his estate), the court turned to IRC section 691, which is given effect in IRC section 453B:[79]

> If a right . . . to receive an amount is transferred by the estate of the decedent . . . by reason of the death of the decedent . . . there shall be included in the gross income of the estate . . . for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value[.][80]

The *Frane* court looked at this provision in conjunction with IRC section 691(a)(5)(A)(iii), which provides, "In case of an installment obligation reportable by the decedent on the installment method under section 453, . . . any cancellation of such obligation occurring at the death of the decedent shall be treated as a transfer by the estate of the decedent . . . ." Since the transfer is made by the estate and the statute provides that the income is reported in the estate's gross income, the Eighth Circuit concluded that the estate must report the gain as income.[81]

VII. CONCLUSION

Intrafamily SCINs can be an excellent tool for transferring property to family members at a reduced transfer tax cost. Before recommending a SCIN, the planner should consider issues like income tax versus estate tax rates, especially given current and future possibilities of a thirty-five percent gift tax and higher income taxes. Most important, however, a sale to a family member in exchange for a SCIN must be carefully structured and implemented to avoid any IRS attempt to pull the property back into the estate because the sale for SCIN was not a bona fide or not in exchange for full and adequate consideration.

The *Costanza* case illustrates the moving boundary between a successful SCIN and one that fails to pass muster. In the author's view, the Costanza estate was fortunate that the Sixth Circuit improperly applied the "clear error" standard of review and reversed the Tax Court. Although the author disagrees with the Sixth Circuit's findings of fact, the law on SCINs is clear: for an intrafamily SCIN to overcome the presumption of a gift, there must be a bona fide transaction with an affirmatively demonstrated expectation of repayment, supported by full and adequate consideration. If a court finds the transaction was not bona fide, the parties risk pulling the entire property back into the estate for estate tax purposes. This may happen if a court finds that there were terms consisting of actual or constructive ownership by the party selling the property (usually the parent). Otherwise, a court may find that a SCIN lacking the indicia of a bona fide transaction was a gift and the donor (or her estate) may be liable for gift taxes on the difference between any consideration received and the value of the property at death.

A real debtor-creditor relationship between the family members is necessary to pass the first hurdle of scrutiny in a court determining whether the SCIN transaction was bona fide. There must be objective evidence that the debtor has the means, intent and plan to repay the loan. Courts strongly emphasize consideration when evaluating whether an intrafamily SCIN is bona fide. Because of the statutory presumption that intrafamily SCINs are gifts, an intrafamily SCIN should be *more* "bona fide" than a true arms-length SCIN might be between strangers. Whereas a stranger might offer a discount to a buyer if the buyer makes certain guarantees (e.g., only use local suppliers for a term of years), such an offer may and should be viewed as evidence of a less than bona fide transaction between family members due to the risk of an "intrafamilial wink."

The opinions in the *Costanza* cases notwithstanding, the risk premium should be central when evaluating whether an intrafamily SCIN is a bona fide transaction. Consideration is the heart of a contract and the lack of a risk premium is akin to inadequate consideration which, in turn, is strong evidence that a true debtor-creditor relationship is absent.

A risk premium must account for the risk that the terminating life will expire before the SCIN matures. Otherwise there is no difference in consideration from a regular installment note. Without a risk premium the SCIN does not constitute adequate and full consideration and is, therefore, not indicative of the arms-length business transaction. Nevertheless, there is no problem with "betting" that one party will die before the termination of the SCIN. This is actually the point of a SCIN and courts have upheld the legitimacy of SCINs in this regard.

If a taxpayer fails to create a bona fide transaction via proper valuation and risk premiums and a manifest subjective creditor-debtor relationship, she risks paying more for the transfer than she would have if she had just given the property away and paid full gift taxes.

The same goes for adequate and full consideration. This is because she will have added the cost of creating the SCIN to the accrual of both gift and income taxes due to a poorly drafted SCIN.

Practitioners should keep in mind that there is no guidance by the Service as to how a valid SCIN is executed. Therefore, one cannot take too much care in designing a SCIN. An opinion from a neutral party should help to bolster the effectiveness of a practitioner's SCIN. If the property is valuable enough, a private letter ruling may be a prudent safeguard.

