

*IRS: SCIN Valuation Must Account for Life Expectancy,  
Medical History of Creditor*

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The IRS made headlines last year when it assessed a \$2.8 million tax deficiency against the Estate of former Detroit Pistons owner and industrialist William Davidson. A substantial portion of that tax deficiency arises from the Estate's alleged undervaluation of self-cancelling installment notes (SCINs), which were issued to Davidson by his various trusts in exchange for corporate stock and other property. While the Estate's challenge to the deficiency is pending, the IRS has expressed its litigation position as to the proper valuation of SCINs in Chief Counsel Memorandum 201330033 (the "CCM"), which differs from the valuation method currently used by many planners.

Section 2512(b) of the Internal Revenue Code provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift that is included in the amount of gifts made during the calendar year. Accordingly, where a SCIN serves as consideration and is worth less than the property received, the deficiency is subject to gift tax. Thus, to avoid gift tax, proper valuation of the SCIN is crucial.

Davidson and the CCM decedent both contributed property to grantor trusts in exchange for SCINs, in part, as a means of avoiding gift tax. As the name implies, SCINs cancel upon the death of the creditor. To equalize the transaction and obviate any inference of donative intent, the debtor pays a premium for the self-cancelling feature, typically in the form of heightened interest rates, face amounts in excess of the value of property received, or a balloon payment. When the value of the SCIN issued equals the value of the property transferred, there is no gift tax to the creditor.

The CCM estate valued the SCINs at issue using the mortality tables prescribed by IRC § 7520. The IRS takes the position, however, that the § 7520 tables only apply to valuation of annuities, life or term interests, and remainder or reversionary interests; the tables do not apply to valuation of SCINs. Rather, the IRS posits that SCINs should be valued according to the willing-buyer willing-seller standard expressed in Treasury Regulation § 25.2512-8, and should take into consideration the decedent's life expectancy and medical history on the date of the transaction. Unlike the § 7520 table method, establishing the arms-length market value of a SCIN under the willing-buyer willing-seller standard will likely require an appraisal. A federal court will ultimately decide which method of valuation is proper if and when the Davidson Estate goes to trial on its assessed deficiency.

The CCM also advises that, under Estate of Costanza v. Commissioner, 320 F. 3d 595 (6th Cir. 2003), a SCIN signed by family members is presumed to be a gift and not a bona fide transaction. That presumption may be rebutted only if the estate can affirmatively show that, at the time of the transaction, the decedent had a real expectation of repayment and intended to enforce the indebtedness. In Costanza, the presumption was rebutted because the decedent required a steady stream of income from the SCIN to meet his daily living expenses, and the note was structured so that the decedent would receive payments of principal and interest during his lifetime. By contrast, in the CCM facts, payments during the term of the SCIN consisted only of interest, and the decedent had

substantial assets to otherwise meet his living expenses. Moreover, because of the decedent's health, it was unlikely that the full amount of the SCIN would ever be repaid. Accordingly, the CCM SCINs were presumed gifts for gift tax purposes, and the difference between the notes' fair market value and its stated amount constituted a taxable gift.

Finally, the CCM addressed the estate tax consequences in a very limited discussion. IRC § 2033 generally provides that a decedent's gross estate shall include the value of all property to the extent that the decedent had an interest in such property at the time of his death. Pursuant to IRC § 2038, this includes the value of any interest in property which the decedent has at any time transferred (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) and that, in general terms, was subject to change at the date of his or her death through the decedent's exercise of certain powers. In this case, upon finding the SCINs were more appropriately taxed as gifts, the IRS held that there were no estate tax consequences associated with the SCINs' self cancellation feature upon the decedent's death.