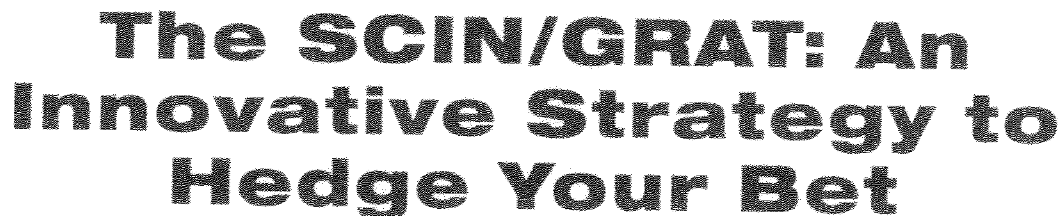

# The SCIN/GRAT: An Innovative Strategy to Hedge Your Bet

The inherent overpayment exposure of a self-canceling installment note (used in an installment sale to a defective grantor trust) may be avoided by placing the SCIN in a grantor retained annuity trust, as the authors explain.

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### Basic structure—The note sale component

An installment sale to an intentionally defective grantor trust ("IDGT") in exchange for the trust's promissory note has become an increasingly popular wealth transfer strategy that offers many significant benefits. Generally, this technique is used to sell non-controlling interests in entities, such as limited partnerships, limited liability companies ("LLCs") and corporations (particularly S corporations), to an IDGT that is also a dynastic trust, taking advantage of valuation discounts. Other presumptively undervalued assets such as options or lettered stock are also excellent candidates for this technique.

The trust is set up as a grantor trust by intentionally violating one or more of the grantor trust rules. Typically, the note is structured as interest-only for a term certain with a balloon payment at the end of the term and a right of prepayment without penalty although as described below, alternative payment arrangements are often used which can accentuate the wealth transfer. The Service has opined in Rev. Rul. 85-13,[1] and in several private letter rulings, that transactions between a trust and its "owner" for income tax purposes will be ignored. Thus, the person who is treated as the "owner" of the trust for income tax purposes can sell an asset to the trust without any income tax ramifications.[2] In addition, the trust can satisfy its obligation with appreciated assets without income tax consequences.

*Use of deferred payment increases leverage.* Although the sale may be for cash, leveraging the sale using a deferred payment significantly enhances the economics of the sale of discounted assets. Income tax-free growth of the deferred amount in excess of the interest paid inures to the benefit of the trust rather than the seller and because the trust is generation-skipping, the growth during and after the grantor's life is somewhat exponential.

*SCIN alternative.* The note element of an installment note sale to an IDGT can take a variety of forms. The typical structure is an interest-only (at a minimum applicable federal rate ("AFR")) note with a balloon payment at the end of the note term. In such instance, the fair market value of the unpaid note as of

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the date of the seller's death is includable in the seller's estate.

A fairly popular alternative to the more traditional note is a sale for a self-canceling installment note ("SCIN"). If the installment note contains a bona fide provision canceling the buyer's remaining obligation at death and as a result there is no residual value included at death because the obligation to make further payments is extinguished, there is no estate inclusion for the canceled obligation.[3] The estate tax savings can be significant if the seller dies during the early years of the SCIN. To avoid a gift as a result of the self-cancellation feature, the buyer must pay a premium, either by increasing the price for the property or by paying interest on the note at a rate that is higher than the AFR.

The effect of the premium paid for the cancellation feature is that unless the seller has a reduced life expectancy, the probability is that he or she will be overpaid for the property transferred, negating some or all of the anticipated wealth shift.

Consequently, in the absence of the protective strategy discussed below, a SCIN is generally advisable only where the seller's actual life expectancy is sufficiently shorter than a life expectancy of a typical person of that age.

**The GRAT should be structured so as to reduce the term to as short a period as possible, provided that the annuity can be paid out of cash flow.**

## SCIN/GRAT solution

The inherent overpayment exposure of a SCIN may be avoided by placing the SCIN into a GRAT. The SCIN/GRAT strategy alters the general rule of thumb that the risk premium paid is counterproductive if the seller survives the term because the GRAT will pass any excess premium paid to the GRAT remainder beneficiary. The analysis should factor in, however, that there will be some leakage from the dynastic trust (unless a GRAT remainder transfer is also used[4]) to the GRAT remainder beneficiary, which is a neutral result from an estate tax perspective but reduces the amount that can be exempt for generation-skipping transfer ("GST") tax purposes.