Finally, a valid SCIN cancelled as a result of death is taxable to the estate as income. Because the estate, as opposed to the decedent, is taxed, the income tax on an intrafamily SCIN cancelled by the terminating life's death is not deductible against the estate tax. This is another consideration planners must take into account when deciding whether an intrafamily SCIN is proper for a potential taxpayer.

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ENDNOTES

1. *Estate of Costanza v. Commissioner* (6th Cir. 2003) 320 F.3d 595 (hereafter *Costanza Appeal*).

2. See Kalb & Hirsch, *Planning for the Principal Owner: Deciding upon the Appropriate Income Tax Planning and Estate Planning Techniques for the Principal Owner* (Feb. 21-23, 2008) (American Law Institute-American Bar Association 2008) § V (hereafter, "ALI Article").

3. See *Estate of Moss v. Commissioner* (1980) 74 T.C. 1239, 1247.

4. See Drake, *Transitioning the Family Business* (2008) 83 Wash. L.Rev. 123, 187.

5. The income tax treatment of *bona fide* SCINs cancelled by death is discussed in § VI, *infra*.

6. *Estate of Costanza v. Commissioner* (2001) 81 T.C.M. (CCH) 1693 at p. 3 (hereafter *Estate of Costanza*).

7. See Drake, *supra, Transitioning the Family Business* (2008) 83 Wash. L.Rev. 123, at p. 186.

8. See Banoff & Hartz, *New Tax Court Case Expands Opportunities for Self-Canceling Installment Notes* (1992) 76 J. Tax'n 332, 332-33.

9. See Instructions 1040 U.S. Individual Income Tax Returns, Cat. No. 11325E (IRS), at 92, *available at* http://www.irs.gov/pub/irs-pdf/i1040.pdf.

10. See IRC, §§ 2001(c) and 2502(a).

11. See Department of the Treasury, February 2010, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, at p.127 (herafter, "Green Book"), *available at* http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf. The highest marginal tax rate in the 1990s was 39.6% for individuals earning between $89,150 (in 1993) and $283,150 (in 1999). See *Personal Exemptions and Individual income tax rates, 1913-2002* (IRS), at 220, *available at* http://www.irs.gov/pub/irs-soi/02intpetr.pdf [hereafter Tax Rates 1913-2002].

12. Green Book, *supra*, at p. *i*, fn. 1.

13. See Tax Rates 1913-2002, *supra* note 11, at 219.

14. *Estate of Musgrove v. United States* (1995) 33 Fed. Cl. 657.

15. See generally *Estate of Musgrove, supra,* 33 Fed. Cl. 657 (granting summary judgment in favor of the United States where facts indicated no intent to repay the loan and decedent-parent died within four months of signing the self-canceling note).

16. See Section III. (imposing a gift tax on the transaction when the Tax Court deemed the Costanzas' SCIN not to be a bona fide transaction, but not finding that Duilio Costanza retained constructive ownership).

17. IRC, § 2035(a)(2).

18. IRC Section 2512(b) provides:

    Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

19. See *Costanza Appeal*, *supra*, 320 F.3d at p. 596.

20. See *Estate of Costanza*, *supra*, 81 T.C.M. (CCH) 1693 at p. 1. The author occasionally refers to the parties by their first names, because they both have the same last name. No disrespect is intended toward the parties.

21. *Id*. at p. 4.

    The Service originally argued that the decedent retained an interest in the transferred property and that, therefore, the property should be included in the gross estate under IRC § 2036(a)(1), but this argument failed in the Tax Court. Since the Tax Court did not agree with the Service that Duilio had made a revocable transfer, it applied IRC § 2512(b), which applies to gifts made for less than full and adequate consideration. See *Estate of Costanza*, *supra*, 81 T.C.M. (CCH) 1693 at p. 4. Gift taxes theoretically function as a remedy to potential abuses with regard to estate and income taxes, such as the type the Tax Court found regarding Michael's consideration for the note. See Richard B. Stephens, et al., *Federal Estate & Gift Taxation (8th ed. 2002),* paragraph 9.01.

