Coordinating Income Tax Planning with Estate Planning:
Uses of Installment Sales, Private Annuities and
Self-Canceling Installment Notes

By

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§ 1000. Introduction.

Today, an almost overwhelming array of estate and income tax planning techniques are available to achieve the goals of reducing the amount subject to the Federal transfer taxes and saving income taxes.\footnote{The Federal transfer taxes include the gift tax, the estate tax and the generation skipping transfer tax. For purposes of this paper, the selling senior family member will be referred to as “Senior” and the purchasing junior family member will be referred to as “Junior.”} The estate tax planning techniques range from the simple, such as outright gifts using the recently increased $11,000 annual exclusion, as announced in Rev. Proc. 2001-59, 2001-52 I.R.B. 623, §3.19(1), to techniques practitioners view as cutting edge, such as installment sales of discounted limited partnership interests to grantor trusts. The income tax planning techniques have as their primary objective the deferral of income and, potentially, its eventual exclusion. The estate tax planning techniques have two primary objectives: (i) the creation of valuation discounts and (ii) the freezing of that discounted value as the amount exposed to the transfer taxes.

Deferred payment sales of a family business or other financial assets within a family can serve a variety of goals. In many families, there comes a time when it is appropriate to transfer management and control of the family business, other family financial assets, or even nonfinancial property to the next generation. Although this time in the life of Senior may be an appropriate occasion for making major family gifts, frequently, Senior needs to retain some financial stake in the family business or other financial assets to finance retirement after it is time to transfer control. More often than not, there is a general reluctance to pay a gift tax. At the same time, those taking over the family business or other property usually do not have sufficient financial resources to purchase the assets for cash, and cannot, or are not willing to, obtain the necessary financing from commercial sources.

A seller-financed, deferred payment sale can bridge the gap, using the future cash flows from the newly-acquired assets as the primary source of funds to satisfy the obligation undertaken by Junior as the purchaser. The deferred payment sale can be structured as an installment note, a self-canceling installment note (“SCIN”) or a private annuity. An installment note calls for a specified number of fixed payments over a fixed term of years with designated interest. A SCIN is essentially an installment note that also provides that the payments terminate upon the death of the selling senior family member. This termination feature means that the value of a SCIN is less than that of a standard installment note providing for equal fixed payments over the fixed term. Accordingly, to achieve an equivalent initial value, a SCIN must provide greater interim and potential total payments than a standard installment note. A private annuity provides for specified payments over a term of uncertain duration, typically the life of the selling senior family member or the joint lives of the senior family member and spouse. Although a private annuity, like any commercial annuity, involves an implicit interest factor, the interest is not expressly stated.

There are significant differences in the financial terms and economic risks associated with the three types of deferred payment financing identified above. Yet, in the final analysis, all three provide economically equivalent payment arrangements for the assets transferred. Any difference in the risks associated with the different payment terms should be in the amounts
provided as deferred payments for the assets or, if it is not, in the portion of the value of the
assets transferred that is a gift, compensation, or otherwise. Nevertheless, the differences in the
Federal income and transfer tax treatment of the three type of deferred payment arrangements are
disproportionate to the financial differences among them.

Under traditional income tax principles, the timing for reporting gain realized by the
seller under the annuity rules is significantly different from that under the installment method.
There are similar differences in the basis of the property acquired by the buyer. The buyer
obligated under a private annuity sale must capitalize the amount treated by the seller as annuity
income, but the buyer in an installment sale can deduct as interest expense the amount the seller
reports as interest income.

Even greater differences exist in the income taxation of the interest or other time value of
money factor inherent in each payment. Although the seller reports interest income in an
installment sale and, implicitly, as annuity income in a private annuity sale, the timing of this
income is significantly different. Similarly, although the buyer is entitled to an interest expense
deduction (subject to the investment interest or other interest limitations) in an installment sale,
the buyer is not allowed any deduction for what is the practical equivalent of the interest cost in a
private annuity obligation. An anomaly is that an unsecured private annuity obligation is
governed by a different set of rules than a secured private annuity obligation on identical terms.
Another distorting factor is the use of different interest rate and mortality assumptions for
income tax purposes than those used for transfer tax purposes.

The first part of this paper provides an analysis of the income tax and transfer tax
treatment of the three financing arrangements (in so far as it is clear) to show how the selling
senior family member and younger generation buyer are taxed at the time of the initial sale, the
time each payment is made, and the death of the seller while the obligation is outstanding.

We address: (i) the principles applicable to fixed deferred payment obligations under the
installment method; (ii) traditional private annuity sale principles; (iii) the application of
installment sale principles to SCINs, and (iv) the transfer tax treatment applicable to each,
including the sometimes surprising differences between similar transactions.

§ 1001. Deferred Payment Sales: Basic Rules

There are three forms of deferred payment sales, fixed payment installment sales, self-
canceling installment note ("SCIN") sales and private annuity sales. Traditionally, the IRS has
distinguished between SCINs and private annuities on the basis of the maximum term of the
deferred payment obligation—if the maximum term was shorter than the transferor-seller's
actuarial life expectancy, a sale was classified as a installment sale under § 453; if longer, it was

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2 Frequently referred to simply as SCINs although technically a SCIN is a form of promissory note that contains a
cancelation feature based on the seller’s death.

3 Using the Reg. § 1.72-9 Table V mortality table. The lives in Table V are based on a 1983 study of individuals
who purchased annuities. Annuity purchasers tend to live longer than people of the same age in the general
population, presumably because they are self-selected and enjoy better living conditions.
classified as a private annuity sale governed by § 72.⁴ A SCIN for a maximum term exceeding the seller’s life expectancy is sometimes referred to as a private annuity for a term of years (a “PATY”), with income tax reporting prescribed by the § 72 annuity rules. However, a 1998 regulation amendment, intended primarily to prevent noninsurance company financial institutions from offering tax-sheltered investments,⁵ may require treating PATYs as installment sales under § 453, in effect, as SCINs, leaving only annuities for life with no term limits or refund features subject to traditional private annuity taxation.

Any of the three deferred payment sale arrangements can be either a sale to a grantor trust, that is not treated as a taxable sale for Federal income tax purposes, or a sale to a non-grantor trust so that is treated as a taxable sale for Federal income tax purposes, even if the sale is to a partnership or S corporation in which the transferor-seller is substantially the sole owner.⁶

§ 1001.1 Installment Method for Fixed Payment Obligations

The installment method defers payment of the income tax on the gain realized from a sale. It allows a selling senior family member who has realized a gain on the sale of property to postpone reporting any gain from the time of the sale to the receipt of payments of the selling price, regardless of the seller’s method of accounting. Specifically, a fraction of each payment, the gross profit ratio (the gross profit divided by the selling price) is included in income.

Example 1: Senior sells family assets worth $1,000 that have a basis of $100, for ten payments of $100 each, plus adequate stated interest. The gain, or gross profit, is $900 ($1,000 - $100). Under the installment method, the gross profit ratio is 90% ($900/$1,000). Thus, 90%, or $90 of each $100 principal payment on the note, is included in income as gain on the sale.

Regardless of the buyer’s method of accounting, the obligation to make fixed principal payments is part of the purchaser’s basis in the property acquired from the date of sale.

A selling senior family member can elect out of an installment sale,⁷ and report the entire gain in the year of sale.⁸

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⁶ If Senior’s grantor trust is a 100% shareholder in an S corporation, or a 99% limited partner in a partnership, a sale by Senior to his controlled entity is a taxable sale despite the fact that Senior is deemed to be the income tax owner of the purchasing entity under the grantor trust rules. Under Reg. § 1.707-3(a)(3) and (f) Example 1, a transfer may be a sale only in part if the amount paid is less than the fair market value of the property. Under Reg. § 1.707-5(a)(1) and (f) Example 1 a transfer of property subject to a liability is a disguised sale only to the extent that a share of the liability is shifted to other partners. The grantor trust provisions (§§ 671-679) do not apply related party or attribution rules similar to those found in the income tax area, §§ 267(b) and (c), 318, 453(f)(1) and 707(b) and the related party rules used in the gift taxes under § 2701(c)(3). In the absence of specific statutory authority, a sale by a grantor to an entity owned by a grantor trust is not treated as a sale to the grantor trust.
⁷ § 453(d); Temp. Reg. § 15A.453-l(d).
The senior family member can arrange for part or all of the family business interest to be redeemed by the corporation or partnership instead of being purchased by the younger generation family member. A redemption by the family entity has the same economic effect as a sale if the younger generation already owns an interest in the business. A corporate redemption for deferred payments, including one by an S corporation, that qualifies as a sale or exchange under § 302(b) and is not a dividend, is an installment sale. Accordingly, the income tax treatment for the selling senior family member is the same as in a direct sale to the younger family member. Any interest deduction, however, belongs to the corporation (or S corporation shareholders). The corporation does not have any basis in the shares redeemed and the younger family members do not increase the basis of their shares for the amount of the redemption price. The taxation of a deferred payment redemption of a partnership interest is determined under special partnership provisions and not under the installment method.

All initial cash received, and the value of all other assets initially received (other than the buyer’s evidences of indebtedness), in a deferred payment sale are treated as payments in the year of sale under the installment method. Demand obligations of the younger generation buyer, or obligations of a corporate issuer regularly traded in an active securities market, do not qualify as the buyer’s evidence of indebtedness, so that the deferral under the installment method is not available for these notes.

The buyer’s note obligation may be received in an installment sale without immediate gain recognition, regardless of the solvency of the buyer. The installment method is the basic approach to taxing deferred payment sales that qualify; its availability does not depend on the taxpayer’s method of accounting or on lack of certainty of payment. All other amounts received in the year of sale, including any third party debt obligations, are payments in the year of sale and result in immediate recognition of gain.

Gain can be reported under the installment method even when the buyer’s obligation is secured. Common forms of security include a mortgage on the property sold, a third-party guarantee or even a standby letter of credit. It is possible to go too far. An obligation secured by an escrow arrangement or by a cash equivalent (e.g. government securities) is treated as a payment in the year of sale.

When liabilities are transferred as part of the sale of the family business or other financial assets, the liabilities are part of the selling price, included in both the seller’s amount realized and

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10 See Reg. § 1.1736-l(b)(5), (6) and (7).
11 § 453(f)(4) and (5); Temp. Reg. § 15A.453-l(b)(3)(i) and (e)(l).
12 § 453(e) and (f)(3); Temp. Reg. § 15A.453-l(b)(3)(i); see Holmes v. Commissioner, 55 T.C. 53 (1970) (third party note guaranteed by the buyer constituted a payment).
13 § 453(f)(3); Temp. Reg. § 15A.453-l(b)(3)(i) and (ii).
When property is sold subject to liabilities, special rules apply under the installment method. The liabilities are, in effect, applied first against basis instead of simply being considered additional payments. The contract price, instead of the selling price, is used to calculate the gross profit ratio. The contract price is defined as the selling price reduced by liabilities transferred that do not exceed basis.

**Example 2:** Senior sells property worth $1,000 with a basis of $600, subject to a mortgage of $400, for ten principal payments of $60 each. Although the sales price is $1,000, the contract price is $600 ($1,000 - the $400 mortgage), and the gross profit ratio is 66-2/3% ($400 gross profit/$600 contract price). As each $60 payment is received, only $40 is included in income as gain on the sale.

If the amount of the Senior’s transferred liabilities exceeds the basis for the business, the excess is “deemed” to be a payment in the year of sale, because otherwise the gross profit ratio would exceed 100%.

**Example 3:** Senior sells property worth $1,000 with a basis of $100, subject to mortgage of $400, for ten principal payments of $60. The gross profit is $900 ($1,000 price - $100 basis), and the contract price would be only $600 ($1,000 price - $400 mortgage), resulting in a gross profit ratio of 150%. To prevent this, the mortgage offset in determining the contract price is limited to the $100 basis. Thus, the contract price is also $900, resulting in a gross profit ratio of 100%. The $300 excess is a “deemed” payment in the year of sale. This results in immediate recognition of gain in the amount of $300 because the entire basis has been fully offset against the liability.

Taxpayers have succeeded in avoiding immediate gain recognition when liabilities exceed basis by use of a wrap-around note. In a wrap-around note, the selling senior family member does not transfer the liability, but remains primarily liable, agreeing to make payment on the indebtedness as it becomes due. Although the IRS initially resisted this technique, it eventually conceded that it works.

**Example 4:** The facts are the same as in Example 3. Senior may avoid the gain on the excess of the liability over basis in the year of sale by agreeing to pay off the original borrowing himself. He then receives ten annual principal payments of $100 each, and must use part of each payment (or other resources) to make the payments on the original mortgage. He reports $90 of his gain as he collects each payment.

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16 Reg. § 1.1001-2(a); *Crane v. Commissioner*, 331 U.S. 1 (1947); *Commissioner v. Tufts*, 461 U.S. 300 (1983) (amount realized on transfer of property subject to nonrecourse liability is amount of liability even if value of property is less).
18 Temp. Reg. § 15A.453-l(b)(2)(ii) and (iv).
21 Wrap-around notes can be for purposes other than avoidance of the payment in year of sale, most commonly to preserve for the selling senior family member the benefit of a low interest rate on the original loan.
23 The IRS acquiesced in *Professional Equities, Inc. v. Commissioner*, supra note 20.
principal payment, and he has no deduction or other offset for the mortgage payments.

Because the deferral of tax under the installment method is considered an extraordinary benefit, almost any disposition by a selling senior family member of an installment obligation accelerates the unreported gain realized on the sale of the family business. Even a gift by the selling senior family member is considered an early disposition that accelerates the reporting of gain.

In contrast, a disposition occasioned by the selling senior family member’s death does not accelerate the unreported gain. Instead, the deceased selling senior family member’s successor-in-interest steps into the decedent’s shoes, and, in turn, is subject to the early disposition provisions.

Finally, use of the installment note as collateral for a loan is treated the same as an early disposition to the extent of the loan proceeds, with the result that all or a portion of the deferred gain is reported at that time.

Interest paid by individual buyers for shares of a C corporation is investment interest, deductible only within the applicable limits. The character of interest paid by a buyer of an S corporation is determined by an allocation based on the nature of the corporation’s underlying assets, that is, business assets, investment assets, etc. When the buyer is a C corporation, the interest should be fully-deductible as business interest.

If Senior dies during the term of the note, the note is included in his gross estate at its fair market value, which is not necessarily the principal amount. Because the gain was realized while Senior was alive, it is income in respect of a decedent (“IRD”). Consequently, there will be no tax-free step-up in basis for the note. Under Section 691(a)(4), the successor-in-interest will report the capital gain and interest income as payments are received on the installment note, offset by a deduction under § 691(c) for any estate tax attributable to inclusion of the note in Senior’s gross estate. The purchaser has a cost basis in the property equal to the principal amount of the note and any additional consideration. That cost basis is not affected by Senior’s

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24 A transfer of an installment obligation incident to a divorce that meets the requirements for nonrecognition under § 1041 does not result in acceleration of gain, but transfers the unreported gain to the (often unsuspecting) transferee spouse. § 453B(g).
26 § 691(a)(2). Since the deferred gain is “income in respect of a decedent” under § 691(a)(4) and Reg. § 1.691(a)-l(b), the successor-in-interest cannot obtain a tax-free step-up in basis for the unreported gain. § 1014(c). P.L.R. 88-06-048 (Nov. 17, 1987).
27 § 453A(d) (1).
28 § 453A(a)(l) and (b)(l).
29 § 163(d)(5); Temp. Reg. § 1.163-8T(b)(3).
30 See Notice 89-35, 1989-1 C.B. 675, 676. In Priv. Ltr. Rul. 91-16-008 (Jan. 10, 1991), the IRS applied this approach to a redemption of S corporation shares, determining the character of the interest by the nature of the corporate assets. Presumably, a similar rule applies to the purchase of a partnership interest.
31 See § 163(d)(1) and (h) (investment interest and personal interest limits apply only to taxpayers other than C corporations).
32 § 691(a).
33 § 1014(c).
death, so that any pre-death appreciation that escapes transfer tax is subject to, presumably capital gain, tax to the purchaser. Since the maximum estate tax rate will eventually be 45% and the capital gain tax is 20% and may be further delayed, the tradeoff is usually a good one. If there is a decline in value, the reverse may be true, except to the extent that the value of the promissory note is correspondingly reduced.

Although the installment method is available even when the younger generation buyer’s obligations are secured, certain forms of security can convert the buyer’s obligation into a current payment. Specifically, security in the form of a cash equivalent, such as a certificate of deposit, triggers gain recognition. The same is true for any form of escrow. Later substitution of an escrow or cash equivalent terminates the deferral for a previously qualified installment sale. On the other hand, a standby letter of credit is permissible security. Thus, as a practical matter, when security other than the property sold is needed, a qualifying standby letter of credit should be used.

