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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: The IRS Renews Its Interest in Intra-Family Installment Sales.

MARKET TREND: Given IRS interest in, and review of, certain intra-family installment sales, clients considering this planning approach will need the assistance of experienced advisors.

SYNOPSIS: After a period of relative silence, the IRS has started to examine intra-family installment sales more closely, particularly those structured as self-cancelling installment notes (so-called "SCINs"). In a recently released Chief Counsel Advice memorandum and two high-profile estate tax audits, the IRS has rejected some generally accepted approaches to conducting these transactions, with an apparent focus on valuation of the notes used. A provision in recent budget proposals of the Administration, if enacted, also would impact the tax treatment of installment sales to grantor trusts.

TAKE AWAYS: Intra-family installment sales, whether to grantor trusts, non-grantor trusts or individuals, are effective legacy management and business succession planning tools.Key components to a successful installment sale plan, particularly given the renewed IRS interest, include ensuring that the value of the installment note matches the fair market value of the assets sold, and that the parties respect and comply with the note terms and payment requirements. Advisors and their clients can no longer assume reliance on the traditional use of mortality tables under the Treasury Regulations to determine the risk premium associated with SCINs or the market value of installment notes. One way to minimize the risk associated with installment sale planning is to incorporate life insurance into the plan. Making provision for an additional liquidity source upon the seller's death (or upon the buyer's death, if an individual) can ease the concerns if federal tax payments unexpectedly arise.

PRIOR REPORTS: 13-46, 13-16, 12-22.

MAJOR REFERENCES: *CCA 201330033 (July 26, 2013).*

Intra-family installment sales have long been a useful tool in legacy management and business succession planning, as they can transfer appreciating family or business assets to the next generation without imposing a significant transfer tax burden (or income tax burden if the sale is to the seller's grantor trust) on the seller.

The IRS has taken a renewed interest in challenging intra-family installment sales, including taking the position that promissory notes must be valued based on a willing-buyer willing-seller standard, as demonstrated in its recently released Chief Counsel Advice ("**CCA**") memorandum and in notices of deficiencies issued in two high-profile estate tax audits.

INSTALLMENT SALE TRANSACTIONS GENERALLY

In the standard intra-family asset sale, a client will sell a large asset, like a family business, to his children or to a trust for their benefit, in exchange for an installment (promissory) note as part of a succession plan. The sale in effect preserves the business for the next generation by removing the asset, and its future appreciation in value, from the client's estate, replacing it with a non-appreciating, fixed income note (the installment note generally bears interest at the applicable federal rate ("**AFR**") in effect for the month of the sale). If the sale is to a trust treated as a "grantor trust" for federal income tax purposes with regard to the seller, the seller will not recognize income or gain on the payments he receives. If the seller dies before the note is paid off, the balance of the note is included in his estate (rather than the family company).

In the right circumstances, the buyer and seller may elect to structure the note as a self-cancelling installment note, or a "SCIN". The distinguishing feature of a SCIN, as compared to a standard installment note, is that the note automatically terminates and the outstanding balance is cancelled if the seller dies prior to the end of the note's term, removing the value of the note from the seller's estate for estate tax purposes.[1] To avoid making a gift when selling property in exchange for a SCIN, the fair market value of the SCIN must equal or exceed the fair market value of the property sold.[2] Because of the note's mortality feature, SCIN valuations often rely on the actuarial tables under Internal Revenue Code ("**IRC**") §7520 ("**7520 tables**") to determine the note's fair market value. Unlike standard installment notes, the valuation of a SCIN must include a premium for the risk of early cancelation due to the seller's death. This so-called "risk premium" can be accomplished by increasing the purchase price, using a higher interest rate, or some combination thereof.

When structuring an installment sale, care must be taken to ensure the transaction will be treated as a bona fide sale for full and adequate consideration. Otherwise, the difference between the value of the property transferred and the deemed value of the note will be considered a gift from the seller to the buyer, causing an immediate gift tax. Indicia that the sale is bona fide and for full and adequate consideration include: (i) the ability of the buyer to pay the debt, (ii) the buyer has other assets that can be reached in the event of a default, (iii) there is a reasonable expectation of payment of the debt and an intent to enforce collection at the time of the sale, and (iv) if the note is a SCIN, the term of the note is within the seller's life expectancy.

> *SCIN Example*: T, the owner of FamCo, creates a dynasty grantor trust for the benefit of his descendants. T is 70 years old and is generally in good health. After making an initial seed gift to the trust equal to 10% of the value of FamCo, T sells his interest in the company to the trust in exchange for a 10-year SCIN, expecting the payments to provide an income stream for him. The promissory note includes a risk premium that is added to the AFR specified for the note term. The notes require annual payments of interest and principal, with all unpaid

interest and principal due at the end of the 10-year period. If T dies prior to the end of the 10-year term, the promissory note is terminated and the outstanding balance is cancelled.