*Structure of the GRAT.* The GRAT should be structured so as to reduce the term to as short a period as possible, provided that the annuity can be paid out of cash flow. By condensing the term, the risk of the amount of estate inclusion is also reduced.

*Example.* Assume that the client sells a discountable asset to a dynastic IDGT in exchange for a SCIN. The client[5] transfers the SCIN[6] into a GRAT. Once the planner computes the cash flow from the SCIN, he can then structure the GRAT so that the cash flow from the SCIN can be recycled in payment of the GRAT annuity. With elderly clients, the interest payments will be extremely high, providing an excellent source for making the GRAT annuity payments.

*Result.* If the grantor dies during the GRAT term, the IDGT will explode in value because its debt is

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1 1985-1 CB 184.

2 Rev. Rul. 85-13, 1985-1 CB 184.

3 Estate of Moss, 74 TC 1239 (1980) *acq.* 1981-1 CB 2; Cain, 37 TC 18 (1961); GCM 39503 (5/19/86).

4 McCaffrey, "The Care and Feeding of GRATs—Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring," 39 *U. Miami Heckerling Inst. on Est. Plan.*, Ch. 7 (2005); Handler and Dunn, *Drafting the Estate Plan—Law and Forms* (CCH); McCaffrey, R. Oshins, and Ice, "Planning with GRATs," 62 *NYU Inst. on Fed. Tax'n* (2004); Adams, "Proprietary Approaches for Planning with Individuals and Their Business," Teleconference Services at 13 (3/27/01); R. Oshins, "Planning Strategies Using Grantor Trusts," 60 *NYU Inst. on Fed. Tax'n* (2002); R. Oshins and S. Oshins, "Protecting and Preserving Wealth Into the Next Millennium," Part 1, 137 Tr. & Est. 52 (Sept. 1998), and Part 2, 137 Tr. & Est. 68 (Oct. 1998); Harrison, "Ten Best Ideas I Am Willing to Share," 37 *U. Miami Heckerling Inst. on Est. Plan.* (2003); Handler and S. Oshins, "The GRAT Remainder Sale," 141 Tr. & Est. 33 (Dec. 2002); R. Oshins and Sederbaum, "Generation-Skipping and the GRAT: Sale or Gift of the Remainder," 30 ETPL 259 (June 2003); Handler and S. Oshins, "The GRAT Remainder Sale to a Dynasty Trust," 138 Tr.& Est. 20 (Dec. 1999).

5 Perhaps after the original transaction is old and cold.

6 Even better, the client may transfer the SCIN to an LLC and then transfer minority interests or non-voting interests in the LLC to the GRAT. The LLC should contain other assets. The advisor must be careful that the existence of the entity will be recognized for gift tax purposes but not for income tax purposes. However, if the entity is not recognized (or the discount is reduced) and the annuity is expressed as a fraction or percentage of the initial contribution, the self-adjusting valuation clause allowable by Reg. 25.2702-3(b)(2) would prevent gift tax exposure.

extinguished. In addition, the cancellation feature of the SCIN blocks future payments to the GRAT, resulting in little or nothing being includable in the grantor's estate. Alternatively, if the grantor survives the GRAT term, there will be a substantial windfall to the GRAT remainder beneficiaries, reducing the adverse effect of leakage from the IDGT resulting from the risk premium of the SCIN.

**Many variations**

The SCIN/GRAT combination has many variations.[7] For example, an LLC taxed as a disregarded entity, which owns an asset (e.g., a shopping center) can sell fractional interests in the asset to IDGTs. The fractional interest discount will be less than what would normally be applicable to the same percentage interest in the case of a non-controlling interest in an entity that has limited marketability, but we are advised by some in the appraisal community that it is not that much. Non-controlling interests in the LLC would then be transferred to GRATs. If we assume a fractional interest discount of 30% and a discount for non-controlling interests in the entity of 35%, the value of the LLC interests transferred to the GRATs after the combined discount is 45.5% of the value of the underlying assets.