A selling senior family member may have suspended passive losses, for example, losses from an S corporation owned by a shareholder who does not materially participate or passive losses that were suspended when an activity was contributed in a § 351 transaction. A sale reported under the installment method is not a complete disposition that permits immediate deduction of suspended passive losses. Instead, the suspended passive losses are deducted only as gain is recognized. By parallel reasoning, losses suspended under the at-risk rules should be deductible only as gain is recognized. Losses of a partnership or S corporation that have been suspended because the selling senior family member’s basis was not sufficient, do not become deductible at the time of disposition. The sale does not provide the requisite basis. This is not inappropriate, since if deduction of the loss is taken, basis in the shares is reduced, and gain on the sale is equivalently larger.

If the selling senior family member cancels the note by a clause in his will or indirectly effects a cancellation because he bequeaths the note to the obligor, the fair market value of the note is still property included in the selling senior family member’s gross estate. The

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34 § 453(f)(3).
35 Temp. Reg. § 15A.453-l(b)(3)(i). This regulation effectively overrules Porterfield v. Commissioner, 73 T.C. 91 (1979) (installment sale qualified even though the buyer’s note was secured by escrow when court found escrow was intended as security not source of payment); see also Sprague v. Commissioner, 627 F.2d 1044 (l0th Cir. 1982) (impractical to evaluate security and whether its quality creates risk).
39 § 469(g).
41 § 465.
43 §§ 704(d) and 1366(d).
44 § 1367(b)(2)(B).
45 Reg. § 20.2033-l(b) specifically provides that “[n]otes . . . held by the decedent are likewise included [in the decedent’s estate] even though they are cancelled by the decedent’s will.” The rule is different for a SCIN, which expires upon the selling family member’s death by its own terms.
cancellation of a note on the death of the seller is, however, a disposition that results in the immediate reporting of gain previously deferred under the installment method. Any gain triggered in this manner is reported on the seller’s final individual income tax return.

If the obligor under the canceled note is related to the decedent-seller and the value of the note is less than its face amount, then the amount (fair market value) included in the gross estate for Federal estate tax purposes is irrelevant for Federal income tax purposes. Instead, for purposes of determining the gain reported by the estate, the face amount of the note is determinative. Thus, although the theory is different, the amount of gain recognized is the same as for a gift.

**Example 5:** S dies in 2001 when $300,000 remains unpaid on the note and the gross profit ratio is 100%. S leaves this note as a specific bequest to B, the obligor on the note, who is also his son. At the date of death the value of the note in S’s gross estate is $280,000. S’s basis in the note is zero. The Internal Revenue Service takes the position that S’s estate is treated as having transferred the note for $300,000 under § 691(a)(2), and that the estate must report the remaining $300,000 of capital gain on its fiduciary income tax return. A better view, supported by the Tax Court’s decision in the Frane case, is that the gain should be reported on S’s final income tax return. B’s basis in the land purchased from his father should remain as the same cost basis, on the ground that the termination of the notes is a bequest, even though B pays $300,000 less.

**Example 6:** The facts are the same except that B, the obligor-buyer is, S’s son-in-law. Either S or S’s estate must report $280,000 of capital gain upon the cancellation of the note. B’s cost basis in the property purchased by issuing his own note is reduced by $20,000 under § 108(e)(5).

When the fair market value of the installment obligation is more than its face amount, the selling senior family member’s estate recognizes gain measured by the value of the note. The younger generation buyer should be able to increase his basis in the property purchased by the excess of value over the face amount of the note. If the buyer whose note is canceled by the selling senior family member’s will is not a related party within the statutory definition, for example, a son-in-law, the fair market value of the note is used to determine the gain reported by the estate. The rule that the value of the note is not less than its face amount applies only when the buyer is related to the selling senior family member. The amount reported as income in respect of a decedent by the successor is the excess of value over the decedent’s basis in the note.

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46 § 691(a)(5)(A)(ii).
47 § 691 (a)(5)(B).
48 Read § 691(a)(5)(B) carefully.
50 § 691 (a)(4)(A).
51 §§ 691(a)(5)(B) and 453B(f)(2).
52 § 691(a)(4)(B).
§ 1001.2. Private Annuity Sales

Private annuity sales are arrangements that permit a senior family member to receive a fixed amount periodically for the remainder of the seller’s life or the joint lives of the seller and the seller’s spouse. The traditional tax treatment of private annuity sales developed in a series of rulings and cases as an application of cash accounting principles in combination with some of the rules that apply to primarily commercial annuities, all without specific statutory authority.

1. Commercial Annuities

Under a commercial annuity arrangement, the insurance company receives one or more premium payments and agrees to make a prescribed series of future payments, usually measured by the annuitant’s life, a specified term or some combination. The payments represent not only return of the premium but also an implicit interest element for the annuity term. Under § 72, a portion of each annuity distribution is treated as a tax-free return of the annuitant’s initial deposit by use of a mechanism called the “exclusion ratio,” and the balance, representing what is essentially interest income, is annuity income. Any distributions representing the annuitant’s cost in the annuity contract, referred to as the “investment in the contract,” is a tax-free return of basis. This investment in the contract, the numerator of the exclusion ratio, is the total of premiums the annuitant paid the insurance company. The denominator of the exclusion ratio is the total of all amounts the annuitant expects to receive under the annuity contract (without discounting to present value) determined by actuarial tables, referred to as the “expected return.” The exclusion ratio in annuity taxation has a function similar to that of the gross profit ratio in the installment method as the mechanism for defining the recovery of basis. The exclusion ratio determines the amount of each payment that effectively represents interest income. This exclusion ratio differs in that it provides a straight-line allocation of the income on a cash basis rather than the compound-interest accrual approach of the OID interest rules.

When annuity payments are payable for a period measured by a life, the annuitant can die before or after the actuarial provided in the mortality table. An annuitant who dies exactly when his actuarial life expectancy ends excludes from income an amount exactly equal to the premiums paid. An annuitant who dies prematurely deducts the unrecovered “investment in the contract” on the final income tax return. An annuitant who survives beyond the table’s life expectancy recovers the entire investment in the contract, and can no longer exclude any portion of subsequent annuity payments.

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53 § 72(b)(1); Reg. § 1.72-4.
54 § 72(c)(1); Reg. § 1.72-6.
55 § 72(b)(1); Reg. § 1.72-3.
56 See Reg. § 1.72-9.
57 § 72(c)(3), Reg. § 1.72-5.
59 § 72(b)(2). Prior to 1987, the annuitant could exclude a portion of all annuity payments, including the mortality gain payments, and no deduction was permitted for unrecovered basis if there was a mortality loss. There was previously a conflict between Rev. Rul. 69-74, 1969-1 C.B. 43, and Reg. § 1.1011-2(c) Example (8) about what happened if the selling family member lived beyond the actuarial period.
When a senior family member sells the family business or other financial assets to a junior family member on terms that measure the payments by the selling senior family member’s (or another person’s) life, the transaction is a private annuity sale. Traditional private annuity sale treatment is a special application of cash accounting principles, in which the gain on the sale is allocated over the payment period using the principles of annuity taxation outlined above. A deferred payment redemption by a family corporation can be a private annuity obligation.

During the actuarial life expectancy of the selling senior family member in a private annuity sale, the annuity payments are divided into three parts: (1) a basis recovery element, determined by allocating the basis of the shares over the selling shareholder’s life expectancy under the income tax annuity tables; (2) a (capital) gain element, measured by any excess of the value of the annuity under the gift tax actuarial tables over the basis of the shares, which is also allocated over the income tax life expectancy; and (3) an annuity (or interest) income element, measured by the difference between the amount of the payment and the sum of the first two items, using the lower of the fair market value of the family business or the present value of the annuity to measure the payment. Thus the recovery exclusion in a private annuity sale is divided between the recovery of the selling senior family member’s basis in the family assets transferred and any unrealized gain inherent in those assets. Accordingly, private annuity sale treatment parallels the installment method, but with significant differences.

Surprisingly, traditional private annuity sale treatment is not available for secured private annuity sales. Although G.C.M. 39503 seems to assume that being ineligible for private annuity sale treatment means immediate recognition of gain, this is questionable. The cases requiring immediate recognition for secured private annuity sales did so as an application of cash accounting principles and did not discuss installment sales, because, at that time, contingent deferred payment sales were not eligible for installment sale treatment. This is no longer true. Accordingly, the IRS position may create an anomaly in that an unsecured private annuity sale is taxed under annuity principles, while an identical secured one is an installment sale. Despite this possibility, most commentators assume that if a private annuity is secured, immediate gain recognition is required.

The buying family member is not entitled to any interest deduction even though the portion of the payment representing the time value of money is annuity income for the selling family member. On the other hand, the buyer’s initial basis of the family assets transferred is

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60 Rev. Rul. 69-74, 1969-1 C.B. 43. The IRS revoked its earlier position in Rev. Rul. 239 where it applied the open transaction approach and allowed all principal payments to be first a recovery of basis. See also Rev. Rul. 55-119, 1955-1 C.B. 352, dealing with the family buyer’s basis.

61 Cf. Fehrs Finance Co. v. Commissioner, 487 F.2d 184 (8th Cir. 1973), cert. den. 416 U.S. 938 (applying § 304 to a redemption through a related corporation with the price paid in the form of a private annuity).


63 See generally, Manning and Hesch, supra note 4 at ¶ 302.2.

64 See Estate of Bell v. Commissioner, 60 T.C. 469 (1973); 212 Corp. v. Commissioner, 70 T.C. 788 (1978); but see Priv. Ltr. Rul. 81-02-029 (Oct. 14, 1980) (applying traditional private annuity sale analysis to basis determination in a secured private annuity sale without comment).


66 See, e.g., Dix v. Commissioner, 392 F.2d 313 (4th Cir. 1968); G.C.M. 39503, Issue (2)(C)(3), supra note 4. See, Rye v. United States, 92-1 U.S.T.C. ¶ 50,186 (Cl. Ct. 1992), denying an interest deduction even though the
measured by the anticipated payments to the extent of the fair market value of the annuity obligation. Both of these results are inconsistent with those that apply to contingent payment installment sales, but are consistent with the exclusion of annuity transactions from the OID rules. Even with that exclusion, the denial of an interest deduction for the younger generation buyer is questionable.

The younger generation buyer’s initial tentative basis for the property is increased when the aggregate of the actual payments exceed the initial tentative basis. Because there is no interest deduction, this occurs well before the end of the selling senior family member’s actuarial life expectancy and can lead to a final basis far in excess of value. If the family seller dies before payments equal the tentative basis, the basis is reduced to payments already made. A buyer who disposes of the property during the selling family member’s lifetime generally computes gain or loss using the tentative basis at the time of the sale. Subsequent payments are additional losses on sale of the family assets.

When an intended source of payment for the deferred payment obligation to purchase the family business (or other family financial assets) is the income generated by the assets purchased, and the payment is dependent on the selling senior family member’s life, there is an appearance of a trust equivalent where there is a retained interest in the property transferred. Nevertheless, the family assets sold should not be included in the gross estate of the selling senior family member as a retained life estate under § 2036(a). Section 2701 applies only to retained equity interests, and, thus, does not apply to debt obligations. Accordingly, a bona fide deferred payment sale should fall outside of § 2701 even when the payment is in the form of a private annuity sale, but not if the payments are dependent on earnings.

An individual who saves by depositing money in a commercial savings account must report the interest earned each year under the doctrine of constructive receipt even if no withdrawals are made. Even an individual who buys a long-term certificate of deposit where early withdrawal incurs a penalty must report interest as earned under the OID rules.

**Example 1:** A deposits $2,486.90 in a savings account on January 1, 2000. The bank pays 10.0% annual interest. A intends to withdraw $1,000 annually for the seller reported the transaction as an installment sale. The court in *Rye* explicitly stated that there is no need for symmetry between the buyer and the seller.

---

67 Rev. Rul. 55-119, 1955-1 C.B. 352; G.C.M. 39503, Issue (2)(C)(2)(a), *supra* note 4. As the buying family member makes further payments, they are added to basis, apparently without regard to fair market value of the property. This converts the excess payment, a substantial part of which represents the time value of money, into a capital loss on disposition of the family business or financial assets by the buyer.

68 § 1275(a)(1)(B) (debt obligation does not include amounts taxed as annuities). In G.C.M. 39503, *supra* note 4, and Priv. Ltr. Rul. 90-09-064 (Dec. 8, 1989), the IRS indicated that it will continue to apply the § 72 annuity rules instead of the § 453 installment method to private annuity sales. In *Rye v. United States*, *supra* note 66, the court applied the § 72 annuity rules to a private annuity sale.


73 Reg. § 1.1275-1(b).
next three years beginning on December 31, 2000. The following illustrates the interest income earned each year:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposit on January 1, 2000</td>
<td>$2,486.90</td>
</tr>
<tr>
<td>Interest at 10.0% for 2000</td>
<td>+ 248.69</td>
</tr>
<tr>
<td>Withdrawal on December 31, 2000</td>
<td>- 1,000.00</td>
</tr>
<tr>
<td>Balance on January 1, 2001</td>
<td>$1,735.59</td>
</tr>
<tr>
<td>Interest at 10.0% for 2001</td>
<td>+ 173.55</td>
</tr>
<tr>
<td>Withdrawal on December 31, 2001</td>
<td>- 1,000.00</td>
</tr>
<tr>
<td>Balance on January 1, 2002</td>
<td>$  909.14</td>
</tr>
<tr>
<td>Interest at 10.0% for 2002</td>
<td>+  90.91</td>
</tr>
<tr>
<td>Withdrawal on December 31, 2002</td>
<td>- 1,000.00</td>
</tr>
<tr>
<td>Balance</td>
<td>-0-</td>
</tr>
</tbody>
</table>

When an individual purchases an annuity, the implicit interest in the internal buildup in the policy is not taxed currently. The doctrine of constructive receipt does not apply because the annuitant does not have a right to withdraw as the interest is earned. Instead, the basic mechanism is to bifurcate each annuity payment between basis recovery and income on a straight line basis by use of the “exclusion ratio,” the fraction determined by dividing the annuitant’s “investment in the contract” by the “expected return,” that is, the total of the undiscounted payments to be made. If all payments to be made are not subject to any contingencies, then the guaranteed number of payments is used to determine the expected return. If there is a contingency, such as payments to be made for the rest of the annuitant’s life, then the life expectancy of the annuitant at the “annuity starting date” is the multiple used to determine the expected return. The annuity starting date is the date in the future that the annuity payments are to commence. The life expectancy multiples used in determining the expected return are prescribed in the Regulations under § 72.

Example 2: B purchases an annuity on January 1, 2002, for $2,486.90, the present value of $1,000 a year for three years at 10.0%, the § 7520 rate. This annuity contract provides that B will receive $1,000 annually for three years, the first payment to be made on December 31, 2002.

The “investment in the contract” is $2,486.90 (the premium paid). The “expected return” is $3,000. The “exclusion ratio” is 82.89%. Therefore, B must report $171.03 as income every time he receives a $1,000 annuity payment.

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74 § 72(b)(1).
75 § 72(c)(1).
76 § 72(c)(3).
77 § 72(c)(3)(B).
78 Reg. § 1.72-9, Table V.
79 § 72(c)(4).
80 Reg. § 1.72-9, Table V.
The annuity reporting rules do not change the aggregate amount of income reported. But the timing rules for annuities create a deferral advantage.

Table A

<table>
<thead>
<tr>
<th>Year</th>
<th>Annuity Income</th>
<th>Interest Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>$171</td>
<td>$249</td>
</tr>
<tr>
<td>2001</td>
<td>171</td>
<td>174</td>
</tr>
<tr>
<td>2002</td>
<td>171</td>
<td>90</td>
</tr>
<tr>
<td>Total</td>
<td>$513</td>
<td>$513</td>
</tr>
</tbody>
</table>

2. Private Annuity Sales

The traditional income tax treatment of private annuity sales developed before the Installment Sales Revision Act of 1980 extended installment sale treatment to contingent payment sales, presumably including sales with payments in the form of an annuity.

The following facts will be used to illustrate the tax consequences of the private annuity and SCIN examples below.

**Example 3:** S is 70 years old. On December 1, 2001, S sells the stock in a family business corporation to B for $1,000,000. S’s basis for the stock is $200,000 and it is worth $1,000,000.

Under Reg. § 1.72-9, Table V, a 70-year old has a life expectancy of 16.0 years. However, the estate and gift tax valuation tables in Reg. § 20.2031-7(f) which adopt the tables in Book Aleph (the 90CM tables) use 13.9 years as the life expectancy of a 70 year old.

As announced in Rev. Rul. 2001-54, the interest rates for December, 2001 are: (i) long-term AFR 5.05% and (ii) § 7520 rate 4.8%.

**a. Installment Sale**

For comparison purposes, we will first illustrate an installment sale in which the younger generation buyer makes a level annual payment over a fixed term. When all payments are fixed, the deferred payment arrangement is an installment sale governed by the installment reporting rules under § 453. The 16-year term for the payments corresponds to the selling senior family member’s 16-year life expectancy used in the income tax tables.

