BLOOMWOOD
CAPITAL ADVISORS

#35: Sale to an Intentionally Defective Grantor Trust (IDGT) with a Self-Cancelling Installment Note (SCIN) Hedge

As a result of large increases in the applicable exclusion amount and a reduction of the estate tax rate to 40%, income tax planning and particularly basis building has become more important for most wealthy taxpayers than estate planning. However, for ultra-high net worth individuals, estate planning is still very much alive. Individuals who expect to have a taxable estate might benefit from combining bet-to-live and bet-to die strategies. Bet-to-live strategies are those that are more favorable if a taxpayer lives a long time and bet-to-die strategies are those that are more favorable if a taxpayer dies prematurely.

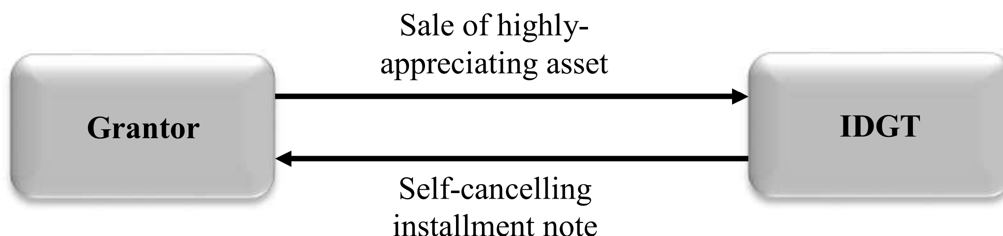
Some of the “bet-to-live” strategies include:

- Lifetime Gifts
  - Annual exclusion gifts
  - Applicable exclusion amount (unified credit) gifts
  - Taxable gifts
- Grantor Retained Annuity Trusts (GRATs)
- Dynasty Trusts
- Sales to an Intentionally Defective Grantor Trust (IDGT)
- Charitable Remainder Trusts

Some of the “bet-to-die” strategies include:

- Self-Canceling Installment Notes (SCINs)
- Private Annuities
- Charitable Lead Trusts
- Life Insurance

Some of the above strategies are covered in more detail in other parts of this series. The focus here is on a great way to achieve a balance of the “bet-to-live” and “bet-to-die” strategies – a sale to an intentionally defective grantor trust (IDGT) with a self-cancelling installment note (SCIN) hedge. The objective with this strategy is to substantially reduce the estate tax of the taxpayer regardless of how long the taxpayer lives.



The Strategy

Self-cancelling installment notes (SCINs) are a special type of installment sale in which the obligation to make further payments is canceled when the seller dies. There are two types of SCINs: 1) a hedge SCIN; and 2) a mortality SCIN. A hedge SCIN is a SCIN designed to hedge against the possibility of death during a "bet-to-live" strategy. A mortality SCIN is a SCIN designed for those who have a high likelihood of dying within a short period of time.

A sale to an IDGT with a SCIN hedge is a similar transaction to and generally structured in the same way as an ordinary installment sale to an IDGT which is covered in more detail in another part of this series. All this strategy adds is a cancellation-at-death feature to the note. This means that if the grantor dies during the term of the SCIN, the obligation to make any additional payments is canceled and the note and assets sold to the IDGT are not included in the grantor's estate. Because a cancellation-at-death feature is added to the note, a mortality risk premium must be paid on the note to compensate the seller for the possibility of not receiving all of the payments under the note. This premium can either be in the form of additional principal or an increased interest rate. The following table provides a sample of SCIN interest rate risk premiums for November 2023: when the IRC Section 7520 rate was 5.6%.[162]

SINGLE LIFE				JOINT LIFE				
Age	SCIN Risk Premium	7520 Rate	Total Interest Rate	Age 1	Age 2	SCIN Risk Premium	AFR	Total Interest Rate
53	0.7500%	5.6%	6.350%	53	53	0.049%	5.6%	5.649%
58	1.0083%	5.6%	6.6683%	58	58	0.099%	5.6%	5.699%
63	1.616%	5.6%	7.216%	63	63	0.2120%	5.6%	5.812%
68	2.500%	5.6%	8.100%	68	68	0.477%	5.6%	6.077%
73	3.983%	5.6%	9.583%	73	73	1.100%	5.6%	6.70%
78	6.536%	5.6%	12.136%	78	78	2.546%	5.6%	8.146%

