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SCIN Alive?! A Tale of Death, Taxes, Doubt, and Redemption.

By Lou Vlahos

Davidson was dead to begin with — dead as a doornail. His death did not come as a great surprise, at least to some, though few (other than the IRS) expected him to go as quickly as he did. And that was the root of the problem. But I don't want to get ahead of myself.

It Was the Best of Times . . .

During life, he had done well for himself. He had accumulated great wealth as the majority shareholder, President, Chairman and CEO of one of the world's leading manufacturers of glass, automotive and building products. He was worth billions of dollars and, like so many other similarly-situated individuals, he indulged himself in acquiring professional sports teams.

Although he was obviously not like most men in terms of the wealth he controlled and the power he derived from it, he was just like any other "Joe" in that, sooner or later, he'd have to meet his maker.

As his health began to deteriorate, and he started thinking about his death, he wondered how he could pass along his great wealth to his family. He became especially concerned about avoiding the significant estate tax liability that would be borne by his beneficiaries upon his passing.

He consulted some of the best minds in the country. The estate tax could be avoided, he was told, by removing assets from his estate. "OK," he thought, "tell me something I don't know." One way to remove assets from his estate would be for him to make substantial gifts of property while he was alive. "Great. Let's do it," he said. "Unfortunately," his lawyers told him, "gifts of the size being contemplated would themselves be subject to gift tax."

"So what's the alternative?" he asked them. "I'm paying you by the hour, and I'm not getting any younger."


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Sale to a trust

A sale, they replied. He could sell shares of stock in his company to his family. Better yet, these sales could be made to trusts that would be created and operated for the benefit of his family. A sale would not be treated as a gift for gift tax purposes provided the trusts paid him an amount equal to the fair market value of the shares being transferred. The trusts could also provide some asset protection for the family.

Now this was sounding good. A transfer of stock to a trust for his family that would escape the estate tax and that would not be subject to the gift tax. But wait, he thought, wouldn't a sale subject me to capital gains tax? And how will these newly created trusts be able to pay me anyway?

Again, he gave his lawyers a searching look —what are they thinking?

"You're probably wondering what we're thinking," they said to him. "Each trust will be structured as a so-called 'grantor trust.' Although you will not have any beneficial interest in the trust, you will retain certain 'rights' or 'powers' in respect of the trust property such that you will continue to be treated as owning the trust and all of its assets for purposes of the income tax. Since you cannot sell property to yourself, the 'sale' will not result in any taxable gain."

"So wait," he stopped them, "you mean to tell me that I can *sell* property to these trusts, but that the sale will not be treated and taxed as a sale?"

"That's almost correct," the lawyers replied. "You need to understand that there are two types of taxes at work here: the gift tax and the income tax. There is a 'sale' for purposes of the gift tax – it provides the consideration that prevents the transfer from being treated as a taxable gift. However, because the trust is 'ignored' for purposes of the income tax — you are treated as owning it — there is no sale for purposes of the income tax."

Hmm, he thought, these guys are pretty smart after all.

Sale to a trust for a note

The lawyers continued, "As for funding the purchase by the trust, the trust will issue a promissory note to you in exchange for the shares."

"So let me get this straight, I sell my shares to a trust in exchange for a note? Don't I own the note? If I die before the note is paid off, won't the value of the note be included in my estate? Am I just substituting one asset in my estate for another?"

After a pause, he continued, "You know, I'm no spring chicken, I've had my share of health issues, some of them serious. You may have noticed that I'm sitting in a wheel chair? What would this note look like?"

The lawyers confirmed that, "without more," the note would be included in his estate upon his death if it were still outstanding at that time. Of course, they added, if the shares appreciated at a rate in excess of the interest accrued on the note, the net result would be positive insofar as removing value from his estate was concerned.

Sale to a trust for a Self-Canceling Note

After some further deliberation, the lawyers peppered him with all sorts of questions about his health. "I thought you guys were lawyers? You do know that it's illegal to practice medicine without a license?"

"Medicine? No. We're tax lawyers. We answer to a higher authority."

"What if we told you that there was a way to exclude the note from your estate upon your passing?" they asked him.

Picture the cartoon thought bubble that appeared above his head at that point. "I sure hope the chauffer has the limo running. These guys have had too much Kool-Aid."

"OK, I'm game," he humored them, "how does the note disappear?"

