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Got Premium?
Costanza v. C.I.R. and the Tax Treatment of Intrafamily SCINs Cancelled by Death

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Abstract

In 2003, the Sixth Circuit Court of Appeals overturned a Tax Court determination that the self-canceling installment note (SCIN) created by Duilio Costanza and his son, Michael, was a gift because it lacked the features of an arms-length transaction. It is the author's assertion that 1) the Sixth Circuit Court of Appeals overstepped its standard of review, and 2) both courts were lacking in an analysis of the most important evidence of a bona fide transaction: the consideration. Consideration for the transaction should have included a premium accounting for the risk that Duilio would die before the term of the note expired, and that was lacking from the Costanzas' SCIN. Thus, the major theme of this paper is that the premium paid for intrafamily SCINs should be the crux of a court's investigation of such matter. Risk premiums should be jurisdictional, not just suggested as they have been in a number of opinions.

This paper further touches on the tax treatment of SCINs canceled by death, including those incidents when the note is considered a gift due to the absence of a bona fide transaction or adequate and full consideration as well as the income tax treatment of the note when the transaction is considered legitimate, but canceled by death nevertheless. Lastly, this paper evaluates scenarios when SCINs may be contraindicated, including some possible forthcoming changes in tax law.

I. Introduction

In 1993, Duilio Costanza died of complications following heart surgery.¹ One result of Duilio’s death was the cancellation of a self-canceling installment note [hereinafter SCIN] between him and his son, Michael.² The Service assessed a $297,062 deficiency pursuant to the SCIN being assigned zero value on the estate tax return.³ The Tax Court found evidence lacking of a bona fide transaction between Duilio and Michael pursuant to the SCIN, and therefore, the

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¹ Estate of Dulio Costanza v. Comm’r., 320 F.3d 595, 596 (6th Cir. 2003) [hereinafter Costanza Appeal].
² Because the primary actors in this case are Duilio Costanza and his son, Michael Costanza, I will refer to the two by their first names. I do this to avoid confusion. No disrespect is intended toward the Costanzas.
³ Estate of Dulio Costanza v. Comm’r., 81 T.C.M. (CCH) 1693 (2001) [hereinafter Costanza Tax Court].
Court deemed the transfer a gift.\(^4\) Michael appealed and the Sixth Circuit found sufficient evidence in the record to overturn the Tax Court regarding the question of whether the SCIN constituted a bona fide transaction.\(^5\) The Sixth Circuit remanded the case for further proceedings regarding the issue of whether the SCIN constituted a bargain sale exposing the estate to possible gift tax liability.\(^6\)

The difference between the two courts’ opinions reflects an interpretation of facts and not an interpretation of law. Both courts recognized that where SCINs are executed between family members, there is a rebuttable presumption that the transaction is a gift; they also recognized that in order to overcome this presumption, the parties must clearly demonstrate that there existed an intent to create a debtor-creditor status.\(^7\)

In this paper I will elaborate on my opinion that both courts should have expressly mentioned the lack of a premium for the risk of cancellation by death in the SCIN: a crucial factor that courts should consider when evaluating SCINs.\(^8\) I will further elaborate on my opinion that the Sixth Circuit overstepped its standard of review: substituting its reasonable factual inferences for the Tax Court’s reasonable factual inferences where the standard of review

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\(^4\) *Id.* at 4. The Service had originally tried to argue that Duilio retained a revocable interest in the transferred property and that, therefore, the property should be included in the gross estate, but this argument did not stand in the Tax Court. *See id.* If the decedent were deemed to have held an interest in the property in either a retained life estate (per I.R.C. § 2036), testamentary transfer (per I.R.C. § 2037) or a revocable transfer (per I.R.C. § 2038) and the gift was made within three years of decedent’s death, then a court could pull the property back into the gross estate under I.R.C. § 2035. *See, e.g.*, Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995). Since the Tax Court did not agree with the Service that Duilio had made a revocable transfer, it implemented I.R.C. § 2512(b), which applies to gifts made for less than full and adequate consideration. *See Costanza Tax Court, supra* note 3, at 4. Gift taxes theoretically function as a remedy to potential abuses with regard to estate and income taxes, such as the type the Tax Court found regarding Michael’s consideration for the note. *See Richard B. Stephens, et al., Federal Estate & Gift Taxation ¶9.01 (8th ed. 2002).*

\(^5\) *See Costanza Appeal supra,* note 1, at 598.