The above table assumes a 9-year term interest only installment note, with annual interest payments and a balloon payment at the end of the 9-year term. Note that the risk premium increases with the seller's age and is higher for a single life SCIN than for a joint life SCIN. The reason, of course, is that the risk premium reflects the probability that the seller or sellers will die during the note term. It is more likely that one person will die during a given time interval than two and more likely that an older person will die during a time interval than a younger person. Also, the total interest rates will change depending on the current AFR and the length of the note (i.e., whether the short-term, mid-term or long-term AFR is used); the longer the term of the note, the higher the AFR and the higher the risk-premium. Finally, if the sale does not adequately compensate the seller for the mortality risk, the IRS may take the position that the transaction is part sale and part gift; therefore, resulting in gift tax liability.

---

[162] There is no consensus about what interest rate should be used to calculate the risk premium. The safest approach to avoid a taxable gift is to use the higher of the 7520 rate or the appropriate AFR. The midterm AFR for November 2023 was 4.64% and the Section 7520 rate was 5.6%. Thus, the calculations in the chart use the 7520 rate for both the the discount rate and the interest rate. The tables also use the complete annuity valuation method rather than the curtate method. NumberCruncher and Tiger Tables default to the Section 7520 rate and the complete method.

Mortality SCIN

Reg. § 25.7520-3(b)(3) provides that the IRS actuarial tables can be used instead of a taxpayer's actual life expectancy to value interests for a term of years, life estates, remainder interests and reversions unless the taxpayer is terminally ill at the time the interest is created. A seller who is known to have an incurable illness or other deteriorating physical condition is considered to be terminally ill if there is at least a 50-percent probability that the taxpayer will die within one year. If the seller actually survives for at least 18 months following the sale, the seller is presumed not to have been terminally ill at the time of the transfer unless the contrary is shown by clear and convincing evidence.

This suggests a great planning opportunity for a seller with an actual life expectancy that is more than one year, but substantially less than the seller's actuarial life expectancy under the IRS tables. For example, if the seller has an actual life expectancy of five years, but an actuarial life expectancy of fifteen years, the seller could sell his or her assets to an IDGT with a SCIN hedge and take back a SCIN with an interest rate based on the tables prescribed under § 7520 for a person with a life expectancy of fifteen years plus a morality risk premium. Since the seller would expect to only receive five interest payments under the SCIN, this could, in effect, be an expected tax-free transfer to the beneficiaries of the last ten interest payments and principal balloon payment.

However, the IRS takes the position that a SCIN does not create an interest for a term of years, a life estate, a remainder interest or a reversion so Reg. § 25.7520-3(b)(3) does not apply. Instead, the risk premium in a SCIN must be valued by reference to the seller's actual life expectancy using a willing buyer, willing seller approach. This would mean that a practitioner would take into account any factors that might be expected to give the seller a shorter life expectancy than the average person of the same age. Thus, it may be advisable to obtain a medical opinion that the seller was in normal health for a person of his or her age when the sale was made. Although it is not clear that the IRS argument would prevail, this IRS hostility makes mortality SCINs an aggressive strategy.

Hedge SCIN

A hedge SCIN is not used by a taxpayer with a shorter than average actual life expectancy, but by a taxpayer who is making an IDGT sale and wants to hedge against the possibility of dying prematurely before the IDGT sale has had time to generate substantial tax benefits. The following example illustrates how it works.

> ***Example 1.*** Suppose a Taxpayer, 58 years old, contacted you to discuss a sale to an IDGT with a SCIN hedge. Taxpayer owns a $10,000,000 asset that will be used in this sale. The Taxpayer will sell the asset to the IDGT and take back a SCIN with a 9-year term and a balloon payment of the principal at the end of the SCIN term. Assume the current mid-term AFR rate is 5.60% (December 2023 rate) and the risk premium is 1.044%, a total interest rate of 6.6440%. Furthermore, assume the IDGT earns a 10% rate of return. Because the present value of the note equals the value of the property transferred, there is no taxable gift. Below is a table representing the payment schedule and balances:

Year	Beginning Balance	IDGT Income	Annual Payment	Ending Balance
1	$10,000,000	$1,000,000	($664,400)	$10,335,600
2	$10,335,600	$1,033,560	($664,400)	$10,704,760
3	$10,704,760	$1,070,476	($664,400)	$11,110,836
4	$11,110,836	$1,111,084	($664,400)	$11,557,520
5	$11,557,520	$1,155,752	($664,400)	12,048,872
6	$12,048,872	$1,204,887	($664,400)	$12,589,359
7	$12,589,359	$1,258,936	($664,400)	$13,183,895
8	$13,183,895	$1,318,319	($664,400)	$13,837,884
9	$13,837,884	$1,383,788	($10,664,400)	$4,557,272

This represents a $4,557,272 estate and gift tax-free transfer to the beneficiaries.