**Example 4:** On December 1, 2001, S sells his family business shares, with a basis of $200,000, to B for $1,000,000. S agrees to finance the entire $1,000,000

---

83 Reg. § 1.72-9, Table V.
purchase price over 16 years. In order to avoid any imputed interest issues, B will pay interest at 5.05%, the long-term AFR for December 2001. A gross profit ratio of 80% is applied to each principal payment to determine the amount of capital gain reported under the installment method.

Using 5.05% interest, the present value of $1.00 annually for 16 years is $10.799304. Therefore, the annual payment is $92,599 ($1,000,000 divided by $10.799304).

For income tax purposes, B’s basis is $1,000,000 because § 1274 treats $1,000,000 as both the imputed and the stated principal amount of B’s obligation.

The amount, character and timing of S’s income upon receipt of each annual payment, using an 80% gross profit ratio for each principal payment, is:

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment</th>
<th>Basis</th>
<th>Capital Gain</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-1-02</td>
<td>$92,599</td>
<td>8,420</td>
<td>$ 33,679</td>
<td>$ 50,500</td>
</tr>
<tr>
<td>12-1-03</td>
<td>92,599</td>
<td>8,845</td>
<td>35,380</td>
<td>48,374</td>
</tr>
<tr>
<td>12-1-04</td>
<td>92,599</td>
<td>9,292</td>
<td>37,166</td>
<td>46,141</td>
</tr>
<tr>
<td>12-1-05</td>
<td>92,599</td>
<td>9,761</td>
<td>39,043</td>
<td>43,795</td>
</tr>
<tr>
<td>12-1-06</td>
<td>92,599</td>
<td>10,254</td>
<td>41,015</td>
<td>41,330</td>
</tr>
<tr>
<td>12-1-07</td>
<td>92,599</td>
<td>10,772</td>
<td>43,086</td>
<td>38,741</td>
</tr>
<tr>
<td>12-1-08</td>
<td>92,599</td>
<td>11,315</td>
<td>45,262</td>
<td>36,021</td>
</tr>
<tr>
<td>12-1-09</td>
<td>92,599</td>
<td>11,887</td>
<td>47,548</td>
<td>33,164</td>
</tr>
<tr>
<td>12-1-10</td>
<td>92,599</td>
<td>12,487</td>
<td>49,949</td>
<td>30,162</td>
</tr>
<tr>
<td>12-1-11</td>
<td>92,599</td>
<td>13,118</td>
<td>52,471</td>
<td>27,009</td>
</tr>
<tr>
<td>12-1-12</td>
<td>92,599</td>
<td>13,780</td>
<td>55,121</td>
<td>23,697</td>
</tr>
<tr>
<td>12-1-13</td>
<td>92,599</td>
<td>14,476</td>
<td>57,905</td>
<td>20,218</td>
</tr>
<tr>
<td>12-1-14</td>
<td>92,599</td>
<td>15,207</td>
<td>60,829</td>
<td>16,562</td>
</tr>
<tr>
<td>12-1-15</td>
<td>92,599</td>
<td>15,975</td>
<td>63,901</td>
<td>12,723</td>
</tr>
<tr>
<td>12-1-16</td>
<td>92,599</td>
<td>16,782</td>
<td>67,128</td>
<td>8,689</td>
</tr>
<tr>
<td>12-1-17</td>
<td>92,599</td>
<td>17,629</td>
<td>70,518</td>
<td>4,451</td>
</tr>
</tbody>
</table>

$1,481,577  $200,000  $800,000  $481,577

As the above indicates, the 80% gross profit ratio is applied each year to an increasing principal payment. As the outstanding principal balance is reduced each year, the interest portion of each succeeding payment decreases. If any of the seller-provided financing is later canceled, the amount of the cancellation is a purchase price adjustment that reduces the buyer’s basis.85

b. Traditional treatment of unsecured private annuities.

Because the IRS does not treat a private annuity as a contingent payment installment sale, the IRS requires the reporting of private annuity sales under the annuity rules.86 Under the

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84 Actual payment is $92,598.56
85 § 108(e)(5).
86 See GCM 39,503 Issue (1) supra note 4. Rev. Rul. 55-119, supra note 67; Rev. Rul. 69-74, supra note 62. At the time Rev. Rul. 69-74 was issued, the annuity rules under § 72 permitted the indefinite use of the exclusion ratio, thereby permitting an annuitant to continue to exclude from taxation a portion of all annuity payments as
annuity rules, the younger generation buyer’s basis initially equals the value of the private annuity obligation, but changes depending upon the aggregate amount the buyer pays under the annuity arrangement. 87

This “tentative basis” is finally determined only after the selling senior family member dies, and all payments are finally fixed. The younger generation buyer’s “final” basis is equal to the aggregate of all annuity payments made to the seller.

Once the total of all payments made exceeds the tentative basis amount, each additional payment is added to the buyer’s basis. The basis only becomes final when the payments cease. If the selling senior family member dies before the total of the annuity payments made equals the tentative basis amount, then the final basis is an amount equal to the payments actually made. If the younger generation buyer sells the family business or other financial assets before the selling senior family member’s death, there is a split basis, with gain determined using the tentative basis, but loss allowed only to the extent the sale price is less than payments made. 88 All subsequent payments are loss, whether gain or loss was realized on the interim sale of the family business or other financial assets.

No interest is imputed for any annuity payment made by the younger generation buyer. 89 The effect is that the entire amount of each annuity payment made by the buyer is treated as a principal payment. The inability of the buyer to treat any portion of an annuity payment as interest expense requires the buyer to capitalize, as part of his basis, what is realistically an interest expense. Because the younger generation buyer cannot treat any portion of the annuity payment as interest expense, the total of the actual payments will exceed the tentative basis amount well before the selling senior family member reaches his actuarial life expectancy. Therefore, a younger generation buyer using a private annuity sale arrangement can expect to have a basis for an asset far greater than the amount he paid for it (i.e., greater than its value).

Another distortion is caused when the generally higher interest rates (the § 7520 rate is 120% of the mid-term AFR) and shorter mortality assumptions found in the gift tax valuation tables under Reg. § 20.2031-7(f), which adopts Book Aleph, are used to calculate the annuity payments. The amount of each annuity payment will be larger than if the lower income tax interest rate and longer income tax mortality assumptions were used. Since Rev. Rul. 55-119 requires the use of the gift tax valuation tables, 90 the younger generation buyer can end up

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88 Id.
89 Dix v. Commissioner, supra note 66; Rye v. United States, supra note 66; Bell v. Commissioner, 76 T.C. 232 (1981). Under § 1275(a)(1)(B)(i), the OID and unstated interest rules do not apply. For the seller, the annuity rules under § 72 accomplish the same objective as the imputed interest rules under § 1274. Under § 72, the seller treats a portion of each payment as “annuity income.” This is in effect the interest component.
90 In Estate of Bell v. Commissioner, supra note 64, the court sanctioned the use of the estate and gift tax tables in valuing an annuity obligation under Rev. Rul. 55-119 for determining the buyer’s tentative basis.
undertaking an obligation that has a value greater than the value of the property purchased as determined under the OID rules. If the buyer lives to the longer actuarial life expectancy used in Reg. § 1.72-9, Table V, the buyer will end up paying far more for the property than it may be worth, with a resultant basis greater than its value.

**Example 5:** The facts are the same as in Example 3. B, the buyer, agrees to pay S an annual annuity payment for the rest of the S’s life. If the annual annuity payment is computed using the transfer tax tables in the Book Aleph at 4.8%, the § 7520 rate, it is $107,853 ($1,000,000 divided by 9.2719).

The investment in the contract is $200,000. The expected return is $1,725,644 ($107,853 x 16.0 year life expectancy using the income tax annuity tables). Therefore, the exclusion ratio is 11.59%.

Assume that S survives for 19 years and dies on 12-15-20. Under the § 72 annuity rules the amount, character and timing of S’s income is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Payment</th>
<th>Basis</th>
<th>Capital Gains</th>
<th>Annuity Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-1-02</td>
<td>$107,853$93</td>
<td>12,500</td>
<td>$50,000</td>
<td>$45,353</td>
</tr>
<tr>
<td>12-1-03</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-04</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-05</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-06</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-07</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-08</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-09</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-10</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-11</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-12</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-13</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-14</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-15</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-16</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-17$94</td>
<td>107,853</td>
<td>12,500</td>
<td>50,000</td>
<td>45,353</td>
</tr>
<tr>
<td>12-1-18</td>
<td>107,853</td>
<td>-0-</td>
<td>-0-</td>
<td>107,853</td>
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<tr>
<td>12-1-19</td>
<td>107,853</td>
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<tr>
<td>12-1-20</td>
<td>107,853</td>
<td>-0-</td>
<td>-0-</td>
<td>107,853</td>
</tr>
<tr>
<td>Total</td>
<td>$2,049,202</td>
<td>$200,000</td>
<td>$800,000</td>
<td>$1,049,202</td>
</tr>
</tbody>
</table>

As illustrated below, the younger generation buyer’s basis in a private annuity sale reported under the annuity rules exceeds the value of the property purchased far before the

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91 Actuarial Tables Book Aleph, Publication 1457 (July 1999).
92 By using a 16.0 year life expectancy under § 72, the seller will end up recovering his basis over a longer term than the 13.9 year life expectancy used to compute the amount of the annual annuity payment. In other words, the recovery of basis is over a 16.0 year period instead of over 13.9 years. The 16.0 years is adjusted for the frequency of payment if less often than quarterly. Reg. § 1.72-5(a)(2)(i).
93 Actual payment is $107,852.75
94 Once basis is fully recovered, all subsequent payments are annuity income. § 72(b)(2).
selling senior family member reaches the end of his actuarial life expectancy. This is because
the buyer cannot deduct any portion of his annuity payments as interest expense, and because the
transfer tax tables used in determining the annual annuity payments use shorter life expectancies
and higher interest rates, thereby increasing the amount of the annual annuity payment that is
required to avoid gift tax.

Example 6: B’s tentative basis for the private annuity sale in Example 5 is
$1,000,000, the present value of the annuity obligation using the transfer tax
tables at 4.8%, the § 7520 rate. As the annuity payments are made, B’s tentative
and final basis is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Annual Payment</th>
<th>Payments to Date</th>
<th>Tentative Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-1-02</td>
<td>$107,853</td>
<td>$107,853</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>12-1-03</td>
<td>107,853</td>
<td>215,706</td>
<td>1,000,000</td>
</tr>
<tr>
<td>12-1-04</td>
<td>107,853</td>
<td>323,559</td>
<td>1,000,000</td>
</tr>
<tr>
<td>12-1-05</td>
<td>107,853</td>
<td>431,412</td>
<td>1,000,000</td>
</tr>
<tr>
<td>12-1-06</td>
<td>107,853</td>
<td>539,265</td>
<td>1,000,000</td>
</tr>
<tr>
<td>12-1-07</td>
<td>107,853</td>
<td>647,118</td>
<td>1,000,000</td>
</tr>
<tr>
<td>12-1-08</td>
<td>107,853</td>
<td>754,971</td>
<td>1,000,000</td>
</tr>
<tr>
<td>12-1-09</td>
<td>107,853</td>
<td>862,824</td>
<td>1,000,000</td>
</tr>
<tr>
<td>12-1-10</td>
<td>107,853</td>
<td>970,677</td>
<td>1,000,000</td>
</tr>
<tr>
<td>12-1-11</td>
<td>107,853</td>
<td>1,082,430</td>
<td>1,082,430</td>
</tr>
<tr>
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If the selling senior family member in a private annuity sale reported under the § 72
annuity rules dies before reaching his actuarial life expectancy, there is an unrecovered
“investment in the contract.” Presumably, the seller may deduct any unrecovered basis on his
final income tax return under § 72(b)(3)(A). The character of the loss for unrecovered basis
should be determined by reference to the character of the property sold, rather than being viewed
as a loss in an independent annuity transaction. Where the asset sold is a capital asset, the loss
is a capital loss. Nevertheless, when the buyer in a private annuity sale is related to the seller, the
loss provided an annuitant for unrecovered basis on premature death should not be disallowed

95 Had an interest deduction been allowed equal to the $45,353 annual annuity income the seller reported, so that
the tentative basis would not have exceeded $1,000,000 until after 16 years.
96 The buyer’s basis in the shares purchased begins to exceed the $1,000,000 value of the shares by the tenth
annual payment.
under the related party rule of § 267(a)(1) because it is not part of the sale, but part of the annuity transaction.  

Example 7: If S dies at the end of the year 2010 at age 80, having received only 10 of the expected 16 annual payments, the remaining, unrecovered basis is $75,000. S is permitted to deduct $75,000 on his final income tax return. B’s basis is finally determined to be $1,078,528, the aggregate of all payments made for 10 years.

c. Secured private annuity.

There is some confusion about what rules apply if the annuity obligation is secured by the property transferred. The obligation is apparently excluded from being a debt obligation for OID purposes, even under Reg. § 1.1275-1(j), because there are no provisions that can significantly reduce the probability that the total payments under the contract will increase commensurately with Senior’s longevity as there would be for a SCIN (or PATY). On the other hand, there is significant authority that a secured private annuity is not entitled to deferral under the private annuity rules, apparently because only unfunded, unsecured obligations are not treated as payment under the cash method. Although the conclusion in those authorities was that the gain was recognized immediately at the time of sale, they were decided for tax years before the enactment of § 453(j)(2) that expressly recognizes contingent payment installment sales.

Accordingly, if it is not a private annuity under § 72, a disposition of qualifying property for a secured private annuity based solely on Senior’s life should be treated as a contingent payment installment sale. The obligation, however, apparently is not a debt obligation under Reg. § 1.1275-1(j) because security is not one of the factors listed for qualifying for the annuity exclusion. As a contingent payment installment sale, the OID rules would treat a portion of each annuity payment as an interest expense. Since it appears that the IRS will not treat a secured private annuity as an installment sale, the IRS will then require all gain to be recognized at the time of the initial sale. Since we believe that it is unsound to have radically different tax treatment of secured and unsecured private annuities, we favor treating all private annuities as contingent payment installment sales. Since this recommendation has not yet been adopted by any regulations, ruling or other published IRS authority, despite Congressional authority to do so, or by any court decision, traditional private annuity treatment apparently remains available only for unsecured private annuities.

As illustrated above, the capital gain realized on the private annuity sale is reported ratably over the life expectancy of the annuitant, but the life expectancy for this purpose is that in Reg. § 1.72-9 Table V instead of the shorter one in used to determine the annual annuity under Table 90CM. Under Table 90CM an individual age 70 has a life expectancy of 13.9 years. Under the Section 72 table, an individual age 70 has a life expectancy of 16.0 years.

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98 § 72(b)(3)(A).
101 Reg. § 1.1275-4(c).
103 As adjusted in Reg. § 1.72-5 (a)(2)(1) if the payments are less frequent than quarterly.
Obviously, the younger the individual, the longer the life expectancy and longer deferral can be achieved. A joint and survivor annuity for the senior family member and that individual’s spouse increases the deferral. For example, the joint life expectancy of two individuals, both age 70, is 20.6 years for Section 72 purposes, as opposed to the 16.0 years for one individual age 70.

§ 1001.3. Self-Canceling Installment Note Sales

A senior family member may desire a sale in which the payments are limited to her life expectancy. When the arrangement involves a fixed term with an earlier limit based on life, it is called a self-canceling installment note.

A SCIN is appropriate when the selling family member does not feel the need to receive payments for her entire life. The maximum term places a cap on how much the younger generation buyer pays, but limits the selling senior family member’s life-time security. A SCIN is a hybrid, using the installment approach in determining the maximum amount the younger generation buyer will pay, and the private annuity sale approach in the event the selling senior family member dies before the end of the note term. Because the selling senior family member no longer has a right to payment when the note is terminated by its own terms on death, no amount is included in the gross estate.104

A major advantage of a private annuity sale to the senior family member seller is that the periodic payments for his life continue to fund his retirement even if he survives beyond the actuarial life expectancy age. The corresponding advantage to the younger generation buyer is that if the selling senior family member dies sooner than actuarially indicated, he may receive a bargain, paying less for the property than it is worth. Because of this risk, private annuity sales and SCINs are generally used only in sales between family members.

The IRS apparently resolves the ambiguity created by the hybrid nature of a SCIN by classifying SCINs as private annuity sales when the maximum fixed period exceeds the selling senior family member’s actuarial life expectancy, and as installment sales when it does not.105

The IRS position, at least prior to 1999,106 is that if the selling senior family member’s life expectancy, using the mortality assumptions in Reg. § 1.72-9, is less than the maximum term of the SCIN, it is taxed as a private annuity sale under § 72, and if the seller’s life expectancy is longer than the loan term, it is taxable as an installment sale.107 In addition to the effects of life expectancy and discount rate differences, there are several crucial income tax differences between these two approaches. The timing of the selling senior family member’s gain and ordinary income, the buyer’s deductions for the time value of money, the buyer’s basis, and the effect of the seller’s premature death all differ. There is further confusion because a private annuity sale cannot be secured, but an installment sale can be secured.