22. See *Costanza Appeal*, *supra*, 320 F.3d at p. 598.

23. See *id*. at p. 599.

24. See *id*. at p. 597 (citation omitted); *Estate of Costanza*, *supra*, 81 T.C.M. (CCH) 1693 at p. 3 (citation omitted).

25. In the author's view, the Tax Court memorandum by Judge Laro was well reasoned, and under prevailing law the inclusion of a risk premium analysis was not necessary. Therefore, the assertion that the risk premium should have been part of the analysis is meant to indicate that such inclusion would have been helpful and should become necessary, but not that it was legally necessary given the fact that no legal precedent requires such analysis.

26. See *Estate of Costanza*, *supra*, 81 T.C.M. (CCH) 1693 at p. 4.

    The Tax Court lays out details regarding Duilio's health that further evidence that, among other details, the parties knew that Duilio was in exceptionally poor health and was going to undergo a second heart bypass surgery shortly after the exchange of the note for the real property. See *id*. at pp. 1, 2.

    The Tax Court further noted that Michael, as trustee of his father's trust, executed the documents necessary to transfer that trust's interest in the restaurant and shopping center properties to himself. Although he did so with the full understanding and consent of his father, *the transfer took place without an objective showing by either of them that they meant to enforce the payment provisions of the transfer*. To the contrary, the haphazard and, at times, contradictory manner in which Michael undertook to make payments to his father falls short of establishing that there was a valid arm's-length sale of the commercial properties involved.

    Id. at 4 (emphasis added).

    During the trial, Michael Costanza admitted that "he did not know how he, as trustee of decedent's trust and therefore seller's representative, could have enforced a collection of the installment note against himself as the obligor of the note." Brief for the Appellee (Final) at 24, Costanza v. C.I.R., 320 F.3d 595 (No. 01-2207) (citing the trial transcript).

27. See *Estate of Costanza*, *supra*, 81 T.C.M. (CCH) 1693 at p. 4.

28. See *Costanza Appeal*, *supra*, 320 F.3d at p. 595.

29. See *Id*. 13.9 years happens to be the exact life expectancy of a typical 73-year old per one of the Service's actuarial tables. *See* Treas. Reg. § 1.72-5 (1986) (TABLE V—ORDINARY LIFE ANNUITIES ONE LIFE—EXPECTED RETURN MULTIPLES). This is one of the tables used for determining the proper value of a SCIN. *See* ALI Article, *supra* note 2.

30. See *Costanza* Appeal, *supra*, 320 F.3d at p. 597-98.

31. See *Costanza* Appeal, *supra*, 320 F.3d at p. 597.

32. See, e.g., *Commissioner. v. Duberstein*, (1960) 363 U.S. 278, 291.

> Where the trial has been by a judge without a jury, the judge's findings must stand unless 'clearly erroneous.' A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.' The rule itself applies also to *factual inferences from undisputed basic facts*, as will on many occasions be presented in this area. And Congress has in the most explicit terms attached the identical weight to the findings of the Tax Court. (emphasis added) (citations and quotations omitted).

33. See *Costanza Appeal*, *supra*, 320 F.3d at p. 597-98.

34. *Banks v. Commissioner*, (8th Cir. 1963) 322 F.2d 530, 537 (citations omitted).

35. *Costanza Appeal*, *supra*, 320 F.3d at p. 598 (emphasis added).

36. See *supra* note 27 (regarding Michael's testimony at trial about this type of scenario).

37. See *Costanza Appeal*, *supra*, 320 F.3d at p. 598.

38. See *Id*.; Drake, *supra* note 4.

39. See *Costanza Appeal*, *supra*, 320 F.3d at p. 598 (citing, generally, Banoff & Hartz, *supra* note 8).

40. *See* Banoff & Hartz, *supra* note 8, at pp. 332-33.

41. See *Id*. at p. 332; Drake, *supra* note 4.

42. See Banoff & Hartz, *supra* note 8, at p. 332; ALI Article, *supra,* note 2, § V.B.3.

43. See Banoff & Hartz, *supra* note 8*,* at p. 333.

44. Generally it is the parent/seller whose death cancels the obligation on a SCIN. The term "terminating life" in this instance illustrates the fact that, really, any person's life may be used in such a way in a SCIN so long as the terms are valid and equitable.