CCA 201330033 - A CHANGE OF COURSE

On July 26, 2013, the IRS' Office of the Chief Counsel released CCA 201330033, which was issued as internal guidance to IRS employees with respect to an audit involving certain grantor trusts created by a deceased taxpayer. The CCA calls into question the valuation assumptions previously used by advisors in SCIN transactions.

In the year prior to his death, the decedent created a number of grantor trusts for the benefit of his family and then engaged in several sale transactions with them. In two sets of transactions, the decedent sold stock in his corporation to the grantor trusts in return for SCINs - the grantor trusts were relieved of the obligation to make further payments if the seller (the decedent) died before all payments under the notes came due. The term of each note was based on the decedent's life expectancy, as determined under the 7520 tables. Each note required only the payment of interest with principal due at the end of the term. In the first set of SCINs, a risk premium nearly equal to the value of the stock being sold, was added to the principal of the note. In the second set of SCINs, the risk premium instead was added to the interest rate. The decedent died less than six months after the transactions were completed, without receiving payments of either interest or principal on the notes.

Following the decedent's death, his estate filed a gift tax return, disclosing the stock sales but not reporting any taxable gifts resulting from the transactions. The estate tax return filed for the decedent's estate did not include any portion of the SCINs as assets of the estate.

Concluding that there was a gift when the stock was sold to the grantor trusts, the Chief Counsel rejected the use of the 7520 tables to value the SCINs, stating that those tables apply "only to value an annuity, any interest for life or term of years, or any remainder," and not to the value of promissory notes. The Chief Counsel determined instead, that the notes should be valued based on a method that takes into account a willing-buyer willing-seller standard under the federal gift tax regulations, including such factors as the decedent's life expectancy based on his medical history on the date of the transfer.

The CCA also includes the following observations regarding the SCINs:

- In general a transaction where property is exchanged for promissory notes will not be treated as a gift if the value of the property transferred is substantially equal to the value of the notes. The face value and length of payments of the notes must be reasonable in light of the circumstances. To determine whether a gift tax applies, both the value of the stock and the value of the notes must be determined, taking into consideration the notes' self-cancelling feature. If the fair market value of the notes is less than the fair market value of the property transferred to the grantor trusts, the difference in value is deemed a taxable gift.

- A SCIN signed by family members is presumed to be a gift and not a bona fide transaction. This presumption can be rebutted by showing that a real expectation of repayment and an intent to enforce collection of the indebtedness existed at the time of the transaction,[3] and that the trust issuing the note had the ability to repay the debt. In the matter discussed in the CCA, the interest only payments indicated that the decedent did not contemplate or require a steady stream of income to cover his daily living expenses. The arrangement was deemed nothing more than a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock.

- Based on the SCINs' self-cancelling feature, the balloon payment of principal, and the decedent's poor health, it was unlikely the full amount of the notes would ever be repaid, making them worth far less than their stated amounts (an approach somewhat steeped in hindsight).

THE DAVIDSON ESTATE

Recent estate tax return audits have also produced fodder for IRS challenges to intra-family installment sales. In *Estate of Davidson v. Commissioner*,[4] currently pending in the U.S. Tax Court, the estate of billionaire William M. Davidson challenged the IRS' determination that the estate owes over <u>$2.6 billion</u> in additional estate, gift and generation-skipping transfer taxes arising out of estate planning transactions carried out by the decedent prior to his death. Mr. Davidson was president, chairman, chief executive officer and majority shareholder of Guardian Industries Corp. ("**Guardian**"). At the time of the transactions, Mr. Davidson was 86 years old and had an actuarial life expectancy of about 5 years.

In January 2009, Mr. Davidson sold common and preferred Guardian stock to six trusts he had created for his grandchildren in exchange for SCINs. Each SCIN had a five-year term, with all principal due at the end of the term. Each note also included a risk premium added to principal based on the 7520 tables, which nearly doubled the face value of each note. Mr. Davidson also sold Guardian stock to his children in exchange for SCINs. Each of these notes had a five-year term with a balloon payment at the end of the term. These notes included a risk premium added to interest based on the 7520 tables.

Mr. Davidson died in March 2009 – less than 2 months after completion of the last transfer. In determining that additional taxes are due with respect to the SCIN transactions, the IRS rejects the use of the 7520 tables to value the SCINs and has taken the position that the value should instead be based on a willing-buyer, willing-seller standard,[5] taking into account the decedent's health at the time of the sale. According to the IRS, based on the decedent's health, the market value of the notes was significantly less than their face value, resulting in a gift equal to the difference between the market value of the notes and the market value of the stock.

The parties are currently scheduled to file a joint status report with the Tax Court on September 14, 2014. The outcome of the case, if not settled, could have a significant impact on the valuation of SCINs going forward.

THE WOELBING ESTATES

The IRS also has recently challenged standard installment sales to grantor trusts. In the companion Tax Court cases *Estate of Marion Woelbing v. Commissioner*[6] and *Estate of Donald Woelbing v. Commissioner*,[7] both filed on December 26, 2013, the Woelbing estates are contesting notices of deficiency issued by the IRS for $63.8 million in gift taxes and $88.4 million in estate taxes.