105 But see impact of recent regulation infra text at note 135.
106 G.C.M. 39503, supra note 4.
107 G.C.M. 39503, supra note 4. In Rev. Rul. 86-72, 1986-1 C.B. 253, the IRS discussed how the installment sale rules under § 453B and § 691(a) applied upon the death of a seller under a SCIN. The maximum term of the obligation in this ruling was 4 years and the seller’s life expectancy was 21 years.
1. Under the Annuity Rules

The annuity rules applied to a SCIN are the same as for a straight private annuity sale with only minor modifications to reflect the maximum term.

In calculating the “expected return,” the two factor life expectancy multiple under Reg. § 1.72-9, Table VIII, must be used. A SCIN is a “temporary life annuity” because it has a maximum duration. The “exclusion ratio” so determined allocates the same amount of principal and annuity income to each payment.

Even though the income tax consequences are determined using the annuity tables of § 72, the younger generation buyer uses an initial tentative basis equal the present value of the SCIN obligation. As for a standard private annuity sale, the younger generation buyer is not permitted an interest deduction.

When the annuity rules apply, and the SCIN is canceled by the selling senior family member’s death before the maximum payment term, the younger generation buyer’s final basis under the annuity rules is limited to payments made. Neither the selling senior family member nor the estate reports the remaining gain inherent in the canceled payments because the early disposition rules of § 453B apply only to obligations reported on the installment method. The annuity reporting rules permit the selling senior family member to deduct any remaining basis on his final income tax return.

2. Under the Installment Method

When a SCIN is treated as an installment sale under the IRS approach, the installment method employs dramatically different rules from those that apply to a SCIN classified as a private annuity sale.

a. Fixed or contingent installment sale?

A SCIN is a contingent payment sale with a stated maximum selling price. The maximum selling price is the “selling price” that is used in the denominator of the “gross profit ratio,” and determines the “gross profit” used in the numerator. However, it appears that the IRS treats a SCIN as a fixed payment installment sale.

It is not clear whether the entire premium representing the risk that the selling senior family member will die before the end of the note term must be treated as additional principal, or

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108 It is not clear whether the income tax rate (the AFR) or the § 7520 rate is the proper discount rate to use. See text at note 160 infra.
109 § 72(b)(3)(A). Because practitioners rarely use SCINs characterized as annuities, we omitted examples of § 72 treatment.
110 Temp. Reg. § 15A.453-1(c)(1) and (2).
112 See text at note 176 infra.
can be treated as additional interest as long as the interest does not become so high as to be excessive. The IRS has not issued any guidance on this issue.  

b. Reporting the gain in canceled principal

If the tax treatment of a SCIN is governed by the installment method, the remaining capital gain is accelerated upon cancellation of the obligation if it is an obligation of a related party.  

Although the entire capital gain inherent in the deferred payment obligation is reported even though the obligation is canceled, there may be no symmetrical treatment for the younger generation buyer’s basis. Under the contingent payment regulations, the buyer undertaking a contingent payment obligation may obtain basis only for principal payments actually made. We feel that this anomalous result should not apply, and that the younger generation buyer’s basis should equal the principal amount of the obligation, even if the note is canceled.  

In Rev. Rul. 86-72, the IRS reached the questionable result that the accelerated gain upon the cancellation of a SCIN is reported by the estate. A better view is that the accelerated gain should be reported on the selling senior family member’s final income tax return. Under the IRS view, the “transfer” treated as an early disposition within the context of § 691(a)(2) does not automatically occur at the moment of death. The IRS has ruled that the triggering transfer, and related recognition of gain, does not occur until the earlier of (i) the executor’s assent to the distribution of the notes under state law, (ii) the cancellation of the notes by the executor under state law, (iii) the note becoming unenforceable, or (iv) termination of the estate administration for Federal income tax purposes. In other words, state law controls when the obligations are transferred for purposes of determining when the taxable early disposition has occurred.  

The SCIN term should not be set to expire too far beyond the grantor’s life expectancy because of both practical and reality-of-sale considerations. As a practical matter, the greater the SCIN term, the greater the risk premium and corresponding increase in interim interest payments. Moreover, under reality-of-sale principles, if the principal payment is postponed to a date that makes payment of principal during the grantor’s life highly unlikely, the transaction is likely to be recast as a trust substitute under § 2036(a)(1). Possibly because of the practical

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113 There has been a debate on the treatment of this risk premium. Compare Blum, *Self-Cancelling Installment Notes—The New SCIN Game?*, 60 Taxes 183 (1982), with Banoff and Hartz, *It’s No Sin to SCIN! A Reply to Professor Blum*, 60 Taxes 187 (1982).
115 Reg. §§ 1.483-5(b)(3)(iv) and 1.1275-4(c)(4) Example (1)(iii); but see G.C.M. 39503, Issue (2)(C)(2)(b), *supra* note 4 allowing the buyer who purchases for a contingent price to include the maximum principal amount of the obligation in basis. In *Rye v. United States*, *supra* note 66, the court stated that symmetry between the buyer and seller is not required in a private annuity sale.
117 § 691(5)(A)(iii).
118 The Tax Court agreed that the gain should be reported on the seller’s final income tax return. *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992), *rev’d* 998 F.2d 567 (8th Cir. 1993). The Eighth Circuit reversed on this issue, requiring the gain to be reported on the estate’s first fiduciary income tax return (Form 1041).
considerations, there has been little discussion of the maximum SCIN term. One possible analogy is Reg. § 1.1275-1(j)(6)(iii) that treats an annuity with a time limit greater than twice the annuitant’s life expectancy as not being subject to a significant limitation, which suggests the contrary—that a SCIN for a term greater than twice the decedent’s life will not be treated as a bona fide sale for a stated principal amount. The negative pregnant—that a sale for any shorter period will be treated as bona fide—is sound. Whatever actuarial table is used to measure the decedent’s life expectancy already has a built-in assumption that approximately 50% of the class of persons measured—the general population in Table 90CM and annuitants in Reg. § 1.72-9 Table V—will die before the specified term. Accordingly, any term more than a small period beyond that date is subject to substantial risk. The Reg. § 1.72-9 Table V more closely reflects the individuals who are likely to engage in the types of transactions considered in this paper. Any period longer than the Reg. § 1.72-9 Table V life is risky, and should be used only for clients who take an aggressive approach to estate planning even recognizing that, because of the risk premium, a SCIN is only a good deal if the grantor-seller dies before payment of the principal on the promissory note.

When Senior dies, any unpaid balance on the SCIN is not included in Senior’s gross estate because of the self-canceling feature. Nevertheless, the trust has a cost basis in the assets measured by the initial principal amount of the SCIN. This is because notwithstanding the cancellation of the note at death, it is deemed to be satisfied at its principal amount because the obligee is a related party, so that the previously realized but deferred gain is recognized. Although the Frane case on appeal held that the gain is reported as IRD on the estate’s income tax return, the better view is that the accelerated gain is reported on the decedent’s final income tax return.

The difference in payment terms between a SCIN taxed as an installment sale on the one hand, and a SCIN taxed as a private annuity sale on the other is complicated by the different life expectancy and discount rates used for income tax purposes than those used for transfer tax purposes. Using the 90CM tables and the § 7250 rate, the IRS has published a simplified method for determining the relevant divisor to be used in determining the annual payment for a SCIN.

c. Income Tax Characterization of a SCIN

Example 1: Senior, age 70, owns stock in the family business worth $1,000,000, with a basis of $200,000. The long-term AFR for December 2001 is 5.05% annual interest. The § 7520 rate for December 2001 is 4.8%. Under Reg. § 1.72-
Senior’s life expectancy is 16.0 years. Under 90CM Senior’s life expectancy is 13.9 years.

Senior agrees to sell his stock to Junior for a 16-year, interest-only installment note, with all principal due at the end of the note term. The note provides that Junior’s obligation to pay principal and accrued interest is canceled if Senior dies during the note term.

As discussed above, the income tax treatment of a SCIN depends on whether it is classified as an installment sale or as a private annuity sale. Under G.C.M. 39503, this in turn depends on whether the maximum term exceeds the selling senior family member’s life expectancy under the income tax annuity tables of § 72. If it does not, it is an installment sale; but if it does, it is a private annuity sale. Thus, major consequences can depend on relatively minor differences in payment periods.

Example 2: A selling senior family member who is 70 years old has an actuarial life expectancy of 16 years under the § 72 annuity tables. Accordingly, a SCIN that provides a maximum period of 15 years and 11 months is an installment sale, while one that provides a term of 16 years and 1 month is a private annuity sale under the IRS view.

For purposes of the illustrations that follow, we will assume that a 16-year note term for a SCIN is taxable as a fixed payment installment sale.

When a SCIN is taxed under the installment method, the gross profit ratio determines the allocation of each principal payment between return of basis and capital gain.

The following examples illustrate the income tax consequences of a SCIN treated as an installment sale by taking into account:

(i) whether the risk premium is to be treated as additional principal (“SCIN-PRIN”) or as additional interest (“SCIN-INT”), and

(ii) the income tax mortality assumptions contained in Reg. § 1.72-9 Table V and the long-term AFR.

If the premium required, because of the risk that the selling senior family member will die before the end of the maximum term of the obligation, is characterized as an additional principal amount, then the maximum sales price of the property is greater than for a fixed payment sale. This may result in additional capital gain and a larger basis for the younger generation buyer. If the risk premium is characterized as a higher interest rate, the principal, gain and basis are the same as for a fixed payment sale, but the interest is significantly more. The discounted value of the series of payments is the same no matter how the payments which

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124 The 12.7 year life expectancy multiple used to determine the expected return is obtained from Reg. § 1.72-9, Table VIII.
are split between principal and interest are characterized, as long as the same discount rate and actuarial assumptions apply.

The seller.

The literature and the computer software on SCINs assume that the gift and estate tax mortality tables and the § 7520 rate are used to determine the risk premium for the SCIN payments. As previously discussed, this assumption is not appropriate in all situations. Therefore, the examples that follow will illustrate the tax treatment for a SCIN using the long-term AFR as the interest rate and the longer life expectancy multiples found in Reg. § 1.72-9, Table V. The following table for a 16-year, interest-only $1,000,000 note illustrates the risk premiums using the 5.05% long-term AFR and Reg. § 1.72-9 Table V:

<table>
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<th>Life Expectancy</th>
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<td>Risk Premium</td>
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<tr>
<td>Rate Risk Premium</td>
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</tr>
<tr>
<td>Interest Rate With Premium</td>
<td>8.65709%</td>
</tr>
<tr>
<td>Principal Risk Premium</td>
<td>$ 441,528</td>
</tr>
<tr>
<td>Principal With Risk Premium</td>
<td>$1,441,528</td>
</tr>
</tbody>
</table>

Example 3 SCIN-PRIN at 5.05%.

Using the long-term AFR of 5.05% and the 12.7-year actuarial period for a temporary life annuity, based on the lesser of 16 years or the life of a 70-year old, found in the income tax annuity tables, the annual interest payment for the purchase of $1,000,000 worth of shares is $72,797 and the principal obligation is $1,441,528.

The $441,528 principal risk premium increases the selling price and the seller’s gain by that amount. Thus, the gross profit ratio is now 86.13% instead of the 80% for a fixed payment installment sale. The annual interest payment is greater even though the 5.05% annual interest rate remains the same because of the augmented principal amount.
The amount, character and timing of the income reported by Senior is:

### DEBT AMORTIZATION SCHEDULE WITH PRINCIPAL RISK PREMIUM

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<th>Pmt No.</th>
<th>Yearly Payment</th>
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<th>Capital Gain Principal</th>
<th>Tax Free Principal</th>
<th>Remaining Principal</th>
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**Totals**: $2,606,282 $1,164,254 $1,241,528 $200,000

**Example 4** SCIN-INT at 5.05%.

Using the long-term AFR of 5.05%, the interest risk premium is 3.60709%. Since the $1,000,000 principal remains the same, the gross profit ratio also remains at 80%. With an 8.65709% annual interest rate, the annual interest payment is now $86,571. The amount, character and timing of the income reported by S is:

### DEBT AMORTIZATION SCHEDULE WITH INTEREST RISK PREMIUM

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</table>

**Totals**: $2,385,134 $1,385,134 $800,000 $200,000

Compared to a SCIN-PRIN, the total payments are $221,148 less for a SCIN-INT, the reason being the larger interest payments received during the 16-year note term.

If all payments are made, the total gain is $441,528 less and the total interest is $220,380 more than in Example 3, a difference of $221,148.
The buyer.

As a fixed payment installment sale, the buyer’s basis is $1,000,000 for a SCIN-INT and $1,441,528 for a SCIN-PRIN.

3. When the SCIN is canceled

Because there is a possibility that none of the note principal payments will be made, under general income tax principles a SCIN is a contingent obligation, and it should be treated as a contingent payment installment sale. As a contingent payment installment sale, the younger generation buyer’s basis is limited to payments made. This is an anomalous result when the senior family member seller dies before the end of the maximum SCIN term in a related party sale, in that the younger generation buyer’s basis can be less than the aggregate of the capital gain and return of basis reported by the seller or the estate. Whatever the merits of the position of Rev. Rul. 86-72 and G.C.M. 39503 in giving the buyer an initial basis measured by the principal obligation, the logic of requiring the decedent’s estate to report the entire inherent gain, supports the view that the cancellation is a bequest to the younger generation buyer that should support a basis at least equal to fair market value at death.125 A counter argument is that although the gain is reported by the selling senior family member, the value of the remaining payments is not included in the gross estate. Nevertheless, the income tax result should prevail. We believe that a SCIN governed by the installment sale rules should be treated as a fixed payment installment obligation by both the buyer and the seller.

The effect of differences in the amount of principal depending on whether the risk premium is treated as interest or principal carries through to the consequences of termination of the SCIN upon the premature death of the selling senior family member. When the buyer and the seller are related parties, the value of the canceled installment obligation is deemed to be equal to its face amount.126 Since a SCIN-PRIN treats the risk premium as additional principal, there is more capital gain potential than in a SCIN-INT and a greater basis for the younger generation buyer. Again, when the gain is reported by the senior family member seller’s estate, the full basis should be allowed the younger generation buyer.

Example 5: Using the facts in Examples 3 and 4, assume that S dies having received only 10 annual payments. B’s obligation to make the remaining six annual payments is canceled. B and S are related parties. Therefore, the value of the canceled payments is treated as equal to its face amount.

(a) SCIN-PRIN. The outstanding principal amount for the remaining payments is $1,441,528, and the unrecovered basis is $200,000. The decedent’s final return or the decedent’s estate reports $1,241,528 of capital gain upon

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125 See Rev. Rul. 67-96, 1967-1 C.B. 195 (basis of stock acquired through exercise of option provided in will is date of death value plus any consideration paid for option). In Estate of Frane v. Commissioner, supra note 118, the facts indicate that the buyer’s basis only included the principal payments actually made. Presumably, the buyer should have claimed a basis measured by the contingent payment obligation. The authors feel that the approach taken in G.C.M. 39503, supra note 4, giving the buyer an initial basis for the SCIN equal to the note principal is consistent with the required reporting of the remaining gain upon the cancellation of the note.

126 § 691(a)(2), (a)(4)(B) and (5)(B). § 453B(f).
cancellation of the obligation. B’s basis in the shares should remain at $1,441,528 after the obligation is cancelled.

(b) SCIN-INT. The outstanding principal amount is $1,000,000, and the unrecovered basis is $200,000. The decedent’s final return or estate reports $800,000 of capital gain. B’s basis in the shares should remain at $1,000,000.

All of the capital gain inherent in the annual payments is eventually reported by the seller and the seller’s estate. The only difference is that for a SCIN-PRIN there is an additional $441,528 of capital gain. Therefore, an advantage of a SCIN-INT is the potential for less aggregate income being reported in the event of the selling senior family member’s premature death.

The irrebuttable presumption that the value of the canceled payments equals the principal amount does not apply if the buyer is not a related party, such as a son-in-law. The built-in termination reduces the amount received upon the disposition to zero, permitting the unreported realized gain on a sale to an unrelated party to escape income taxation. The tax savings are further increased because the selling senior family member should receive a deduction for any unrecovered basis. Therefore, an advantage of a SCIN-INT is the potential for less aggregate income being reported in the event of the selling senior family member’s premature death.

Example 6: The facts are the same as in Example 5, except that B is S’s son-in-law, who is not a related party.

