The pros and cons of a SCIN

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Many estate planning techniques are intended to minimize or even eliminate gift and estate taxes when transferring assets to family members. Sometimes, the most powerful techniques also have a significant drawback: mortality risk. For example, you may have to outlive the term of a trust to realize its tax benefits. A self-canceling installment note ("SCIN") eliminates mortality risk, so it may be appropriate for anyone in poor health who isn't expecting to reach his or her actuarial life expectancy. But it has other potential downsides.

How a SCIN works

To use a SCIN in estate planning, you sell your business or other assets to your children or other loved ones (or to a trust for their benefit) in exchange for an interest-bearing installment note. As long as the purchase price and interest rate are reasonable, there's no taxable gift involved. So you can take advantage of a SCIN without having to use up any of your annual gift tax exclusions or lifetime gift tax exemption.

Generally, you can avoid gift tax on an installment sale by pricing the assets at fair market value and charging interest at the applicable federal rate. As discussed below, however, a SCIN must include a premium.

The "self-canceling" feature means that if you die during the note's term — which must be no longer than your actuarial life expectancy at the time of the transaction — the buyer (that is, your children or other family members) is relieved of any future payment obligations.

Beware of the "premium"

To compensate you for the risk that the note will be canceled and the full purchase price won't be paid, the buyers must pay a premium — in the form of either a higher purchase price or a higher interest rate. There's no magic number for this premium; the appropriate premium is a function of your age and the stated duration of the note. If the premium is too low, the IRS may treat the transaction as a partial gift and assess gift tax.

Both types of premiums can work, but they may involve different tax considerations. If you add a premium to the purchase price, for example, a greater portion of each installment will be taxed to you at the more favorable capital gains rate, and the buyers' basis will be larger. On the other hand, an interest-rate premium can increase the buyers' income tax deductions.

But the premium also comes with some risk. In fact, SCINs present the opposite of mortality risk: The tax benefits are lost if you live *longer* than expected. If you survive the note's term, the buyers will have paid a premium for the assets, and your estate may end up *larger* rather than smaller than before.

If you're considering including a SCIN in your estate plan, please contact us before taking action. We can explain the benefits and risks involved.

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