Also note, that if the Taxpayer had passed away before the end of the term, let's assume in year 6, this would have represented a $12,589,359 estate and gift tax-free transfer to the beneficiaries. Additionally, both amounts, if Taxpayer survived until the end of the term or if Taxpayer died in year 6, would be excluded from the Taxpayer's estate.

If the seller survives the term, there is a cost to using a SCIN, however. Without the death terminating feature, the annual installment payments would have been $560,000 per year instead of $664,4000 and the amount in the SCIN at the end of nine years would have been $5,974,970 instead of $4,557,272, a difference of $1,417,698. Thus, the seller is giving up $1,417,698 of tax-free transfer for the possibility of eliminating the $10,000,000 balloon payment.

If the SCIN would have been a joint life SCIN, the interest rate would have been lower because the risk premium would have been lower. Assume Taxpayer and Spouse, both age 58, were the joint lives. The interest rate on the SCIN would be 5.699%. At the end of the SCIN term, $5,860,902 would have transferred estate and gift tax-free to the beneficiaries, $1,302,630 more than under the single life SCIN. Further, if both Taxpayer and Spouse died by the end of year 6, $13,318,484 would have been transferred estate and gift tax-free to the beneficiaries, $729,125 more than under the single life SCIN.

In the two-life alternative, the cost of hedging is much less than for a single life SCIN. The death terminating feature increases the annual payment from $560,000 to $568,400 instead of $664,400. If the seller survives the SCIN term there will be $5,860,902 left in the IDGT after nine years. If the seller used a straight installment note there would be $5,974,970. Thus, the seller is giving up only $114,608 ($5,974,970 - $5,860,902 (less than 2%) by using a SCIN instead of a straight installment note. On the other hand, the probability that both sellers will die during

the term and cancel any further payments is far less. According to the Social Security Administration Actuarial Life Table the probability of a 58 year-old dying within 9 years is 13.306%. Thus, the probability of two 58 year-old dying within 9 years is .13306 x .13306 = .0177%.[163]

Advantages and Disadvantages

As with any tax planning strategy there are some advantages and some disadvantages. Some of the advantages of a sale to an IDGT with a SCIN hedge include:

- The future appreciation above the installment note's interest rate (including both the AFR and the risk premium) is removed from the grantor's estate;
- The asset sold and principal owed on the note is not included in the grantor's estate if the grantor prematurely dies during the SCIN term;
- In most cases, the value of the assets transferred out greatly exceeds the value of the payments coming back into the estate of the grantor if he or she passes away prematurely;
- No gain or loss is recognized on the sale;
- Payment of the trust's income tax liability by the grantor creates an additional tax-free gift and allows for greater appreciation to inure to future generations;
- Valuation adjustments increase effectiveness of the sale for estate tax purposes; and
- Because the IDGT is a grantor trust, it is an eligible S corporation shareholder.

Some of the disadvantages of a sale to an IDGT with a SCIN hedge include:

- Complex calculation of the risk premium;
- Possible gift tax exposure if the SCIN risk premium is inadequate;
- Possible gift tax exposure if the trust is insufficiently funded;
- Possible gift tax under IRC § 2701 or § 2702 if note is not treated as bona fide debt (*Karmazin*);[164]
- Possible estate inclusion under IRC § 2036 if seller is treated as retaining an income interest rather than a debt instrument (*Karmazin*);[165]
- No step-up in basis at grantor's death;
- Possible acceleration of capital gain at grantor's death;[166]
- Death terminating feature increases payments back to seller and brings more value back into the seller's estate;
- Trust income taxable to grantor during his or her life could cause a cash flow problem if there is not sufficient income earned by the grantor; and
- Possible upstream transfer if the grantor survives the term of the note (or lives a significant portion of the term and/or is relatively old).

Why it Works

There are many reasons why a sale to an IDGT with a SCIN hedge works; some of these include:

---

[163] Actuarial Life Table (ssa.gov)

[164] *See Karmazin v. Commissioner,* Tax Court Docket No. 2127-03 Unagreed Report. Case settled without going to trial.