\(^6\) *See id.* at 599.

\(^7\) *See id.* at 597 (citation omitted); Costanza Tax Court, *supra* note 3, at 3 (citation omitted).

\(^8\) It is my view that the Tax Court opinion was very well reasoned as written, and under prevailing law the inclusion of a risk premium analysis was not necessary. Therefore, my view that the risk premium should have been part of the analysis is meant to indicate that such inclusion would have been helpful and should become necessary, but not that it is necessary given the fact that no legal precedent requires such analysis.
for factual findings was “clear error.” Further, I will opine upon the remand to the Tax Court for further proceedings regarding the possibility of characterizing the SCIN as a bargain sale. Finally, I will discuss the income tax ramifications of SCINs cancelled by death, both in general and relating specifically to Costanza.

In addition to the specifics as applied to the Costanza case, I will discuss the benefits of SCINs, including factors potential taxpayers should consider when deciding whether an intrafamily SCIN is right for a given situation. In discussing such benefits, I will also elaborate on the pitfalls of ill-created SCINs.

II. SCINs between family members

A SCIN is a hybrid between an installment sale and a private annuity. In generic terms, a SCIN transaction goes as follows. Parent wants to get the family business out of her estate without incurring gift or estate tax liability. She sells the business to her child in exchange for a note entitling her to regular payments (at least annual) of a certain sum over a fixed number of years. The “self-canceling” part of the transaction comes in the form of a term in the note which cancels the obligation of the child to continue making payments on the note upon the death of the parent if the parent dies before the note terminates. The parent’s death results in the child holding the property free of the SCIN encumbrance. The SCIN has no value at death and, thus, the property is out of the estate and the note is not included in the gross estate. In a sense, parent is saying to child, “In exchange for this property, I want $X per [month/quarter/year] for a term of Y years. But if, due to my death, I cannot enjoy the periodic payments, then the property has no more value to me and it is yours free of the note obligation.” The SCIN is financially

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10 See Estate of Moss v. Comm’r., 74 T.C. 1239, 1247 (1980).
advantageous only if the parent dies prior to the note’s term. If the parent outlives the SCIN’s term, she pays income taxes on the installments and estate taxes on the SCIN funds remaining in the estate at death.\footnote{See Dwight Drake, Transitioning the Family Business, 83 Wash. L. Rev. 123, 187 (2008).}

SCINs are usually intrafamily transactions. They must be objectively bona fide transactions due to their potential as a tool for inappropriately avoiding estate or gift taxes. Imagine a mother selling her auto dealership to her son for $5,000,000 (current fair market value) in exchange for a SCIN with a twenty-year term at four percent interest to be paid in equal yearly installments. Now imagine that same mother is eighty-five years old suffering from advanced terminal cancer. Moreover, imagine that the Applicable Federal Rate for long-term loans at the time of the transaction is eight percent. Allowing such terms would constitute an end-run around the gift and estate taxes – allowing the parent to get property out of her estate by disguising a sizeable gift under the cloak of the SCIN.\footnote{The income tax treatment of \textit{bona fide} SCINs cancelled by death is discussed in § VII, \textit{infra}.}

One of the most important factors, therefore, in assessing whether the SCIN represents a bona fide transaction is determining whether the value assigned to the note reflects an appropriate premium for such factors as the time value of the money (the longer the note, the higher the premium should be); and the age and health of the person whose death cancels the note.\footnote{See Drake, supra note 11, at 186.} The premium charged on the note can come in the form of an above-market interest rate, or an increase in the principal.\footnote{See Sheldon I. Banoff & Michael O. Hartz, NEW TAX COURT CASE EXPANDS OPPORTUNITIES FOR SELF-CANCELLING INSTALLMENT NOTES, 76 J. Tax’n 332, 332-33 (1992).} It is my opinion that courts should give much weight to the risk premium in determining whether an intrafamily SCIN was a bona fide exchange, because appropriate pricing is the crux of a bona fide business transaction.

