

Using a Self-Canceling Installment Note in Estate Planning

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There are many strategies that can be utilized by business owners to transfer a family-owned business to the next generation. However, all strategies are not created equal. Each has a different level of benefits and drawbacks depending upon the valuation environment the business currently exists within, along with the prevailing interest rate at the time of a transfer. One technique that may be particularly advantageous given the current state of affairs is the use of a self-canceling installment note (SCIN).

A SCIN is essentially a debt obligation that, by its terms, is extinguished at the death of the seller/creditor, with the remaining note balance canceled automatically. The advantage of a SCIN over a standard installment note is that if the seller dies prior to the debt being fully repaid, the remaining value of the installments is not included in his or her taxable estate, which can be extremely beneficial.

The appreciation in the value of the business realized by the transfer can be spread out over the term of the note. This essentially lessens the upfront tax impact from the transfer. While some might not be inclined to use this strategy solely because of the capital gains tax exposure of the transfer, when compared to the potential estate tax costs of not transferring the asset now along with any future appreciation of the business, capital gains tax treatment would be preferred by most. The purchaser, on the other hand, acquires the asset with a new basis set at the acquisition price (not the seller's basis, as would be the case if the asset were gifted and not sold).

Since adequate consideration is being given under this strategy, a SCIN does not require the use of any annual exclusion or unified credit (applicable exclusion amount). This leaves the owner with the ability to further defund his or her estate through supplementary gifting strategies.

A SCIN can be an effective tool when it comes to estate tax minimization planning. This tool, however, does not come without a few things that need to be measured.

In order to ensure that the transaction will be allowed by the Internal Revenue Service (IRS), there needs to be sufficient consideration offered for the cancellation benefit of this note. This can be accomplished two ways. First, the borrower can agree to a higher-than-normal interest rate for the note. With the extremely low interest rate environment that currently exists, even a higher-than-normal interest rate could potentially be quite favorable. Another way to effectively create adequate consideration would be to agree

to an above-market purchase price for the underlying business which is being financed via the SCIN. This alternative could also be potentially advantageous given the fact that many business assets have depreciated in value over the past few years. Therefore, even an above-market purchase price could be favorable.

A separate area which requires careful attention is the overall term of the note. The IRS stipulates that the term cannot exceed the normal life expectancy of the seller. Family-specific information can be used however to craft a term that meets the objective of not exceeding normal life expectancy, while providing for the potential estate tax benefits of not having the remainder counted in the decedent's taxable estate should he or she not outlive the term.

What happens if the seller does not outlive the term? The ramifications depend on the appreciation potential of the underlying business assets being transferred. If the business appreciates in value at a rate greater than the cost of either the higher-than-normal interest rate charged on the note or the above-market purchase price, then the heirs are still better off having utilized this strategy as the after-tax effect would be more advantageous. As with any estate planning technique, careful consideration should be given to the benefits and drawbacks of this strategy.

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