**If the grantor survives the GRAT term, there will be a substantial windfall to the GRAT remainder beneficiaries.**

The forgoing structure would also be income tax neutral. The LLC's existence is ignored for income tax purposes. Because the trust is income tax defective, its existence is also ignored. Hence, the estate owner is dealing with himself, and the transaction will be ignored for income tax purposes under the theory of Rev. Rul. 85-13.

The use of the "disregarded entity" significantly enhances the transaction by adding creditor protection and valuation discounting opportunities. The planner, however, must be sure that the entity retains its status as a "disregarded entity" at all times until the earlier of either (1) the satisfaction of the SCIN or (2) the death of the grantor. Therefore, it is essential that the IDGT remains a grantor trust and that the GRAT remainder interest at all times after the cessation of the annuity interest is owned by a grantor trust.

[7] One variation that might be considered is for the dynastic trust (or other grantor trust) to purchase assets from a GRAT in exchange for a SCIN. See McCaffrey, "The Care and Feeding of GRATs," *supra* note 4.

Structuring the GRAT remainder beneficiary as a grantor trust offers the ancillary benefit of enabling the IDGT and the GRAT remainder trust to transact with each other income tax-free since both are treated as being owned by the grantor. Accordingly, the IDGT could purchase discountable assets from the GRAT remainder trust, increasing the dynastic wealth shift and reducing the amount "caught" in the children's estate.

One of the major negative features of GRATs is that Section 2642(f) precludes allocating GST exemption to a trust until the estate tax inclusion period ("ETIP") has expired. The sale by the GRAT remainder trust of discounted assets to the IDGT has the effect of partially depleting the GST non-exempt remainder trust and augmenting the GST tax-exempt IDGT.

### Multiple discounting and leveraging opportunities

The multiple leveraging factors of this scenario for the "right client" (one who survives the GRAT term, but dies prematurely relative to the mortality tables), include the following:

- Valuation adjustment because a discountable asset is sold to the IDGT;
- Presumptively low "hurdle" rate used in computing SCIN payments;
- The fact that income tax is borne by the grantor on assets held by the IDGT;
- Self-cancellation feature of the SCIN;
- Discount on GRAT transfers;
- Favorable relatively low interest rates factored in computation of GRAT annuity payments;
- The fact that GRAT income is taxed to the grantor during the annuity term; and
- The fact that after the term, the GRAT remainder beneficiary is an income tax defective trust.

### Income tax consequences at death

The normal rule with regard to the income tax consequences of death with an outstanding SCIN is that death is treated as a disposition resulting in gain or loss to the decedent/seller/transferor.[8] There is, however, some uncertainty as to who is the proper taxpayer: the estate or the decedent.

A similar issue arises upon the death of the seller who received an interest-only balloon note, or any other installment note and the note is still outstanding. Many commentators believe gain must be recognized.[9]

**Practice Notes**

The SCIN/GRAT strategy alters the general rule of thumb that the risk premium paid is counterproductive if the seller survives the term because the GRAT will pass any excess premium paid to the GRAT remainder beneficiary.

A concept that Prof. Jerry Kasner has suggested is that the transaction can be structured so that income tax can be avoided by having the seller elect out of installment reporting.[10] In the election out of installment note reporting, the taxpayer would report the transaction on his return, explain that under Rev. Rul. 85-13 the gain would not be recognized and that there would be carryover of basis.

In the normal course of action (for example, a sale to a non-defective trust), if the taxpayer elects not to use the installment method, the entire gain would be reported in the year of sale. Nothing further would be reported at death. Because the gain is not recognized by the trust, being a grantor trust, why would future years be affected? It would be reasonable to conclude that each successive year would stand on its own, and if an estate owner were to die in year 10, for instance, we would not look back to year 1 to see if gain was recognized in determining the treatment for year 10.

Because a SCIN is an installment note, we can see no reason that the strategy suggested by Prof. Kasner should not be equally applicable to a death-terminating installment sale a/k/a a "SCIN." ■

[8] Section 453B.

[9] See, for example, Covey, Practical Drafting at 4365-4367.

[10] Section 453(d); Kasner, *Maybe the Cup Is Half Empty—Planning for Premature Death*, Outline (1988).