[165] *Id.*

[166] *See Madorin v. Commissioner*, 84 TC 667 (1980); Reg. § 1.1001-2(c), Example 5.

- Backend-loading of installment payments;
- Payment of trust income taxes by the grantor;
- Valuation adjustments;
- The cancellation-at-death feature; and
- The difference between the actual rate of return and the risk-adjusted AFR.

The difference between the actual rate of return and the risk-adjusted AFR is already demonstrated above and in the Sale to an IDGT topic – the greater the difference between the actual rate of return and the risk-adjusted AFR, the greater the estate and gift tax-free transfer to the beneficiaries will be. Furthermore, by having the SCIN include a balloon payment at the end of the term for the principal amount, the strategy backend loads the payments. This allows funds and assets within the IDGT to grow and accumulate. Moreover, if the grantor dies prematurely, the cancellation-at-death feature of the note will take effect and more will transfer to the beneficiaries tax-free and not be included in the grantor's estate.

Valuation Adjustments

The effect of valuation adjustments is covered in the Sale to an IDGT topic, but it is an important concept to understand and, therefore, deserves another illustration of its effects. To recap, if a valuation discount can be applied to the asset when it is sold to the IDGT, it will allow more to transfer estate and gift tax-free to the beneficiaries. Additionally, it reduces both the amount of principal (should the grantor survive the term of the note) and the amount of interest payments that come back into the grantor's estate. Valuation discounts may apply to assets like interests in closely-held family businesses.

Example 2. Assume the same facts as in Example 1, except that a valuation discount of 30% applies to the assets used to fund the IDGT. Therefore, the balloon payment at the end of the term of the SCIN will only be $7,000,000 instead of $10,000,000 and the annual interest payments will be 664,400 x .7 = $465,080.. The effects of the valuation discount are illustrated in the table below:

Year	Beginning Balance	IDGT Income	Annual Payment	Ending Balance
1	$10,000,000	$1,000,000	($465,080)	$10,534,920
2	$10,534,920	$1,053,492	($465,080	$11,123,332
3	$11,123,332	$1,112,3339	($465,080	$11,770,585
4	$11,770,585	$1,177,059	($465,080	$12,482,564
5	$12,482,564	$1,248,256	($465,080)	$13,265,740
6	$13,265,740	$1,326,574	($465,080)	$14,127,234
7	$14,127,234	$1,412,723	($465,080)	$15,074,878
8	$15,074,878	$1,507,488	($465,080)	$16,117,285
9	$16,117,285	$1,611,729	($7,4625,080	$7,263,934[167]

[167] This is the amount in the trust at the end of Year 9 ($17,263,934) minus the $10,000,000 balloon payment made at the end of the note term.

This represents a $7,263,934 estate and gift tax-free transfer to the beneficiaries. Because of the effect of the 30% valuation discount, $2,464,947 ($7,263,934 - $4,798,987) more is transferred tax-free to the beneficiaries than in Example 1. Also note, that if Taxpayer had passed before the end of the term, let's assume in year 6, this would have represented a $14,127,234 estate and gift tax-free transfer to the beneficiaries, $1,537,875 more thanin example 1 ($14,127,234-$12,589,359 .

Payment of the IDGT's Income Taxes by the Grantor: "Tax Burn" SCIN Strategy

Because the IDGT is a grantor trust, the grantor is responsible for paying the trust's income tax but these tax payments aren't treated as taxable gifts from the grantor to the trust. Thus, the payments have the effect of additional gift tax tax-free transfers. This tax-free transfer is sometimes referred to as a "tax burn" because it reduces the taxable estate. The payments also enable the trust assets to grow at their pretax rate of return for the benefit of heirs. Over the term of the IDGT this benefit can be quite substantial.. **Example 3**. Taxpayer (T) transfers $10,000,000 to an IDGT. The trust produces ordinary income of $1,000,000. Assume that the combined federal and state tax rate on the trust income is 40%. If the trust pays its own income tax, its assets will grow at 6%. After 10 years the trust will have a value of $17,908,477. If the settlor pays the trust's tax liability, the assets will grow at 10%, making the value $25,937,425 after 10 years.

Disclosures

NOT FOR REDISTRIBUTION

https://www.bloomwoodcapital.com/smdisclosures