In 2006, Donald Woelbing sold non-voting shares of his company, Carma Laboratories Inc. ("**Carma**"), to an insurance trust in exchange for a promissory note bearing interest at the AFR for the month of the sale. At the time of the sale, the insurance trust held three life insurance policies with combined cash surrender values of about $12.6 million. In addition, the two Woelbing sons (who are beneficiaries under the insurance trust) executed guarantees for 10% of the purchase price of the stock. Donald and Marion filed gift tax returns for 2006, electing to split gifts made by either of them during 2006. Donald died in 2009, and Marion died in 2013.

The IRS asserted several grounds for its determined gift and estate tax deficiencies:

- The IRS determined that the installment sale to the trust was actually a contribution to the trust with a retained right to receive payments under the installment note. As such, pursuant to IRC § 2702, the installment note should be valued at zero, and the entire value of the Carma shares transferred to the trust should be treated as a gift.

- Alternatively, if IRC § 2702 does not apply, then the IRS asserts that the Woelbings made a taxable gift to the trust equal to the difference between the fair market value of the Carma shares transferred to the trust, and the note received in exchange (which the IRS argues is worth far less than its face value due to the artificially low and commercially unreasonable interest rate).

- Finally, the stock transferred to the trust (rather than the promissory note) should be included in Donald's estate, at its value on Donald's death, pursuant to IRC §§ 2036 and 2038 as a gift with a retained interest.

The IRS has been unsuccessful in pursuing these arguments in the past. It remains to be seen whether the IRS will succeed in this case.

PROPOSED CHANGES TO THE TAXATION OF GRANTOR TRUSTS

A proposal in the President's FY 2015 budget also would curb the use of sales to grantor trusts by coordinating the income and transfer tax rules that apply to such trusts. The proposal notes that the discrepancy in the income and transfer tax treatment creates opportunities to structure transactions between the grantor and the trust that can result in the transfer of significant wealth by the grantor without transfer tax consequences.

Under the proposal, if a "deemed owner" of a trust under the grantor trust rules (*e.g.*, a grantor of a grantor trust) engages in a sale or comparable transaction with the trust that is disregarded for income tax purposes under the grantor trust rules, then the portion of the trust property received in the transaction (including all retained income, appreciation, and reinvestments thereof, net of the consideration received by the grantor in the transaction): (i) will be subject to estate tax as part of the grantor's gross estate, (ii) will be subject to gift tax at any time during the grantor's life when his treatment as the deemed owner of the trust terminates, and (iii) will be treated as a gift from the grantor to the extent any distribution is made to another person during the grantor's life. The estate or gift tax imposed under the proposal would be paid from the trust.[8] Substantially the same proposal was included in the President's FY 2014 and FY 2013 budgets.

Such tax changes would directly impact the usefulness of installment sales to such trusts, although it appears unlikely that steps will be taken to include this proposal in tax legislation this year.

INCORPORATING LIFE INSURANCE INTO THE PLAN

In light of the IRS' renewed challenges to intra-family installment sales, insurable sellers may want to consider the use of life insurance as a complement to the plan as a hedge against the risk of unexpected gift or estate tax liabilities. In addition, life insurance (either on the seller or the seller's spouse) can be used to equalize other heirs of the seller who may not participate in the sale as part of a partial business succession to only active heirs. If the buyer is an individual, life insurance on the buyer also can protect against a potential default in the event of the buyer's early death or offset the buyer's increased estate tax exposure as the new owner of the assets.

TAKE AWAYS

- Intra-family installment sales, whether to grantor trusts, non-grantor trusts or individuals, are effective legacy management and business succession planning tools. Key components to a successful installment sale plan, particularly given the renewed IRS interest, include ensuring that the value of the installment note matches the fair market value of the assets sold, and that the parties respect and comply with the note terms and payment requirements.

- Advisors and their clients can no longer assume reliance on the traditional use of mortality tables under the Treasury Regulations to determine the risk premium associated with SCINs or the market value of installment notes.

- One way to minimize the risk associated with installment sale planning is to incorporate life insurance into the plan. Making provision for an additional liquidity source upon the seller's death (or upon the buyer's death, if an individual) can ease the concerns if federal tax payments unexpectedly arise.

NOTES

[1] *See*, *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result*, 1981-2 C.B. 1.
[2] See IRC § 2512(b); Reg. § 25.2512-8.
[3] *See*, *Estate of Costanza v. Commissioner*, 320 F. 3d 595 (6th Cir. 2003), *rev'g,* T.C. Memo 2001-128.
[4] T.C. No. 013748-13, *filed* June 14, 2013, *answer filed* August 9, 2013.
[5] See, Treas. Regs. §25.2512-8.
[6] T.C. No. 30260-13.
[7] T.C. No. 30261-13.
[8] General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (March 2014), pages 166-167.

THE ABOVE ADVICE WAS NOT WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.

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