"It doesn't really disappear. It cancels itself if you die before the end of the note term. Based on your age, your life expectancy is almost six years. Assume the note has a term of 5 years (less than your life expectancy). You die in the second year of the term. The remaining balance of the note is canceled and never has to be satisfied. They're called self-cancelling installments notes, or 'SCINs.'"

The devil is in the details

Well, the planning moved pretty quickly from there. Davidson was stuck, poked, prodded and probed by four physicians, each of whom concluded that he had a greater than 50 percent probability of living for at least one year. According to the lawyers, this was a key factor. With that prognosis, he was not deemed to be "terminally ill" within the meaning of those IRS regulations that would be used to calculate the actuarial fair market value of the notes based upon his actuarial life expectancy. The regulations would not have been available otherwise.

The lawyers obtained appraisals for the shares to be transferred to the trusts, and prepared the documentation needed to effect the transfers, including the five-year SCINs.

Importantly, they also obtained valuations for the "premium" that each trust would have to pay in exchange for the self-canceling feature. After all, why would a note holder allow a self-cancelation provision in the note without being compensated for the actuarial risk of his or her premature death? In the case of some of the notes, this premium took the form of an increased amount of principal. In others, it was reflected as an increased rate of interest.

The notes were secured by the shares being transferred and by other assets that had been contributed to the trusts at their creation. They provided for annual payments of interest and a balloon payment of principal (either in cash or in kind) at the end of the five-year term.

Death waits for no one

In December 2008, the various trusts were created and "seeded" with some assets. The stock transfers to the trusts were completed in January 2009. Davidson died in March 2009 and as per the terms of the SCINs, the notes were canceled.

His estate filed his 2009 gift tax returns (on Form 709), on extension, in May of 2010. These disclosed the transfers of stock in exchange for the SCINs. (The Form 709 for 2008 disclosed the creation of the trusts.) His estate tax return was filed (on Form 706), on extension, in June of 2010.

Death and taxes

The IRS examined these returns. With respect to the estate tax return, the IRS determined an estate tax deficiency of over $1.87 billion (not a typo). It also determined gift tax and generation-skipping transfer taxes of approximately $846 million for 2009. Over $2.7 billion in the aggregate (plus interest and penalties) – did Davidson roll over in his grave?

The IRS arrived at this figure, in part, by challenging (practically a given) the reported fair market value for Davidson's company.

It also refused to treat the SCINs as bona fide consideration equal in value to the Company stock he had transferred to the trusts in exchange for the SCINs.

The IRS asserted that the regulations utilized to calculate the actuarial fair market value of the notes were inapplicable because Davidson's life expectancy was less than the terms of the notes. Instead, the IRS determined that his life expectancy was approximately 2.5 years. The IRS asserted that the SCINs should have been valued using this life expectancy, which would have significantly reduced their value.

According to the IRS, Davidson never intended or expected to collect all payments due under the SCINs. Moreover, the IRS said, the trusts would not have been able to make payments on the SCINs when due. Thus, the IRS concluded, the SCINs were not bona fide debt.

In June 2013, Davidson's estate filed a petition with the U.S. Tax Court (https://ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=6610435), in which it challenged the IRS's assertions. Trial was set for April 2014, but was subsequently continued (often done where the parties are engaged in serious settlement negotiations) and stricken from the court's calendar. The court, however, retained jurisdiction of the case, and required the parties to file a joint status report with the court every three months.

And so I face the final curtain

Davidson's estate and the IRS submitted a stipulated decision in July of 2015, in which they agreed to deficiencies of gift tax for 2009 of approximately $178 million, of estate tax of approximately $153 million, and of 2009 GST tax of approximately $46 million. A total of $377 million, as opposed to the approximately $2.7 billion originally sought by the IRS.

Although the basis for the decision was not spelled out, it seems reasonable to surmise that the settlement was based upon a compromise regarding the valuation of the shares transferred — not at all unusual — and that the SCINs were otherwise not implicated in the decision.

The hereafter?

The story set out in this post is based upon a real taxpayer. The narrative, of course, is pure conjecture. It is, however, based upon discussions that I have had with many clients (except the part about the Kool-Aid).

There's a lesson in almost every story, fictional or not. The take-away here is straightforward: know all the rules, pay attention to the details, implement and document the plan completely, and educate the client. Having done this, you will be in a strong position to withstand any IRS scrutiny.

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