(a) SCIN-PRIN. B’s initial basis in the shares is $1,441,528. Upon the death of S, the right to the $1,441,528 of principal payments becomes worthless. Therefore, none of the remaining capital gain is reported as income. B’s basis in the shares should now be reduced to zero because the $1,441,528 of debt cancellation is a reduction in basis under § 108(e)(5).

(b) SCIN-INT. B’s initial basis in the shares is $1,000,000. Upon S’s death, the remaining $636,641 principal obligation becomes worthless. None of the remaining $1,000,000 capital gain is reported as income. B’s basis in the shares is reduced to zero under § 108(e)(5).

4. Impact of Reg. § 1.1275-1(j)

Prior to the effective date of Reg. § 1.1275-1(j), it was generally conceded that a SCIN for a fixed term greater than the seller’s life expectancy, as determined by Reg. § 1.72-9, Table V, was characterized as an annuity so that its income tax consequences were determined under the § 72 annuity rules rather than the § 453 installment sale rules. With the issuance of Reg. §

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127 Temp. Reg. § 15A.453-1(3)(i) and (4). There is some argument for denying a deduction on the grounds that the loss is not part of a transaction entered into for profit, see Rev. Rul. 72-193, 1972-1 C.B. 58, or that the loss did not occur until death so that it is essentially a reduction in value of the property at death.


129 G.C.M. 39503 (Issue (1)) (Jun. 28, 1985), supra at note 4.
1.1275-1(j), it is likely that few PATYs, even ones with a maximum terms significantly greater than the seller’s life expectancy, can be “annuities.”

The OID rules generally require current accrual of interest on “debt instruments” as defined in § 1275(a)(1) and Reg. § 1.1275-1(d). Annuities are exempted from the application of the OID rules, which has the effect of allowing the “inside buildup” of annuity contracts to escape taxation until amounts are paid out on the annuity. To limit financial arrangements that take advantage of this tax shelter in a manner that the IRS considers improper, Reg. § 1.1275-1(j) limits the annuity exception to contracts containing terms ensuring that the life contingency under the contract is both “real and significant.” Reg. § 1.1275-1(j) takes the position that the contract is “real and significant” only if, on the day the contract is purchased, there is a high probability that total distributions under the contract will increase commensurately with the longevity of the individual over whose life the distributions are to be made. The regulation identifies terms and provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity, including a maximum payout provision. This applies to most PATYs and SCINs because the Regulation defines a maximum payout provision as a contractual provision that provides that no distributions under the contract may be made after some date even if the terminating death has not occurred. Although the Regulation provides a situation whereby the existence of a maximum payout provision can co-exist with an annuity, it is highly unlikely that a SCIN or PATY would qualify. Although apparently not intended to deal with private annuities, the Regulation eliminating the G.C.M. 39503 distinction based on the relation between the maximum term and the seller-annuitant’s life expectancy is sound tax policy. Indeed, although not appropriate for an OID regulation, we believe it would probably be sound policy to treat all private annuities, even those with no maximum term, as contingent payment installment sales subject to the OID rules.

130 There appears to be an exception for annuities with a maximum payout period that is more than twice the annuitant’s life expectancy, determined, not by Reg. § 1.72-9 Table V, but by the tables prescribed in § 417(e)(3)(A)(ii)(I) relating to determining present value for purposes of restrictions on cash-out of joint and survivor annuities under qualified pension plans.

131 § 1275(a)(1)(B)(i) exempts an annuity contract to which section 72 applies if the contract depends (in whole or in part) on the life expectancy of 1 or more individuals.

132 Reg. § 1.1275-1(j)(1).


134 Reg. § 1.1275-1(j)(6)(i).

135 Reg. § 1.1275-1(j)(6)(ii).


137 See Manning and Hesch, Private Annuities After the Installment Sales Revision Act of 1980, 6 Rev. Tax’n Indiv. 20, 32 (1982).
5. Comparison to using § 7520 rate and 90CM

For an individual age 70, the 90CM life expectancy is 13.9 years and the Reg. § 1.72-9 Table V life expectancy is 16.0 years. Generally, the § 7520 rate (which is 120% of the mid-term AFR) is higher than the long-term AFR. But, in a low interest rate environment, such as we have at this time, the § 7520 rate happens to be lower than the long-term AFR as the following table illustrates:

<table>
<thead>
<tr>
<th>Month</th>
<th>§ 7520 rate</th>
<th>Long-term AFR</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 2002</td>
<td>5.8%</td>
<td>5.85%</td>
</tr>
<tr>
<td>Apr. 2002</td>
<td>5.6%</td>
<td>5.62%</td>
</tr>
<tr>
<td>Mar. 2002</td>
<td>5.4%</td>
<td>5.48%</td>
</tr>
<tr>
<td>Feb. 2002</td>
<td>5.6%</td>
<td>5.60%</td>
</tr>
<tr>
<td>Jan. 2002</td>
<td>5.4%</td>
<td>5.46%</td>
</tr>
<tr>
<td>Dec. 2001</td>
<td>4.8%</td>
<td>5.05%</td>
</tr>
<tr>
<td>Nov. 2001</td>
<td>5.0%</td>
<td>5.31%</td>
</tr>
<tr>
<td>Oct. 2001</td>
<td>5.6%</td>
<td>5.39%</td>
</tr>
<tr>
<td>Sept. 2001</td>
<td>5.8%</td>
<td>5.57%</td>
</tr>
<tr>
<td>Aug. 2001</td>
<td>6.0%</td>
<td>5.72%</td>
</tr>
<tr>
<td>July 2001</td>
<td>6.2%</td>
<td>5.82%</td>
</tr>
<tr>
<td>June 2001</td>
<td>6.0%</td>
<td>5.75%</td>
</tr>
<tr>
<td>May 2001</td>
<td>5.8%</td>
<td>5.43%</td>
</tr>
<tr>
<td>Apr. 2001</td>
<td>6.0%</td>
<td>5.43%</td>
</tr>
<tr>
<td>Mar. 2001</td>
<td>6.2%</td>
<td>5.58%</td>
</tr>
</tbody>
</table>

As the next tables illustrate, for a SCIN, the use of the longer mortality rates under Reg. § 1.72-9 Table V results in lower risk premiums. Assume that Senior is age 70, the asset sold is worth $1,000,000, the note is 16 years, interest-only and the long-term AFR is 5.05% annual interest.
**Results Using Reg. § 1.72-9 Table V and AFR**

<table>
<thead>
<tr>
<th></th>
<th>Interest Only Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate Risk Premium</td>
<td>3.6071%</td>
</tr>
<tr>
<td>Interest Rate With Risk Premium</td>
<td>8.6571%</td>
</tr>
<tr>
<td>Principal Risk Premium</td>
<td>$ 441,528</td>
</tr>
<tr>
<td>Principal With Risk Premium</td>
<td>$ 1,441,528</td>
</tr>
</tbody>
</table>

**Results Using Table 90CM Book Aleph and AFR**

<table>
<thead>
<tr>
<th></th>
<th>Interest Only Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate Risk Premium</td>
<td>5.0104%</td>
</tr>
<tr>
<td>Interest Rate With Risk Premium</td>
<td>10.0604%</td>
</tr>
<tr>
<td>Principal Risk Premium</td>
<td>$ 640,945</td>
</tr>
<tr>
<td>Principal With Risk Premium</td>
<td>$ 1,640,945</td>
</tr>
</tbody>
</table>

**Benefit of Using Reg. § 1.72-9 Table V**

<table>
<thead>
<tr>
<th></th>
<th>Interest Only Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction of:</td>
<td></td>
</tr>
<tr>
<td>Interest Rate Risk Premium</td>
<td>1.4033%</td>
</tr>
<tr>
<td>Principal Risk Premium</td>
<td>$ 199,418</td>
</tr>
</tbody>
</table>

§ 1001.4. **Comparison of Installment Method to Annuity Rules**

The differences between the income tax treatment of installment sales, SCINs and private annuity sales makes the choice among them ridiculously complex.

The following list details the large number of differences that makes this choice a true challenge to the tax professional.

(i) The younger generation buyer’s basis is finally determined at the initial time of purchase using the value of the buyer’s obligation for a fixed payment installment sale, tentatively determined at the actuarial value of the annuity in a private annuity sale, and may be determined only as payments become fixed for contingent installment sales.\(^{138}\)

(ii) The younger generation buyer is permitted an interest deduction in fixed or contingent payment installment sales, but not in private annuity sales.

(iii) The selling senior family member reports interest income as it financially accrues, back- or front-loaded for installment sales, but a uniform annual amount for private annuity sales.

(iv) If the younger generation buyer’s obligation for a fixed or contingent installment obligation is terminated prior to maturity, the selling senior family member or the

\(^{138}\) There may be a purchase price adjustment under § 108(e)(5) if the value of the obligation at death is less than its face amount and the buyer is unrelated to the seller.
estate must report the remaining capital gain, if the buyer and seller are related parties, under the installment method, but not for a private annuity sale. Consequently, the seller does not have unrecovered basis in an installment sale, but may in a private annuity sale.

(v) Depreciation recapture cannot be deferred under the installment method, but there is no similar limitation for private annuity sales.

(vi) The anti-Rushing rule of § 453(c) for a subsequent sale by a related purchaser applies to installment sales, but not to private annuity sales.

(vii) The installment method is not available for sales of depreciable property to related parties, but there is no similar limitation for private annuity sales.

(viii) The installment method is not available for dealer or inventory sales, but may be for private annuity.

(ix) The selling senior family member in a large installment sale may be required to pay interest under § 453A on taxes deferred under the installment method, but there is no similar requirement for private annuity sales.

(x) Pledging of an installment obligation as collateral for a loan results in reporting of the gain otherwise deferred, with no similar provision for private annuity sales.

(xi) The installment method is not available if the younger generation buyer’s obligation is readily tradable, but such trading may not prevent qualification as a private annuity sale.

(xii) The installment method is available even if the younger generation buyer’s obligation is secured, but the private annuity sale approach is not.

(xiii) The installment method is not available for deferred payment sales of publicly-traded securities, but the private annuity sale approach may be.

(xiv) The OID and imputed interest rules apparently determine the transfer tax value of obligations taxed under the installment method, but do not apply to private annuity sales, so that the value is determined by discounting under the § 7520 rate.

\[139\] § 691(a)(5)(B).
\[140\] § 453(i).
\[141\] § 453(g).
\[142\] § 453(b)(2) and (1).
\[143\] § 453A(d).
\[144\] § 453(f)(4).
\[145\] § 453(k) (2).
\[146\] §§ 483(c)(3) and 1275(a)(1)(B).
(xv) The status of a selling senior family member’s health and other factors may be considered in an installment sale, but the actuarial tables are more likely to control private annuity sales.

(xvi) Specific rules control when the selling senior family member elects out of the installment method that generally prohibit use of the basis-first method; similar, but different rules avoid basis-first recovery for private annuity sales.

(xvii) The installment method can be used by shareholders for obligations resulting from a corporate sale of property,147 but there is no similar express provision for private annuity sales.

(xviii) An S corporation can distribute an installment obligation without immediate gain recognition,148 but there is no similar provision for private annuity sales.

§ 1002. Unresolved Tax Issues.

§ 1002.1 Valuation Departures from The Actuarial Tables

In Rev. Rul. 77-454149 the IRS imposed a minimum funding standard on a trust which paid for the asset purchased by issuing its private annuity obligation. The purchasing trust was obligated to only one annuitant. The IRS was concerned about the possibility that the annuitant will live beyond his actuarial life expectancy. Accordingly, the ruling determined how many annual payments could be made by the trust taking into account its initial corpus plus earnings at the assumed interest rate. Using Table S (4.8%) in Book Aleph for an individual age 70, the annuity factor is 9.2720. Therefore, an annuity payable annually, at the § 7520 rate of 4.8% for $1,000,000 is $107,853 ($1,000,000 ÷ 9.2720 = $107,853).150 A 70-year old individual has a 90CM life expectancy of 13.9 years. If he lives to age 83.9, he will have consumed the entire original corpus plus income at 4.8% by age 83.9. Accordingly, Rev. Rul. 77-454 determines the gift by recasting the annuity as one for the lesser of 13.9 years or life, which has a value of $762,446, resulting in a taxable gift of $237,554. In order to have a value of $1,000,000, the initial corpus must be sufficient to fund the annuity to age 110, the maximum age on table 90CM. The amount needed is $1,902,460. Accordingly, to avoid any gift tax, the family trust must have additional funding of $902,460. Presumably, as with family trusts used for installment sales, the additional funding can be provided by arrangements other than current or prior transfers, including guarantees.151 If the purchaser is an individual, there is no extra funding requirement as it is presumed an individual has the ability to obtain additional funds by his or her ability to earn future income. One way to lower the capital reserves is to use an

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147 § 453(h).
148 § 453B(h).
150 If the annuity payments are less frequent that quarterly, an adjustment is required by Reg. § 1.72-5(a)(2)(i). For a 70-year old individual, the adjustment for an annual annuity is -0.5 years. Thus, the 16.0-year life expectancy for a 70-year old is reduced to 15.5 years for determining the “exclusion ratio.”
annuity for joint lives. For example, an annuity for the joint lives of a married couple, both age 70, is $86,151 and the amount of the required capital reserve is $519,672.\textsuperscript{152}

If one accepts the IRS’s view in Rev. Rul. 77-454 as correct, then this approach should be used in determining the minimum funding of the purchasing trust. There are practitioners who apply the mythical 10% minimum funding standard used for installment sales to grantor trusts for private annuity sales. Obviously, if one wants a minimum funding safe-harbor, the standard promulgated in Rev. Rul. 77-454 is the safer approach.

Since the actuarial value of the $107,853 annual annuity is $1,000,000, the question arises whether the IRS was justified in Rev. Rul. 77-454 in ignoring this objective actuarial standard and using its more pragmatic approach. Interestingly, the Rev. Rul. 77-454 approach was rejected in \textit{Estate of Shapiro v. Commissioner}.\textsuperscript{153} The Tax Court refused to allow the IRS to deviate from its own actuarial tables, finding that to do so would contravene the fundamental purposes and functions underlying the actuarial tables. The Tax Court went on to say that one is justified in ignoring the actuarial tables only when their use will violate reason, and that absent an unreasonable result, the actuarial tables must be used.

A Federal district court recently valued a right to an annuity arising from a state lottery,\textsuperscript{154} and applied the same standard used in \textit{Estate of Shapiro}, holding that departure from the actuarial tables is justified only where the tables do not produce a value that reasonably approximates fair value. Courts have long recognized that a table-produced valuation is not appropriate only when the result is unrealistic and unreasonable.\textsuperscript{155} Surprisingly, the \textit{Shackleford} court found that the state’s restrictions on the lottery annuity justified such a deviation. Using the same standard, the Tax Court refused to depart from the actuarial tables in \textit{Estate of Gribauskas v. Commissioner}, 116 T.C. 142 (2001). In \textit{Gribauskas}, the decedent died owning a right to the remaining payments under a lottery he previously won. The estate reported the value of this annuity using general valuation principles for unsecured debt under § 2031. The IRS valued the payments under § 7520 and disregarded the non-assignability factor. The Tax Court disagreed with \textit{Shackleford} and held that the lottery annuity must be valued under § 7520 because they were a series of fixed payments not tied to any specific asset or subject to any market fluctuations. The Tax Court refused to follow the decision in the \textit{Shackleford} case, stating that the district court’s analysis in \textit{Shackleford} would undercut the legislative purpose of § 7520 to produce standardized actuarial valuations. The Tax Court went on to state that Reg. § 20.7520-3(b), which provides exceptions to the general application of § 7520, did not apply as there was no substantial risk that the payments would not be made.

In \textit{Estate of Cook v. Commissioner}, 82 T.C.M. (CCH) 154 (2001), the taxpayer owned a winning ticket from her state lottery, entitling her to a fixed amount payable in 20 annual installments. Under Texas law, lottery prizes payable in installments could not be transferred without a court order or converted to a lump sum at any time and there was no market in Texas

\textsuperscript{152} The joint life expectancy of two individuals, both age 70, is 18.4 years under Table 90CM and 20.6 years under Reg. § 1.72-9 Table V.

\textsuperscript{153} 66 T.C.M. (CCH) 1067 (1993).

\textsuperscript{154} \textit{Shackleford v. United States}, 262 F.3d 1028 (9th Cir. 2001).

for lottery prizes payable in installments. The taxpayer contributed her lottery annuity to a limited partnership. In valuing her limited partnership interest on her estate tax return, the Tax Court held that the lottery annuity must be valued under the actuarial tables rather than under general valuation principles, despite the fact that they were held in a limited partnership rather than individually. The Tax Court in *Cook* relied on its previous decision in *Gribauskas* and agreed with the IRS that a lack of a marketability discount was appropriate in valuing the partnership interests but was not grounds for altering the use of the annuity tables to value the underlying annuity owned by the partnership. The Tax Court held that the use of the actuarial tables did not produce a result so unrealistic and unreasonable that the tables were inapplicable.

