Self Canceling Installment Note

Help your business owner clients take advantage of today's low interest rates.

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Take advantage of today's low interest rate environment with a Self Canceling Installment Note

Perhaps you have clients who are business owners and who want to transfer their business interests to the next generation while minimizing the potential impact of the estate tax.

One frequently used technique is an installment sale – the business owner (or "Seller") sells his or her interest in the business to one or more members of the younger generation in exchange for a promissory note with payments of principal and interest scheduled over a period of years. So long as the Seller charges an adequate rate of interest, such a sale keeps the transfer of business interest from being a taxable gift and has the potential to remove future growth in the value of the business from the Seller's taxable estate. However, the unpaid balance of the promissory note is included in the estate at the Seller's death.

A Self Canceling Installment Note (SCIN) can be an excellent way for a Seller to transfer a business to a child and remove the entire value of the business from the Seller's estate. Just like a traditional Installment Note, the note must bear an interest rate at least equal to the Applicable Federal Rate (AFR), which is currently at historic lows. The "Self Canceling" part of the installment note means that the note is canceled upon the death of the Seller. In order to avoid the cancellation of the note from being a gift, a SCIN must contain a "risk premium" that compensates the Seller for the possibility of death prior to receiving full payment on the note. The cancellation provision should be bargained for as part of the consideration for the sale and should include a higher than market value price (principal risk premium) or higher than market interest rate (interest rate premium) as part of the terms of the SCIN.

Although the key advantage of a SCIN is the cancellation feature which eliminates any estate tax on the balance on the installment note remaining at the Seller's death, the remaining gain on the balance on the note must be reported for income tax purposes on the fiduciary income tax return (Form 1041) for the Seller's estate.

It is also important to note that this technique can only be used if the client has a better than 50% chance of living at least one year at the time the arrangement is put into place, and that there is a presumption that someone who lives 18 months after entering into a SCIN satisfied the 50% chance of living requirement, unless the opposite is proven by clear and convincing evidence.

While structuring the sale as a SCIN removes the risk of having some or all of the value of the business included in the Seller's estate, there is another risk involved in the sale – the risk that the Buyer will die before the end of the SCIN's term. The Seller may want the Buyer to purchase life insurance on his or her life to provide for continued payments in the event of the Buyer's death. In such situations, term life insurance is often used. But if the Seller also needs a source of supplemental retirement income, then using a life insurance product with the potential to accumulate cash surrender values – such as ING Indexed Universal Life-Global (ING IUL-Global) – may prove to be another solution.

A Self Canceling Installment Note can be an excellent way for a Seller to transfer a business to the next generation and remove the entire value of the business from the Seller's estate.

SITUATION:

Jim Jones is 65 years old and is the owner of a business worth $1,000,000.

Jim would like to retire soon and his daughter, Janet, age 40, would like to buy him out. While Jim wants to make sure Janet has life insurance coverage to cover her obligation, he also is looking for something that could help provide him with supplementary retirement income.

POSSIBLE SOLUTION:

Jim offers to sell his business to Janet in exchange for a Self Canceling Installment Note. The interest rate on the note reflects the current long-term AFR rate plus a premium. The ING Life Companies' underwriting guidelines specify that coverage for debt repayment can be for up to 75% of the loan amount. Therefore, Jim purchases a $750,000 ING IUL-Global policy on Janet's life, names himself as policyowner, and creates an Endorsement Split Dollar agreement to endorse part of the death benefit to Janet. The amount endorsed to Janet is based upon the amount of the obligation due to Jim based on the terms of the SCIN. Jim uses part of the proceeds from the Janet's payments to pay for the life insurance coverage.

If something should happen to Janet during the term of the note, Janet's estate will have valuable death benefit protection to help cover her obligation to Jim. Assuming Janet survives the term of the SCIN, Jim can later use the cash values of the ING IUL-Global policy to help supplement his income in retirement.

How does it work?

