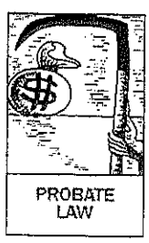
Self-Canceling Installment Note Can Be Powerful Planning Tool

By Bruce Givner

A self-canceling installment note is a promissory note with a special feature: If the payee dies before the note is paid in full, the unpaid balance is canceled. Parents commonly use self-canceling installment notes to transfer property to their children. The principal advantage is that, when the payee/parent dies, because the note is canceled, nothing is included in the parent's estate. If the parent dies before the note is paid in full, the asset has been transferred to the children at a significantly reduced cost, saving estate tax.

To be respected by the Internal Revenue Service and to avoid gift tax as a bargain sale, the cancellation feature (called a "mortality risk premium") must be paid for by the payee by either a premium price or a premium interest rate.

Example: Mom, 70, has an apartment building worth $1 million. She wants to transfer it to her son in such a way as to have the chance to reduce her taxable estate. A relatively current life expectancy table lists mom's life expectancy as 17 years. However, she believes that, because of her various ailments, she will not make it to 75. Mom transfers the property to her son in exchange for a promissory note that requires monthly payments (and amortization) over a 14-year period.



The principal advantage is that, when the payee/parent dies, because the note is canceled, nothing is included in the parent's estate.

Assume that money can earn 2 percent risk free and that the applicable federal rate, Internal Revenue Code Section 7520(a)(2), is 3.8 percent. With level principal payments, the interest rate on the $1 million note would be 7.474 percent.

In other words, the son would be paying an extra 5.474 percent for the cancellation feature. If the mortality risk premium is reflected in the price, the note would still bear interest at 2 percent, but the face amount would be $1,411,361.18, instead of $1 million. In other words, the son would be paying an extra $411,361.18 for the cancellation feature. See Stephen R. Leimberg & Robert T. LeClair, "Estate Planning Tools Version 2002.00" (Brentmark Software Inc. 2002).

If the son makes one year of payments and the mom dies, the son owns the property free and clear. Neither the property nor any remaining note value ($928,571 if an interest rate premium; $1,310,550 if a principal premium) is included in the mom's estate. As a result, more than 90 percent of the value of the asset has been excluded from the mom's estate.

The earliest case in which a court sustained the estate-tax exclusion for a self-canceling installment note occurred in 1932. *Austin v. IRS*, 26 BTA 1216 (1932). The first "modern" case was *Cain v. Commissioner*, 37 TC 185 (1961). In *Cain*, the taxpayer's stock was redeemed by a family corporation for a self-canceling installment note. At her death, the IRS argued that the balance should be included in the decedent's estate as a transfer with a retained life estate under Internal Revenue Code Section 2036. According to this view, the decedent transferred the sales price (that is, her stock) to the corporation and retained a right to a return on it (that is, the installments) until her death.

Under Section 2036, the value of property that a decedent transfers for less than full consideration is includable in the estate if, under the transfer's terms, the decedent retained for life, for a period not ascertainable without reference to the decedent's death, or for any period that does not end before the decedent's death, one of the following: the possession or enjoyment of, or the right to the income from, the property; or the right, alone or in conjunction with any person, to designate the people who will possess the property or its income.

The Tax Court held that nothing had been transferred to the corporation for less than full consideration and that nothing should be included in the decedent's estate.

Until now, the leading self-canceling installment note case was *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980). There, the decedent sold stock in his business and received self-canceling installment notes from his corporation. The IRS argued that, at his death, the decedent had an interest in the notes and that the unpaid principal was includable in his gross estate under Section 2033. That section includes in an estate the value of all property to the extent of decedent's interest at death.

The Tax Court disagreed, noting that the cancellation provision was part of the agreed terms for the notes and could not be revoked unilaterally during the decedent's life. Further, the court found the notes analogous to an annuity or life estate for the term of the decedent's life, both of which become worthless at death and are not includable in the estate. The court said that, although the stock's book value was $440 per share, the decedent sold it for $800 per share: "This supports our conclusion that the cancellation clause was not intended as a Will substitute and provided part consideration for the purchase price."