The crucial issue is whether the valuation principles under the § 7520 Regulations, which were intended to establish a brightline test for the valuation of annuities, should be used where there are significant factors which negate their use. In the *Shackleford* case, the district court noted that there were ten California lottery prize winners who attempted to transfer their awards and the prices at which they were able to sell their awards for were substantially discounted to reflect certain factors. The court in *Shackleford* concluded that the actuarial tables did not reasonably approximate the fair market value of the lottery payments because California’s statutory anti-assignment restriction reduced the fair market value.

§ 1002.2. Income Tax Basis at Death in a Carryover Basis World

If the repeal of the estate tax, scheduled for 2010 is made permanent, new § 1022 will also eliminate the tax-free step-up in basis under § 1014(a) for property passing by bequest or inheritance. New § 1022(a) provides that property acquired from a decedent after 2009 is treated as property acquired by gift. Another new provision, § 2511(c), provides that if an individual makes a gift to a grantor trust after 2009, it will not be treated as a taxable gift. In effect, if there is no assignment of income for income tax purposes, there will be no gift for gift tax purposes.

Even if there is no estate tax, an installment sale to a grantor trust is a viable income tax planning technique if the grantor of the trust dies while the installment note is outstanding. As we pointed out previously, if death occurs while the installment note is outstanding, the trust’s income tax status as a grantor trust ceases and the trust comes into existence for income tax purposes as a purchaser. As a result, the trust is treated upon the grantor’s death as acquiring the assets previously transferred from the grantor by purchase, the purchase price being the amount of the note outstanding at the time of the grantor’s death. In effect, the trust acquired a cost basis in the property under § 1012(a). Since death is not a realization event, none of the built-in gain is realized by the seller or the seller’s estate for income tax purposes.

**Example 1:** Senior age 70 has a life expectancy of 16.0 years. This year Senior sells an appreciated asset worth $1,000,000, with a basis of $200,000, to a grantor trust Senior previously set up for her children. Senior takes back a 20-year interest-only installment note. The repeal of the estate tax is eventually made permanent. Senior dies in 2016 with the $1,000,000 installment note still outstanding.

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156 However, §§ 1022(b) and 1022(c) will provide a basis equal in value to $1,300,000 and $3,000,000 worth of property. Additionally, a decedent’s unused losses can increase basis in certain assets.

157 Since Senior anticipates being alive in 2010, no valuation discounts were taken on the asset sold.
outstanding. At the time of her death, the asset originally purchased by the trust was worth $1,600,000. At the moment of death, the trust is treated as having purchased the asset for $1,000,000 and takes a $1,000,000 cost basis in the asset. The other $600,000 of value is a gift, for income tax purposes and is not income to the trust because of § 102(a). Senior does not realize her $800,000 gain upon her death.

Since there was a sale for adequate consideration, there was no gift to a grantor trust. Therefore, there was no gift to a grantor trust. Accordingly, new § 2511(c) cannot apply and remains irrelevant. As we have advocated, none of the appreciation in the value of the asset sold to the grantor trust is realized as a gain for income tax purposes when the grantor dies. The remaining question is the basis that the grantor’s estate takes in the installment note given as consideration by the trust when it was a grantor trust. Although not entirely free from doubt, the estate’s basis in the note should be the same as the grantor’s basis in the note while the grantor was alive. With the repeal of the estate tax, carryover basis applies and the estate is treated for income tax purposes under new § 1022(a) as acquiring the property by gift.

As this analysis illustrates, an installment sale to a grantor trust is a technique designed to shift the built-in gain from the asset sold to the asset (the installment note) which comes into existence for income tax purposes upon the grantor’s death. After the grantor’s death, the non-grantor trust can sell the asset it purchased from the grantor without reporting any of the built-in gain existing at the time of the initial sale. Since the built-in gain has shifted to the installment note upon the grantor’s death, no gain will be reported on the installment note until principal payments are made. Since there is no longer a concern that a note term greater than the grantor’s life expectancy will be treated by the trier-of-fact as a trust substitute under § 2036(a), there is no longer any risk in having a note term longer than the grantor’s life expectancy.

**Example 2:** Upon Senior’s death in the above example, the trust now has a $1,000,000 cost basis in an asset worth $1,600,000. If the trust subsequently sells the asset for $1,650,000, its gain will be limited to $650,000. The potential $800,000 gain is now reposed in the $1,000,000 note which has a $200,000 basis for the estate.

If the estate, actually the estate’s successor-in-interest, wants to continue the deferral of the $800,000 gain after the note reaches maturity, the note can always be extended. Care must be taken so that the extension of the note is not a taxable realization event under Reg. § 1.1001-3. This may prove to be an obstacle if market interest rates at the time of the note extension are more than 0.25% different from the note’s original interest rate.

For those who feel there is no need for installment sales to grantor trusts if the estate tax is repealed, the above-described income tax planning is still something the individual should consider.

§ 1002.3 SCIN Risk Premiums

A risk premium must be added because of the possibility that the note will never be paid. The premium may be reflected in either a higher interest rate or a greater principal amount, or
some combination. Since the process of determining the value of the note is one of discounting, the issues become (i) which of the rates prescribed by the Code for discounting—the AFR prescribed in §§ 1274 and 7872 or the § 7520 rate prescribed for valuing certain term interests—applies and (ii) whether the income tax mortality table prescribed under Reg. § 1.72-9 Table V or the one prescribed in the Book Aleph (90CM) for transfer tax purposes applies. We believe that for a SCIN taxable as an installment sale, it is the AFR, not the § 7520 rate, that applies and that, with somewhat less certainty, the longer lives under Reg. § 72-9 Table V should apply.

1. Discount Rate

Section 7520 prescribes rates (120% of the midterm AFR) to be used for valuing annuities, life estates, remainders and term interests. When a SCIN is not an annuity, the question is whether it is a term interest. 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. This is consistent with (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 G.C.M. 39503 for a SCIN with a maximum term less than the seller’s life expectancy is treated under the installment sale rules of § 453.158 Similarly, according to the Tax Court in Frazee v. Commissioner,159 the interest rate to use in determining the value of the note for both income tax purposes and for gift tax purposes is determined by using § 7872, which uses the AFR. Furthermore, the proposed regulations under § 7872 and related provisions properly recognize that the appropriate-term § 7872 rate controls.160

2. Mortality Tables

There is no clear authority whether the life expectancies in Table 90CM161 or the longer life expectancies in Reg. § 1.72-9 Table V should be used to determine the risk premiums for a SCIN.162 We believe that the correct approach is to use the income tax annuity tables.163 In part this conclusion is based on the same reasoning as that supporting the use of the AFR, that a SCIN is not a term interest under § 7520. Although the § 7520 regulations prescribe the use of Table 90CM,164 there is no corresponding provision in the installment-sale regulations.165 In a broader sense, however, there is no requirement for any prescribed rate. The underlying assumption for the exclusion of installment sales to family trusts, including SCINs, from giving rise to taxable gifts is that they are bona fide business transactions.166 Accordingly, the pertinent

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160 Prop. Reg. §§ 1.7872-1(a), -2(a), 1.1012-2(b) and 25.2512-8.
161 See Reg. § 20.2031-7T(d)(7); Actuarial Tables Book Aleph, Pub. 1457 (July 1999).
162 Under Table 90CM, the life expectancy of a 70-year old is 13.9 years. Under Reg. § 1.72-9 Table V, it is 16.0 years. The reason the annuity tables have longer life expectancies is that they are based on a sample pool of individuals who purchase annuities, which is by self-selection, a healthier group than the general population.
163 See Shore and McClung, Beyond the Basic Super Freeze—An Update and Additional Planning Opportunities, 75 Taxes 41, 50 (1997), mentioning that there is no authority requiring uses of the transfer tax tables and suggests use of Reg. § 1.72-9 Table V.
164 Reg. § 25.7520-1T(b)(2).
165 See Reg. § 15A.453-1(c) relating to contingent payment sales. The absence of a regulation may be due to the fact that the installment sale regulations do not even refer to actuarial issues.
166 Reg. § 25.2512-8.
question is whether an intra-family sale transaction is on arm’s length terms. Unrelated parties, of course, are free to use any reasonable basis for actuarial adjustments. Related parties should have the same freedom provided they can show that they have acted within the range of arm’s length bargaining. On the other hand, it is doubtful that there are many SCIN transactions entered into by unrelated parties.

However computed, providing for the risk premium by increasing principal rather than interest provides two advantages: the premium is eligible for capital gains rates and may be deferred until payment of principal (or even eliminated if the seller dies before the end of the SCIN term). The deferral and chance of elimination can be maximized by providing payment of interest-only during the SCIN term with a balloon payment of principal at the end. The interest will, however, be increased to reflect the increased principal. On the other hand, such a deferral will increase the absolute amount of the principal payment.

3. Disregarding Actuarial Assumptions for a SCIN

Reg. § 20.7520-3(b)(3) provides that the mortality component described under § 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 death. Technically, the position taken in this regulation does not apply to a SCIN because a promissory note is not an annuity or future interest as described in that regulation. However, the better view is that the statement in the regulation is generally illustrative of situations in which the impending death of the individual should be taken into account and that standard actuarial tables do not apply. Indeed, since SCIN transactions of the type being discussed depend for their effectiveness on being treated as bona fide business transactions, applying the actuarial tables for a terminally ill individual would hardly satisfy the standard.

The regulation provides an 18-month safe harbor—if the individual survives more than 18 months, that individual shall be presumed to not have been “terminally ill” unless the contrary is established by clear and convincing evidence. The regulation is an estate tax regulation, which means that the IRS can apply it with the benefit of hindsight. Unfortunately, that type of perfect 20-20 vision is not available when the terms of a SCIN are established. It can only provide limited, after the fact, protection if the grantor-seller survives the 18 months.

4. Application of Estate Freeze Rules to SCINs

Even though it has a contingent payment, a SCIN should not be disregarded in determining whether a SCIN sale to a family trust involves a gift. First, the special valuation rules of § 2701 only apply in determining “the amount of the gift” and a properly crafted

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167 Cf. § 2703(b); Reg. § 25.2703-1(b)(1) to (4) (excluding buy-sell agreements on terms “comparable to similar arrangement entered into in arms’ length transactions”).


SCIN is a sale for transfer tax purposes not a gift.\textsuperscript{170} In addition, since a SCIN is a debt obligation, it cannot be an applicable retained interest subject to the special valuation rules.\textsuperscript{171} For similar reasons, it is not a lapsing right subject to § 2704 even though it may terminate on death. Section 2704 applies only to voting rights and limitations on liquidation, neither of which describes a SCIN. Although § 2704(a)(4) gives the Secretary the power to treat “other restrictions” as interests to be disregarded, there are no such regulations. Furthermore, as the IRS has recognized,\textsuperscript{172} § 2702 should not apply because the SCIN event, though subject to contingencies, is a debt obligation of, not a beneficial interest in, the family trust.\textsuperscript{173} The note holder’s rights are governed by the contract, not the terms of the trust.

5. Inclusion in Gross Income

Despite the breadth of § 61’s provision that all benefits received are gross income and must be reported unless an exclusion applies, the cancellation of the SCIN at death should not result in gross income to the family trust. As discussed above, transfer of even property subject to a liability at death does not give rise to gross income for the decedent. Such non-recognition is also recognized by § 102(a), for receipt of property received as a result of death. This is not inappropriate since any unrealized gain is either reported at death under § 453B(f) if the SCIN was still outstanding, or represented by a transferred basis if it was not.

6. Basis to the Purchaser

Under general income tax principles, a contingent liability is not taken into account by the purchaser in determining basis or by the seller in determining amount realized.\textsuperscript{174} Without more, a SCIN is a contingent liability because of the possibility it may never have to be paid. When the SCIN sale is to related party so that under § 453B(f) the termination of the obligation at death is treated as payment at its face amount, a SCIN should not be treated as a contingent liability. Accordingly, the family trust-purchaser should be entitled to include the SCIN principal in basis and the grantor-seller in determining amount realized and the selling price for installment sale purposes.\textsuperscript{175}

The 1980 Act added § 453B(f) to overturn the result in \textit{Miller v. Usry}\textsuperscript{176} which refused to apply the pre-1980 version of the disposition rule except to actual sales of the note for cash, and to make it clear that a disposition by gift should also be subject to the § 453B(a) disposition

\textsuperscript{171} § 2701(a)(1) applies only to a transfer of an “interest” in a corporation or partnership when there is an applicable retained “interest.” Reg. § 25.2701-2(b)(1) defines an applicable retained interest as an “equity” interest in a corporation or partnership. See e.g. Priv. Ltr. Rul. 94-36-006 (Mar. 14, 1994) (debt is not an interest subject to § 2701); Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (same).
\textsuperscript{173} See Mulligan, supra note 169, at ¶ 1507.2.
\textsuperscript{174} \textit{Albany Car Wheel Company v. Commissioner}, 40 T.C. 831, \textit{aff'd per curiam}, 333 F. 2d 653 (2d Cir. 1964); Reg. §§ 1.338-4T(b)(2)(ii), 4T(d)(2), 5T(b)(2)(ii) and 5T(e)(1).
\textsuperscript{175} See G.C.M. 39503 (Issue (2)(C)(2)(b) last sentence) (Jun. 28, 1985).
\textsuperscript{176} 160 F. Supp. 368 (W.D. La 1958).
The Committee Report makes it clear that in deeming that a payment is received, it also intended that a payment is deemed to be made by stating that:

The court [in Miller v. Usry] did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale.

Accordingly, the payment that is certain to be either received or deemed received by the seller under a SCIN should also be considered certain to be paid by the purchaser, who should receive an immediate basis in the property purchased with a SCIN. The IRS indicated that it approves of this analysis. “We therefore think it appropriate to allow the buyer-obligor to include the full face value of a note in its basis in the property acquired in the transaction.”

The contingent payment OID regulations determine the amount and timing of the interest income to be reported when there is a contingent payment sale. The examples illustrate that the contingent payment OID regulations take the position that a buyer obligated on a contingent payment obligation receives no basis upon incurring the contingent liability and the seller does not initially treat the contingent liability as part of its amount realized. The OID regulations go on to illustrate that the contingent liability gives rise to basis and amount realized only when the obligation becomes fixed or is paid. These regulations do not, however, define the term “contingent payment.” The question is whether a SCIN obligation of a related party (as defined for purposes of § 453B(f)) is a contingent payment obligation for purposes of these regulations and, if so, whether they change the result in G.C.M. 39503. We do not believe it should be. Under a SCIN, even one with a balloon payment, interest will be paid on fixed basis until death or another terminating event occurs. As indicated, under a SCIN to a related party of the type we are discussing, the principal will be paid or deemed paid on or before a fixed date. Accordingly, such a SCIN should not be considered a contingent liability and the IRS position in G.C.M. 39503 remains supportable.

The legislative history to the Installment Sales Revision Act of 1980 also provides support for the position that the purchaser can include the principal amount of the SCIN obligation as part of its initial basis in the purchased property. It explicitly states that the deferred gain recognized at such time is the “quid pro quo” for the buyer’s cost basis. Accordingly, the IRS would be justified in denying a cost basis for the obligation to the buyer only if it were to concede that gain is not recognized upon the extinguishment of the note. Those commentators who have addressed the issue of the buyer’s basis for the SCIN obligation come to the conclusion that the face amount of the note, even if the note is self-canceling, should be included in the basis. Furthermore, the Eighth Circuit in Frane v. Commissioner, mentioned

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177 A disposition by gift comes within “any other disposition” and is necessary to prevent an assignment of income already realized by the noteholder.
179 Reg. § 1.1275-4.
180 §§ 1.483-5 and 1.1275-4(c).
in footnote 5 that it was of the opinion that the buyer is entitled to an initial cost basis for the SCIN obligation. Although this statement was only dicta in the Frane case, the court in Frane went on to conclude that since the G.C.M. 39503 clearly shows that the plain language of § 453B requires that the obligee recognize the gain, it follows that consistent treatment can be afforded to the obligor and no injustice results.

Nor should § 108(e)(5) require an adjustment in the purchaser’s basis. Section 108(e)(5) is intended to apply to situations where the noteholder is able to deduct the canceled obligation as a bad debt. Applying this tax symmetry analysis to the SCIN sale illustrates that § 108(e)(5) does not apply. The cancellation of the SCIN is not treated as a cancellation because, as discussed above, § 453B(a), in conjunction with § 453B(f), treats the cancellation as a deemed payment. Applying the tax symmetry principle, the noteholder cannot take a bad debt deduction because § 453B(a) deems that the noteholder received a payment equal to the amount of the liability canceled. Therefore, the fictions created by the § 453B disposition rule remove the cancellation of the liability from the reach of § 108(e)(5).

a. Comparison and Summary

As mentioned previously, the § 7520 rate is generally higher than the long-term AFR. In such a situation, the effect of the combinations of choice of discount rate and actuarial assumptions can be exemplified by the following table based on an interest-only SCIN for $1,000,000 of property sold by Senior, age 70 and all principal payable at the end of 16 years.\(^\text{184}\) For illustrative purposes, we will use the July, 2001 long-term AFR of 5.82% and the July, 2001 § 7520 rate of 6.2%.