1. Jim and Janet enter into an agreement for Janet to buy Jim out over a 10 year period using a self canceling installment note. Jim has his attorney draft the note and determine the appropriate "risk premium" on the interest rate.
2. Janet will make installment payments to Jim until the earlier of full repayment of the note or until Jim's death.
3. Jim buys a life insurance policy on Janet's life. He has his attorney draft an Endorsement Split Dollar agreement and endorses a death benefit amount to Janet to help pay for the sale amount of the business.
4. Jim will pay gift taxes on the economic benefit cost of the endorsed death benefit amount. This amount can be decreased each year to match Janet's obligation amount, easing the cost of the economic benefit.
5. If Janet dies before Jim, the death benefit proceeds received by her stated beneficiary of the endorsement agreement can be used to continue the installment payments to Jim.
6. If Jim dies before the end of the installment note, the note is cancelled and the Janet has no further obligation to make payments on the note. The Endorsement agreement can be terminated and Jim's estate can dispose of the policy as it sees fit.
7. If Jim survives the term of the note and Janet pays the note in full, Jim can now use the policy cash values to help supplement his income in retirement. Or he could transfer the policy back to Janet for her personal insurance needs.

Why a SCIN and why now?

Jim and his financial and tax advisors want to take advantage of today's low interest rates while also providing a potential source of supplemental income in retirement. A SCIN has the potential to remove appreciated property from his estate. If he dies during the term of the SCIN, the note is canceled and Janet would become full owner of the business with no gift tax due on the balance of the note.

Now is a good time to transact a SCIN due to historically low interest rates. As of September 2012, the Long-Term AFR was 2.18%. In September 2009, the rate was 4.38%. The IRS section 7520 rate is used to calculate the "risk premium." In September 2012, that rate is 1.0% and in September 2009 it was 3.4%. With the interest rate "risk premium" factored in, Janet's payment in 2009 would have been over $118,000. Using the rate based on the September 2012 rate, the payment would be $104,927, for a savings of over $140,000 over the 10 year period of the note.

What have we accomplished?

Jim, Janet, and their attorney create the terms of the SCIN and determine that Janet's annual payment to Jim should be $104,927 for 10 years. Jim uses $22,581 of this payment to maximum fund a $750,000 ING IUL-Global policy on Janet's life for 10 years.

If something should happen to Janet during the term of the note, Jim has valuable death benefit protection on her life to cover her obligation.

Assuming they both survive, starting in year 16, Jim could potentially take over $46,000 in cash value distributions from the policy for 15 years to supplement his income in retirement.

Total premiums paid	Projected loan/withdrawal amount	Cumulative loan/withdrawal amount	Net surrender value at age 121
$225,810	$46,223	$693,345	$100,256

Other case design parameters include: Cash Value Accumulation Test • Option A death benefit • 8.63% hypothetical crediting rate

A portion of the policy's surrender value may be available as a source of supplemental retirement income through policy loans and withdrawals. Income tax free policy distributions may be achieved by policy loans or withdrawing to the cost basis (usually premiums paid). This assumes the policy qualifies as life insurance, is not a modified endowment contract and is not lapsed or surrendered with an outstanding loan. Policy loans and withdrawals may reduce or eliminate index credits, generate an income tax liability, reduce available surrender value and reduce the death benefit, or cause the policy to lapse. Additionally, loans may limit the ability to make elections to the Indexed Strategy; if a loan results in amounts being deducted from a block prior to its block maturity date, no elections from the Fixed Strategy to the Indexed Strategy will be processed in the 36 months following the loan.

There are special rules that apply to installment sales of property between related persons if the related person who purchased the property sells it within 2 years of the purchase.

Neither ING nor its affiliated companies or its representatives give tax or legal advice. Your clients should consult with their legal advisors regarding their individual situation. These materials are not intended to be used to avoid tax penalties, and were prepared to support the promotion or marketing of the matter addressed in this document. The taxpayer should seek advice from an independent tax advisor.

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