In *Estate of Costanza*, T.C. Memo. 2001-128 (June 4, 2001), as in so many other recent Tax Court decisions with anti-taxpayer results, the taxpayer was not a healthy person. Duilio Costanza, 73, had had a heart attack in 1978, had undergone bypass surgery in 1982 and had been suffering with angina and severe coronary disease since April 1991. So he decided to retire.

He conveyed two properties to his son Michael. On Dec. 15, 1992, Michael signed an 11-year self-canceling installment note, secured by a mortgage on both properties. Costanza's life expectancy was 15 years.

Although the note called for monthly payments, Costanza told Michael to pay quarterly. Michael made the January, February and March 1993 payments on March 8 and never made another. Costanza underwent a second coronary bypass on May 11 and died. Michael excluded the properties and any value for the note from his father's estate tax return. The IRS asserted a $300,000 deficiency.

The Tax Court noted the "rigid scrutiny" to which intrafamily transactions are subject. An intrafamily sale of property is presumptively a gift "absent an affirmative showing that there existed at the time of the transaction a 'real expectation of repayment.'"

The Tax Court construed every fact against the taxpayer: "[T]he documents giving effect to the transfer were all executed after December 15, 1992, but were backdated to suggest that they had been signed on that date"; "[a]ll 3 payments were untimely"; "Michael changed the dates he had written on all 3 checks"; and although Costanza lived until May, no payments were made after March.

On appeal, in *Costanza v. Commissioner of Internal Revenue*, 2003 U.S.App.LEXIS 2935 (6th Cir. Feb. 19, 2003), the 6th U.S. Circuit Court of Appeals began by enunciating the standard for re-examining facts: the "clearly erroneous" standard. The court construed every fact in the taxpayer's favor. The court first held that "[a] brief delay in execution after the stated date of 12-15-92 was simply due to the attorney's need to pick a date upon which to base an amortization schedule where the documents were to be circulated by mail for signature. The fact that all of the documents were signed within several weeks ... is thus entirely inconsequential."

The court also held the following: The payments were not untimely because Costanza had told Michael to make the payments quarterly "to ease the burden of having to deposit 1 check every month"; Michael redated the checks "so as to clearly document the months for which Note payments had been made"; and, finally, and most important, "it is not surprising that Michael did not make another payment on the note after tendering the 3 checks in March. The next quarterly payment would not have taken place until June, which was after [Costanza] had died."

Although the self-canceling installment note's estate-tax benefits are secure, the income-tax result remains uncertain. In *Frane v. Commissioner*, 98 F.2d 567 (8th Cir. 1993), aff'g in part and rev'g in part, 98 T.C. 341 (1992), the 8th Circuit affirmed the Tax Court's holding that a self-canceling installment note resulted in taxable income on the obligee's death. Even if the income-tax issue is resolved against taxpayers, the estate-tax benefit alone may justify using a self-canceling installment note.

Self-canceling installment notes and private annuities are similar: Both represent payment obligations that terminate on the payee's death. However, each has disadvantages compared to the other. For example, private annuity payments are nondeductible, while at least the interest portion of a self-canceling installment-note payment may be deductible interest and does not end as long as the payee/parent is living.

Self-canceling installment note payments may end if the payee/parent survives the note's term. By contrast, self-canceling installment-note payments are higher than private annuity payments.

In our example, the first-year principal and interest was $146,169 with an interest premium or $129,039 with a principal premium, compared to $99,883 under a private annuity. Other differences should be examined when considering the use of these techniques, for example, the payee/parent can retain a security interest in the transferred property under a self-canceling installment note but not under a private annuity.

Self-canceling installment notes are powerful tools in the estate tax planner's arsenal. The 6th Circuit's sympathetic view of the taxpayer's motives, resulting in a rebuff of the IRS' effort to circumscribe this technique, is welcome news.

Bruce Givner is an estate-planning attorney in Los Angeles.