<table>
<thead>
<tr>
<th>Mortality and Interest Factors</th>
<th>Interest Rate Increase</th>
<th>Principal Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFR (5.82%) and Reg. § 1.72-9 Table V (16.0 years)</td>
<td>3.56%</td>
<td>$406,212</td>
</tr>
<tr>
<td>AFR (5.82%) and Table 90CM (13.9 years)</td>
<td>4.95%</td>
<td>$587,785</td>
</tr>
<tr>
<td>§ 7520 rate (6.2%) and Reg. § 1.72-9 Table V (16.0 years)</td>
<td>3.53%</td>
<td>$390,418</td>
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<tr>
<td>§ 7520 rate (6.2%) and Table 90CM (13.9 years)</td>
<td>4.92%</td>
<td>$564,229</td>
</tr>
</tbody>
</table>

\(^{183}\) 998 F.2d 567 (8th Cir. 1993).
\(^{184}\) Although we assume that interest only is payable before the end of the maximum term, there probably should be at least one payment (due in the year after the sale) that is not canceled by death to assure compliance with the definition of an installment sale as one where “at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.” § 453(a). A literal reading of this provision could disqualify an interest only SCIN because there may be no payment to be received after the year of disposition if Senior dies in that year.
As the chart indicates, the choice of actuarial table has a much greater effect on the risk premium than the choice of interest rate. When the premium is assigned to principal, it can increase the purchase price from as little as 39% to as high as 59% on the assumed facts. If Senior lives to collect the principal, this can significantly reduce the benefit of the freeze.

§ 1002.4 Reality of Sale Revisited.

A properly structured installment sale to a grantor trust is shielded from the factual argument that it is a trust substitute under § 2036(a), with resultant inclusion in the grantor’s gross estate at death, as long as the reality of the intra-family sale is respected after the sale takes place. Since the senior family member is asking the IRS to respect the intra-family sale as if it were a sale to a third-party, the family should do the same.

Some tax planners suggest that if the death of the grantor is expected before the end of the note term, that the grantor trust should prepay the note while the grantor is alive with some of the appreciated assets originally sold to the grantor trust. Thus, the note’s existence is eliminated and the grantor now owns an appreciated asset eligible for a tax-free step-up in basis at death.

Example: Senior sells an asset worth $1,000,000 with a $200,000 basis to a grantor trust for an interest-only installment note. Several years later, when the property sold to the grantor trust had appreciated in value to $2,000,000, Senior became ill and was not expected to survive. The trust uses $1,000,000 of assets with a basis of $100,000 to prepay the note while Senior is still alive.

If this course of action is followed, the soon-to-be decedent has given the IRS and the Tax Court as the trier-of-fact a factor that can be used to disregard the reality of the sale and treat the note as a § 2036(a) trust substitute. The reason is apparent when viewed in the context of real world seller-financed sales. Sellers do not typically take back the asset sold in satisfaction of the note principal unless there is a foreclosure or the purchaser is in financial distress and unable to meet its obligations on the note as they become due. Therefore, this course of action is not recommended. And, since we believe that the trust takes a cost basis by purchase if the grantor dies while the note is outstanding, there is no need to take this risk by prepaying the note.

§ 1002.5 Conversion of trust’s income tax status.

1. Termination during Grantor’s Life

If Senior relinquishes the power(s) that intentionally made the family trust a grantor trust during his life, a realization event has occurred for income tax purposes. The issue of the family trust’s basis for the property is whether it should be a basis determined under the part sale, part gift provisions of § 1015, or should be a cost basis. We believe the considerations discussed there apply equally to transfers during the grantor’s life. On the other hand, since the


186 See Reg. § 1.1015-4.
transfer is during life, Senior now realizes gain on the installment sale. Because the sale for income tax purposes occurs only upon termination of grantor trust status, it does not relate back to the time when the original sale was made for transfer tax purposes. The gain is measured using the then tax amount of the balance of the installment note, not the original sale price, and the then basis of the property. The tax balance of the note is, in turn, determined using the AFR at that time. The then basis of the property is determined with appropriate adjustment for any depreciation since the transfer, any capital expenditures made by the trust and any other appropriate items.

The conclusion that termination during life is a realization event is not inconsistent with the judgment that the automatic termination of grantor-trust status at death is not a realization event. Transmission of property at death is, as far as we know, the only disposition that is not a realization event and that generally eliminates unrealized gain or loss because of the basis adjustment under § 1014(a). Most so-called nonrecognition transactions involve both basis carryover and recognition to the extent of boot. Donative family transactions involve recognition if consideration is received, including consideration in the form of a liability transfer.187 Even transfers in connection with a divorce under § 1041 can involve recognition under assignment of income principles.188 At most, transmission at death can result in a transfer, not a realization, of IRD.189

2. Conversion of non-grantor trust to grantor trust.

Although not a termination of grantor trust status, similar issues arise when a non-grantor trust is converted into a grantor trust, either intentionally or by mistake. Under principles analogous to those of Rev. Rul. 85-13,190 a taxable event has occurred; the transfer of the assets from the trust to the grantor.191 The family trust should recognize gain, but only for any difference between amount of the liability on the promissory note at that time and its cost basis in the property.

What is clear is that the liability no longer exists for income tax purposes because of the merger of the obligor and the obligee by application of the grantor trust rules. The seller, now treated as the grantor of the purchasing trust, should realize gain on the deemed receipt of the family trust property in satisfaction of the installment obligation, because the conversion means that the grantor is now the owner of the family trust’s property for income tax purposes and the family trust’s note has been satisfied by his “receipt” of the property in settlement of the note.192

188 Temp. Reg. § 1.1041-1T(a) Q&A-4; Kochansky v. Commissioner, 92 F.3d 957 (8th Cir. 1996); Yonadi v. Commissioner, 21 F.3d 1292 (3rd Cir. 1994); Balding v. Commissioner, 98 T.C. 368 (1992); Gibbs v. Commissioner, 73 T.C.M. (CCH) 2669 (1997).
189 § 1014(c); but cf. Rev. Rul. 87-112, 1987-2 C.B. 207 (accrued interest on Series E bond recognized by donor on transfer to ex-spouse in connection with divorce).
190 See also Reg. § 1.1001-2(c) Example 5.
191 Cf. Rev. Rul. 99-5, 1991-6 I.R.B. 8 (dealing with converting an LLC taxed as a partnership into a single member LLC that is a disregarded entity); Reg. § 1.1361-4(a)(1)(i) and (ii) and (a)(4) (dealing with the effect of an election to treat a qualified subchapter S subsidiary as, in effect, a division).
192 See Rev. Rul. 73-423, 1973-2 C.B. 161 (transfer of installment obligation by seller to debtor in § 351 transaction treated as taxable settlement by seller); Jack Ammann Photogrammetric Engineers, Inc. v.
Any future conversion of the grantor trust back to nongrantor trust status has the consequences discussed above, although with lesser consequences because the grantor-seller has now realized the gain and has a purchase price basis in the property.

Example  Senior owned stock in the family S corporation worth $1,000,000 with a basis of $200,000. In 1999, Senior sold her stock to a family trust, which was an eligible S corporation shareholder because it was a QSST. Senior took back an interest-only installment note, 20-year term, for the entire purchase price. The family trust was not a grantor trust at the time of the sale. In 2002, the family trust became a grantor trust for Federal income tax purposes. For 2002, Senior must report the $800,000 capital gain, and the trust’s basis in the stock is now $1,000,000. All subsequent principal payments on the note are a return of basis.

Gain recognition upon the conversion to a grantor trust should occur even though it is possible that the trust may again become a non-grantor trust in the future.

§ 1002.6 Disposition of note or purchased asset

1. Grantor Trust Disposes of Purchased Asset Subject to the Promissory Note

Even though it does not involve a termination of grantor trust status, the family trust’s disposition, while it is a grantor trust, of the purchased asset subject to the obligation on the promissory note, must result in a similar taxable event for income tax purposes. The grantor now has a third-party obligor and is no longer taxable on the income from the purchased property transferred to the obligor. Under the principles of Rev. Rul. 85-13, the grantor has made a taxable sale of the property for income tax purposes at that time. The taxable gain should be measured by the tax amount of the promissory note, determined under the OID rules based on the AFR at that time, plus any additional consideration received by the family trust.193

2. Grantor’s Disposition of the Family Grantor Trust’s Note

Even though it does not involve a termination of grantor trust status, the grantor’s disposition of the promissory note issued by the family trust while it is a grantor trust, must result in a similar taxable event for income tax purposes. The note that was disregarded for income tax purposes as an obligation owed by the grantor to himself, when owed to a third party, can no longer be disregarded.194 In the first instance, the grantor’s transfer of the note should have the same consequences as would apply if the grantor issued the note to the transferee. If the note is

Commissioner, 341 F.2d 466 (5th Cir. 1965) (corporate-purchaser transferee does not realize gain because it issued its stock under § 1032 to settle obligation); Manning, The Issuer’s Paper: Property or What? Zero Basis and Other Income Tax Mysteries, 39 Tax L. Rev. 159 (1984).


194 Cf. U.S. v. Wham Construction Corp., 600 F.2d 1052 (4th Cir. 1979) (liability owed by one corporate division to another is not treated as a liability assumed by the transferee when the division is incorporated, but is treated as boot paid).
given to a charity, it represents a charitable contribution, albeit one that probably cannot be deducted until paid. The fact that the legal obligor on the note is the family trust probably does not change the general rules on payment since, under Rev. Rul. 85-13, the grantor is not merely taxed on the income of the trust, but owns the trust. Similarly, if the family trust’s note is transferred to a family member without consideration, it is a gift. If the note is transferred in consideration of goods or services, it amounts to payment for those goods or services and has the appropriate tax character under general income tax principles as deductible, capitalizable or neither, when appropriate under the taxpayer’s method of accounting.

For income tax purposes, the more difficult question is whether the transfer should also be treated as a taxable sale of the property previously transferred to the family trust. Although the matter can hardly be considered free from doubt, a substantial argument can be made that since the grantor still owns the family trust corpus for income tax purposes and will still be taxed on the family trust’s income used to pay the note, the note does not represent consideration for the property. Under this view, the family trust would not be entitled to a cost basis or even a part sale, part gift basis in the property. On the other hand, the initial transaction was an installment sale, disregarded it is true for income tax purposes, that has become a transaction recognized for tax purposes simultaneously with the transfer of the note. The note is an obligation of the family trust as a matter of state property law, whatever the grantor trust rules may provide as a matter of tax law. Accordingly, it appears more appropriate to view the transaction as involving a transfer of the property to the trust at that time for the note followed immediately by Senior’s transfer of the note. Under this approach, Senior’s transfer of the family trust’s note is a taxable installment sale, so that the disposition rules under § 453B would then apply to require the grantor to recognize the inherent gain in the property and, incidentally to provide the family trust with a cost basis. The tax fiction of Rev. Rul. 85-13 should not be carried to the point of completely disregarding a transaction that has effect under both local law and the transfer tax. Disregarding the transaction for income tax purposes under the grantor trust rules does not change its nature as an installment sale that should be so characterized for income tax purposes when it is no longer disregarded.

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195 See, e.g., Don E. Williams Co. v. Commissioner, 429 U.S. 569 (1977) (corporation’s note not deductible contribution to a qualified pension plan because not cash); Rev. Rul. 68-174, 1968-1 C.B. 81 (taxpayer’s note not deductible charitable contribution); Rev. Rul. 82-197 1982-2 C.B. 22 (written option on corporation’s stock granted to charity not deductible until exercised, no payment).


197 But see Rothstein v. United States, 735 F.2d 704 (2nd Cir. 1984). In that case, the court determined that the grantor trust rules do not actually treat the grantor and the trust as one, but merely require that the grantor report all of the trust’s items as his own and recognized a sale by the trust to the grantor as allowing the grantor-purchase to use the purchase price as the basis of the assets. A taxpayer who initially treated the transaction under Rev. Rul. 85-13 would almost certainly be bound by a duty of consistency in treating the transfer of the note.

198 Rev. Rul. 67-396, 1969-2 C.B. 351 (gift of donor’s note, assumed to be unenforceable under state law, is not gift until paid or transferred for value); Rev. Rul. 84-25, 1984-1 C.B. 191 (gift of enforceable note is gift when delivered).

§ 1002.7. Use of a SCIN for sale to a grantor trust

Most individuals anticipate a slow but steady appreciation in the value of their assets. The use of an installment sale to a grantor trust as an estate freeze shifts future appreciation to the estate-tax exempt trust because the AFR is always lower than comparable market rates. For example, the Dec. 2001 long-term rate is 5.05% annual interest. And, if one uses a note where the interest rate adjusts annually, the short-term AFR can be used (2.48% annual interest for Dec. 2001). If the grantor trust invested in assets that produced a combined annual rate of return of 7.5%, there would be a slow but steady tax-free built-up in the grantor trust.

For this type of situation to be successful, the estate planning freeze depends upon a build-up over several years and the compounding effect which increases over time. Because there is always a possibility the grantor will die sooner, the fixed payment installment sale to a grantor trust may not shift much wealth if early death occurs. For Senior age 70, the probability of Senior dying during the next 10 years is 34.0%. And, the probability of Senior dying before reaching his life expectancy age of 86 is 59.8%. Surviving ten years is significant if there will be no estate tax after 2010.

The use of a SCIN for a healthy senior family member should be considered in this type of situation. Assume that the seller-provided financing that Senior provides is an interest-only 10-year deferred payment sale to a grantor trust and the long-term AFR is 5.05%. If Senior uses a 10-year SCIN and the risk premium is additional interest, the annual interest rate on the note would increase to 7.68%, an increase of only 2.63%. Alternatively, if the risk premium is additional principal for the sale of a $1,000,000 asset, the risk premium would increase the note principal to $1,217,777. Using the 5.05% long-term AFR as the base, the annual interest payment would be $61,498, an effective interest rate of 6.15%.

If a SCIN is used instead of a fixed payment installment note, the financial leverage of the freeze is reduced somewhat. If Senior survives the 10-year term of the note, the freeze is successful, although at a slightly lower amount. If Senior dies during that 10-year period, the SCIN is estate planning insurance because the note is not in his gross estate and the grantor trust receives the estate tax-free wealth shifting windfall of the note cancellation.

§ 1002.8. Does a demand note eliminate the risk premium for a SCIN?

It has been suggested that if a SCIN is payable upon demand, there is no need for a risk premium because the selling senior family member has the ability to obtain the entire principal amount at any time. Although far from clear, it is possible that a demand SCIN without a risk premium is subject to the interest free loan rules under § 7872. In effect, an interest risk premium should be imputed as a gift under § 7872 at year-end for each taxable year the SCIN remains outstanding, probably using the interest rates in effect at the end of each year.

**Example:** Senior sells an asset worth $1,000,000 for a SCIN on January 1, 2001, using the long-term AFR in effect in January. The SCIN is a demand note; the principal is $1,000,000 and the fixed annual interest is the long-term AFR for January, 2001. Using the December, 2001 long-term AFR of 5.05%, the interest
risk premium is 2.3%. Each year-end § 7872 applies, and a gift of $23,000 will be imputed.

§ 1003. Income Tax Planning with Stock Options.

The character of the income reported by an employee upon the exercise of a non-qualified stock option (“NQSO”) is compensation income. First, it is reported as ordinary income, not a capital gain. Second, as compensation income, it is exposed to the Medicare portion of the employment taxes. Third, as compensation income it is subject to withholding where there is actually no cash received. Thus, the amounts withheld must come out of other income the employee receives.

Example: Senior, the founder of a publicly-traded corporation, was granted non-qualified stock options to purchase 10,000 shares of stock for $12 a share. At the time of the grant, the market price of the stock was $12 a share. In December, 2001, shortly before the options were to expire, Senior exercised her options by paying $120,000 for the 10,000 shares she acquired. At the moment of exercise, the stock was trading at $38 a share. For 2001, Senior must report $260,000 of compensation income (ordinary income), and the corporation deducts $260,000 in 2001. Later, Senior sold all 10,000 shares in August, 2002 for $40 a share, a total of $400,000, realizing and recognizing a short-term capital gain of $20,000 for 2002. Senior’s basis in the stock sold was $380,000. The aggregate income Senior reported was $280,000, $260,000 of ordinary income in 2001 and $20,000 of capital gain in 2002.

There are two income tax planning objectives. The first is to freeze the compensation amount at its current level so that all future appreciation in the value of the non-qualified stock option is capital gain. The second is to defer the income tax reporting of the compensation income.