45. See Drake, *supra* note 4 (citing *Estate of Musgrove v. U.S., supra*, 33 Fed. Cl. at p. 658).

46. See *Id*.

47. *Available at* Pillsbury Tax Page http://pmstax.com/afr/ (follow "Search AFRs" hyperlink).

48. *Estate of Musgrove, supra*, 33 Fed. Cl. 687

49. See *id.* at p. 658.

50. See *id*.

51. See *id*.

52. See *id*.

53. See *id*. at p. 659.

54. See *id*.

55. See *id*. at pp. 658-59.

56. (N.Y. 1891) 27 N.E. 256. In *Hamer* the court found that an agreement between an uncle to pay his nephew $5,000 in exchange for the nephew's forbearance from otherwise legal activities (e.g. drinking alcohol and gambling) for a term of years was enforceable as a contract with adequate consideration. While the uncle in *Hamer* felt that the satisfaction of knowing his nephew was living a "clean" life was worth $5,000 to him, the IRS today would not consider this an exchange for gift and estate tax purposes.

57. See *Estate of Musgrove, supra*, 33 Fed. Cl. at pp. 663-64.

58. See *id*. at p. 666, applying IRC 2035(a) as it stood in 1980, prior to the 1982 amendment which restricted the three-year pull-back only to "property that would have been included in the decedent's gross estate under section 2036, 2037, 2038 or 2042 if such transferred interest or relinquished power had been retained by the decedent on his the date of his death…." IRC, § 2035(a)(2).

59. *Id*.

60. See *id*. at p. 669.

61. Banoff & Hartz, *New Tax Court Case Expands Opportunities for Self-Canceling Installment Notes* (1992) 76 J. Tax'n 332, 332-33.

62. See*, supra*, § III.B.

63. See *Estate of Costanza*, *supra*, 81 T.C.M. (CCH) 1693 at p. fn. 2 (AFR was 7.61% (monthly) or 7.66% (quarterly) while the Costanza's SCIN averaged to 7.392% over the eleven-year term); Cf. *Frane*, *infra* (similar facts to *Costanza*, but the parties identified a risk premium pursuant to their agreement).

64. *See Estate of Costanza*, *supra*, 81 T.C.M. (CCH) 1693 at p. 1.

65. See Brief for Appellee, *supra*, note 27 at fn. 10.

66. No case on remand appears in a Westlaw search. Thus, it appears that the case was likely settled privately or voluntarily dismissed after the appeals court decision.

67. See *Estate of Costanza*, *supra*, 81 T.C.M. (CCH) 1693 at p. 4 ("Under these circumstances, we believe that the provisions of section 2512(b) are dispositive . . . decedent's transfer to Michael was a gift to the extent that it exceeded the consideration actually paid.").

68. See *Commissioner v. Wemyss* (1945) 324 U.S. 303, 306 (discussing how Congress expressly removed donative intent as an element for determination of gifts).

69. *Estate of Frane v. Commissioner* (8th Cir. 1993) 998 F.2d 567.

70. See *id*. at pp. 568-69. The Frane children expressly mentioned that 12% was an above-market-rate premium. See *id*.

71. See *id*. at p. 569.

72. See *id*.

73. See *id*.

74. See *id*. at p. 572.

75. See Banoff & Hartz, *supra* note 8, at p. 335.

76. See *Estate of Frane*, *supra*, 998 F.2d p. 569.

77. *Id*. (citing IRC §§ 453B(a),(f) (Supp. III 1991)).

78. See *Id*. at p. 572.

79. IRC, § 453B(c) provides, "Except as provided in section 691 . . . this section shall not apply to the transmission of installment obligations at death." Thus, it is apparent that Congress had SCINs in mind when they authored these provisions. Note that in § 453B(f)(2) Congress expressly recognizes a bias regarding intrafamilial installment notes.

80. IRC § 691(a)(2) (1981).

81. See *Estate of Frane*, *supra*, 998 F.2d p. 572.