§ 1003.1. Income Tax Freeze

One could always exercise the option shortly after it is granted or before the stock has appreciated beyond the exercise price. The problem is where to find the funds needed to pay the exercise price. The employee will either have to come up with the cash to pay the exercise price to the corporation or sign a loan to the corporation for the amount of the exercise price. If the corporation eventually does not prove to be successful, the employee is going to be liable even if the corporation goes bankrupt. The disadvantage is the cash outlay, which has to be paid to the corporation in cash or in the form of a note. A solution is to engage in a taxable sale to a non-grantor family trust or a family entity such as a limited partnership. Any gain realized on the sale to the family entity is compensation. And, all subsequent appreciation in the hands of the family entity, as a purchaser for value and not as an employee, is capital gain. The employee can sell the options to the family entity for cash. No cash is given to the corporation so that the cash stays within the family. If the employee takes back the family entity’s deferred payment obligation for the entire selling price, no cash is needed to implement this intra-family sale.
**Example:** Senior, the CEO of a publicly-traded corporation, has recently been granted non-qualified stock options to purchase 10,000 shares of stock for $12 a share. At the time of the grant, the market price of the stock was $12 a share. Even though the options were not in the money at the time of the grant, the options had a value of $3 a share. Immediately after receiving the option to purchase the 10,000 shares, Senior sold her non-qualified stock options to a family limited partnership where all of the limited partnership interests were owned by junior family members. The FLP issued a $30,000 interest-only installment note, with the interest at the long-term AFR, as consideration for the purchase.

At the time of this sale, Senior realized a $30,000 gain, and the gain is characterized as compensation income.\(^{200}\)

Several years later, the stock appreciated in value to $38 a share, and the FLP then exercised its options by paying $120,000 for shares then worth $380,000. Upon exercise, the FLP does not recognize its $230,000 of potential income.

Two years later, the FLP sells all 10,000 shares for $40 a share. The amount realized is $400,000, and its basis in the stock is $150,000, which includes the $120,000 paid to exercise the options and the $30,000 paid for the options. The FLP realizes and reports a $250,000 long-term capital gain on the sale.

**§ 1003.2. Income Tax Deferral in General**

It has long been recognized that intra-family deferred payment sales, when properly structured to avoid the anti-Rushing rule under § 453(e), have been effective to defer the capital gain the family member realizes on the deferred payment sale.

**Example 1.** Senior owns stock in the family business worth $1,000,000, with a basis of $200,000. Senior sells his stock to a non-grantor trust for an interest-only installment note. Since the stock is not a marketable security, the capital gain is eligible for reporting under the installment method. Two years and one day later, the family trust sells the stock it purchased from Senior for $1,050,000, reporting a $50,000 long-term capital gain. Because the resale of the stock occurred more than two years after the asset was purchased from Senior, Senior may continue to defer the reporting of his $800,000 gain under the installment method.

**Example 2:** Same facts as in Example 1, except that the stock is a marketable security and the family trust issues a private annuity to Senior as payment, promising to pay Senior $107,853 a year for life. The trust’s tentative basis in the stock is $1,000,000. The trust cannot wait the two years as above and resells the stock one month later for $1,010,000, reporting a $10,000 short-term capital gain.

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\(^{200}\) Whether the $30,000 of ordinary gain must be immediately reported or can be deferred is discussed later in this paper. Even if there is no deferral, the employee has sold the option, and the compensation income is frozen at its current level.
Senior can continue to defer the reporting of her $800,000 capital gain under the § 72 annuity rules.

The advantage of a private annuity sale over an installment sale is premised upon the treatment of the private annuity sale under the § 72 annuity rules instead of the § 453 installment sale rules. The two advantages of an annuity are that § 72 has no anti-Rushing rule counterpart\textsuperscript{201} and that the sale of marketable securities is not eligible for the installment method,\textsuperscript{202} while a private annuity sale of marketable securities is eligible for income tax deferral under § 72.

The next question is whether intra-family deferred payment sales can be used to defer the reporting of the compensation gain that would otherwise be reported upon employee’s exercise or other disposition of the non-qualified stock option.

\section*{§ 1003.3 \hspace{1em} Review of Basic Income Tax Principles.}

A. The employer promises to pay the employee a fixed dollar amount in the future. This promise for future compensation is an unfunded and unsecured promise to pay a specific amount in the future. In addition, this right to future compensation is not assignable except by death. The tax results are clear in this situation. Upon receipt of the promise to pay compensation in the future, the employee reports no income, and the employer cannot take a deduction even if the employer uses the accrual method of accounting.\textsuperscript{203} Upon actual payment, the amount received will be reported by the employee as compensation income, and, at that time, the deduction can be taken by the employer.\textsuperscript{204}

B. A taxpayer owns appreciated property. The taxpayer sells this appreciated property, taking back the purchaser’s promissory installment note for the entire selling price. Section 453 is found in the Chapter under “Methods of Accounting: Taxable Year Income Reported.” Section 453 is not found in the subchapter where the non-recognition provisions of the Internal Revenue Code are located, such as Section 1031. Section 453(a)(1) provides that “income from an installment sale can be reported under the installment method.” Consequently, a deferred payment sale between third parties is eligible for deferral of the gain realized on the sale. Technically, an installment sale is not a realization event under Section 1001.

C. The employee has been using a company car. Instead of selling the car, the employer transfers title to the car to the employee. This is a transaction governed by Section 83(a). The business car is “property.” Consequently, the employee must report the value of the car received as compensation income at the time of receipt, and the employer is able to take a compensatory deduction under Section 162 for the value of the car. Furthermore, the employer will report a Section 1245 gain equal to the difference between the employer’s adjusted basis in the car, as reduced by depreciation deductions, and the value of the car.

\textsuperscript{201} § 453(e).
\textsuperscript{202} See § 453(k)(2).
\textsuperscript{203} § 404 places an accrual method employer on the cash method in certain compensatory situations.
Note the definition of property in Section 83. Reg. § 1.83-3(e) provides “for purposes of Section 83, the term property does not include an unfunded and unsecured promise to pay money or property in the future.” Since Section 83 was intended to cover the employer/employee relationship, it is logical to conclude that Section 83 principles should only apply to transactions between the employer and the employee. But, as will be discussed in § 1003.4.A.1., the Regulations under § 1.83-7(a) take a broader view.

D. Grant of a non-statutory stock option (NQSO). The grant to an employee of an option to purchase stock in the corporation is not income to the employee upon the grant because you do not have the receipt of property. For an NQSO, these type of options have no readily ascertainable value. Consequently, Section 83(e)(3) provides that Section 83 shall not apply to the grant of an option with no readily ascertainable value. At this point, the grant of an option, although an enforceable legal obligation under local law, is only an unfunded and unsecured promise to deliver property in the future.

It is not clear as to the circumstances under which options which are non-qualified do not have a readily ascertainable fair market value. A 1976 committee report requested that the Treasury Department develop regulations to allow for valuation of non-qualified stock options in order to allow employees to make the Section 83(b) election. Because Section 83 does not apply to the grant of non-qualified stock options, there is no ability to make a Section 83(b) election at the time of the grant.

E. Exercise of NQSO. At the time the employee exercises the stock option, there is property received, the property being the employer’s stock. At that time the employer reports the spread as compensation income and the employer is able to take a deduction for the spread under Section 83(h). Regulation Section 1.83-7(a) provides that if Section 83(a) does not apply to the grant of an option, then Section 83 principles apply to the exercise of the option.

F. The employee sells the stock option to the employer in an arms-length sale. Recall that Section 83(e)(3) states that Section 83 does not apply to the grant of an option which has no ascertainable value at the time of the grant. The regulations under Section 1.83-7(a), last sentence, provide “If the option is sold in an arms-length transaction, then we apply Sections 83(a) and 83(b) to the receipt of money or property received by the employee in the same manner as Sections 83(a) and 83(b) apply on exercise of the option.”

1. Sale for Cash. If the option is sold back to the employer for cash, then the employee reports the cash received as compensation income at that time, and the employer gets a symmetrical deduction.

2. Sale for Deferred Payment Obligation of the Employer. Assume that the employee sells the option back to the employer for the employer’s unfunded and unsecured promise to pay money in the future, either an installment note or a private annuity note. The obligation is not “property” as defined in Reg. Section 1.83-(e)(3) which states that unfunded and unsecured promises are not property. Even using the narrow view that Section 83 only applies to the employer-employee relationship, no property is received and consequently no compensatory income is reported at the time of the deferred payment sale back to the employer. See also the

Olmstead\textsuperscript{206} and Oats\textsuperscript{207} cases where employees were owed insurance renewal commissions. The employer substituted its promise to pay a fixed annuity for the renewal commissions. The courts held that this was not a sale but a change in the employer’s promise to pay compensation in the future and was nothing more than a change in the employment contract.

G. The employer owns a note of a third party which is an unfunded and unsecured promise to pay. Assume the employer lent a third party money and had a note receivable. If the employer transfers this third-party note to the employee as compensation for services, is this third-party note “property?” Although it is not clear from doubt, it seems that under general income tax principles, if a cash method taxpayer receives a third party note (even if unfunded and unsecured) it is currently taxable as a “cash equivalent.” It is a cash equivalent because the note is “transferable.” It appears that the receipt of this third party note by the employee from the employer is treated as a compensatory payment at the time the note was given by the employer to the employee.

§ 1003.4 Intra-Family Deferred Payment Sale of Stock Options.

A. The employee sells the non-qualified stock option to a family entity in an arms-length sale. Assume that the family entity is a family-limited partnership. In return for selling the stock options to the family entity, the employee receives a promise to pay money in the future which is an unfunded and unsecured promise to pay and is also non-assignable except by death. The first issue is whether Section 83 principles apply to a transaction between the employee and a party who is not the employer?

1. **Taxpayer’s view.** Examine the language of Reg. Section 1.83-7(a) closely. It provides “If the option is sold in an arms-length transaction”, then apply Section 83 to the transfer of money or other property received. This language does not by its terms limit itself to employer-employee transactions. This language should also apply to a transfer between an employee and a third-party. Judicial support for extending the application of Section 83 principles beyond the employer-employee relationship can be found in the Tax Court’s decision in Childs.\textsuperscript{208} If the employee, third-party transaction is governed by Section 83 principles, then the use of the definition of property in Reg. Section 1.83-(e)(3) is mandated. As a result, the employee does not report any compensation income upon receipt of this third-party obligation (which is unfunded and unsecured) because it does not meet the definition of property. It also should be nontransferable so that it is not a cash equivalent. See Mitchell v. Commissioner, 65 TC 1099 (1976), a case where the tax year predates 1969, the year in which Section 83 was enacted. Although the Mitchell case indirectly supports this view, because of its peculiar facts, it is not a viable precedent. But, the result in the Childs case is support for this position. Therefore, one is justified in assuming that Section 83 principles apply to the employee’s sale of a non-qualified stock option to a third party.

2. **The IRS’ View in Childs.** T.A.M. 93-36-001, issued before the Childs case was decided ruled on the same factual situation addressed in the Child’s case. The IRS

\textsuperscript{206} Oats v. Commissioner, 18 T.C. 570 (1952), aff’d, 207 F.2d 711 (7th Cir. 1953).

\textsuperscript{207} Commissioner v. Olmstead Inc. Life Agency, 304 F.2d 16 (8th Cir. 1962).

\textsuperscript{208} Childs v. Commissioner, 103 T.C. 634 (1994), aff’d per curiam 89 F.3d 356 (11th Cir. 1996).
treated this third-party note as property. This TAM can be differentiated because in the TAM the IRS said that the note was akin to a funded promise to pay. The Tax Court in Childs rejected this approach.

Another argument the IRS can make is that the Childs case is distinguishable because it turns on the ambiguous relationship under an insurance malpractice claim as to who is the real party in interest. See Zeltzerman v. Commissioner, 34 TC 73 (1960) aff'd per curiam 283 F.2d 514 (1st Cir. 1960) where an employer’s purchase of an annuity for an employee was currently taxable.209 The Zeltzerman case was relied on by the IRS in TAM 93-36-001. See also Reg. Section 1.61-2(d)(4) which provides that notes received as payment for services constitute income when the notes are received.” This regulation should be limited to the employer’s use of a third-party note to compensate the employee. This Regulation should not be applied to the transferee’s unfunded, unsecured note because that would be inconsistent with the principle of “property” under § 83.

3. Cash method of accounting. For individuals who use the cash method of accounting, the question is whether a cash method employee must report compensation income upon receipt of the family entity’s deferred payment obligation. Three principles deal with cash method taxpayers. The three principles are: (i) the receipt of a “cash equivalent”; (ii) whether the taxpayer is in “constructive receipt”, and (iii) the “economic benefit” doctrine. The development of the economic benefit doctrine occurred in the area of employer-employee relationships.

1. Economic benefit doctrine. In order to be taxed on the right to receive a future compensatory payment, the employee must have an indefeasible right to the future payment. Furthermore, the right to this payment must be protected against the claims of the employer’s general creditors. If the right to the deferred payment from the family entity is not transferable and is not superior to the claims of the family entity’s general creditors, there should be no economic benefit. Of course, the obligation must be unfunded and unsecured. If so, then the cash method taxpayer should not be subject to the economic benefit doctrine.

2. Constructive receipt. Under the constructive receipt doctrine the employee reports income if there is an established right to the present payment of the obligation. If the employee cannot compel current payment of the deferred payment obligation, there is no immediate right to receive the compensatory payments, and therefore, no constructive receipt.

3. Cash equivalent doctrine. The family entity’s obligation must be transferable or otherwise assignable in order for there to be a cash equivalent. The cash equivalent cases take the position that if a promise to pay is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, then such promise is the equivalent of cash and should be taxable as if cash was received. If the family entity’s obligation is not negotiable, is not transferable and is not assignable except by death and the family entity is not a financial entity recognized in the commercial world, there should be no cash equivalent.

209 The court found that there was income because there was “constructive receipt.” 34 T.C. at 85.
4. **What if § 83 does not apply?** Suppose that § 83 principles do not apply to the employee’s disposition and that the note received upon the employee’s sale of the stock option to the family entity is treated as a sale governed by § 1001. The option is clearly property in the hands of the employee, and property has been sold to the family entity.\(^{210}\) Can we then use the deferral available under § 453 or § 72? Remember that a properly drafted purchaser’s note is not a “payment” under the installment method. Under § 453 principles, a secured note is not a payment. If one can use either § 453 or § 72, then the only issue is whether the eligibility requirements and the other limitations on the use of the installment method apply. For example, the exercise of the option by the family entity within two years after having purchased it from the employee is a second disposition under Section 453(e). In addition, the IRS view is that an option to acquire a marketable security is also a marketable security.\(^{211}\) If that position is correct, then an installment sale could not be used because marketable securities do not qualify for the installment method. See § 453(k)(2)(A).

5. **Course of action to take.** The IRS has not issued any guidance on the application of § 83 to an employee’s sale of an option to a family entity in an arms length transaction. Since an unsecured and unfunded obligation, which is also non-transferable, is not property for purposes of § 83, then the first question is whether § 83 principles should apply to a transfer between the employee and the family entity. In other words, should § 83 principles apply beyond the employer-employee relationship? Because of the language in Reg. 1.833-7(a), as explained above, we feel that § 83 can be construed to cover the employee, family entity transaction. Then, it follows that the employee has not received property and the employee need only report compensation income when actual payments under the deferred promise to pay money in the future are made. This is consistent with the general principle that income is reported using one’s method of accounting. See Reg. § 1.83-1(b)(1) and –1(c).

If the disposition of the non-qualified stock options to a family entity are viewed as a sale of property by the employee, then one should only use a private annuity sale because § 72 allows private annuity reporting for a sale of marketable securities and has no two-year resale rule.

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\(^{210}\) In Rev. Rul. 2002-22, 2002-19 I.R.B. 849 (May 8, 2002), the IRS considered the transfer of non-qualified stock options by the employee-spouse to the nonemployee spouse as part of a divorce settlement. The IRS treated the stock option as property once it was in the hands of the employee and went on to treat the exchange of the stock options for marital rights as an income tax sale of property (i.e., an income tax realization event under § 1001(a)). Since the IRS viewed the employee as transferring property to the soon to be ex-spouse, the IRS concluded that the non-recognition provision under § 1041 applied.

\(^{211}\) The IRS takes the position that non-qualified stock options to acquire restricted shares in a public company are not a marketable security for purposes of § 453. See Priv. Ltr. Ruls. 98-03-009, 98-03-021 and 98-03-022. These rulings were premised on the fact that restricted stock in a public company is not a marketable security. These private letter rulings stand for the principle that the character of an option to acquire an asset is determined by reference to the character of the asset that can be acquired by the exercise of the option. Priv. Ltr. Rul. 93-06-001 (8-25-92). Accordingly, it is not unreasonable for the IRS to characterize options to acquire a marketable security as also being a marketable security.