\textit{A. When does an intrafamily SCIN make sense?}
Regardless of whether it is a bona fide transaction, an intrafamily SCIN does not always make sense from an estate planning perspective. First of all, one should inquire about the point of a SCIN. The holder of the SCIN must pay income taxes on the money received over the term of the note. Moreover, as discussed in section VII, *infra*, the decedent’s estate realizes an income tax gain from the cancellation of the SCIN. Thus, one must ask if the income tax liability attached to the note is worth the estate and gift tax savings offered by the note.

In 2008 the highest marginal personal federal income tax rate was thirty-five percent and the highest marginal estate and gift tax rate was forty-five percent. The current president has proposed an increase to the highest marginal income tax rate that approaches the highest marginal estate and gift tax rate. There have been periods in United States history when individual personal income tax rates at the highest bracket were as high as seventy percent (1980) and even ninety-four percent (1945). It is clear that in the latter cases of income taxes above seventy percent, it makes no sense to expose oneself to such high income taxes when the estate and gift taxes are significantly lower. What is less clear, but important for a practitioner to compute is the breaking point at which the income tax approaches the estate and gift taxes so as to create a *de minimis* benefit unworthy of the costs and efforts of creating an intrafamily SCIN. Such a computation needs to be made on a case-by-case basis where the economic realities of the potential estate and gift taxpayer do not readily indicate a benefit from an intrafamily SCIN.

16 *See* I.R.C. § 2001(c); § 2502(a).
For the 2008 taxable year, the rate schedule for gift taxes was indexed to the estate tax.\(^{19}\) Absent any alternative legislation by Congress, the highest marginal gift tax rate for the 2010 taxable year will be thirty-five percent for gifts totaling more than $500,000.\(^{20}\) Thus, we are already approaching a point where potential tax benefits may not obviate a SCIN, again, depending on the potential taxpayer’s specific situation.

Lastly, it is important to consider gift and estate tax credits. As of the writing of this paper, the exemptions for the estate and gift taxes are $3,500,000 and $1,000,000 (lifetime) respectively.\(^{21}\) This, like all tax laws, is open to revision by Congress. Nevertheless, a taxpayer today has these parameters to consider so that if, for example, the hypothetical auto dealership mentioned in this section, \textit{supra}, were worth only $500,000 and the estate was worth an additional $2,000,000, there would be no point in creating a SCIN to get the dealership out of the estate. To the contrary, because the SCIN creates income tax liability for the party getting the property, a SCIN is contraindicated in such a situation.

\textbf{B. Remedies for SCINs deemed not to be bona fide transactions}

There are two basic remedies employed in cases where intrafamily SCINs are deemed not to be a bona fide transaction. A court may pull the property back into the estate, or it may deem the transfer a gift. In cases like \textit{Estate of Musgrove} where a court finds that the intrafamily SCIN is so lacking in evidence of a bona fide transaction that the parent is seen to retain incidents of ownership, the entire property may be drawn back into the gross estate via I.R.C. \S\ 2035 which

\begin{itemize}
  \item \textbf{19} See I.R.C. \S\ 2502(a)(1) (1987).
  \item \textbf{21} See I.R.C. \S\ 2010(c).
\end{itemize}

I.R.C. \S\ 2505 sets the lifetime exemption gifts at $1,000,000 for 2009. Under Pub. L. 107-16, \textit{supra} note 20, that amount remains at $1,000,000 for the year 2010.
allows such a remedy for gifts made within three years of the decedent’s death. In *Musgrove* the loan at issue was interest-free, unsecured and was given to the decedent’s son less than a month before death. However, if there are no incidents of ownership but a court finds that a bona fide transaction is lacking, it may invoke I.R.C. § 2512 and deem the transfer a gift for less than adequate and full consideration. In the former case, the law specifies that “the value of the gross estate shall include the value of any property . . . which would have been so included.” Therefore, any consideration that may have been exchanged for the property has no affect on the valuation of the amount to be included in the gross estate for estate tax purposes. If, on the other hand, the transaction is deemed a gift, the statute provides that the amount included in the gift tax shall be reduced by the amount of consideration furnished. Thus, incidents of ownership may visit a significant difference in the estate or gift tax treatment of the property if a transaction is deemed by a court as not bona fide.

**III. The facts regarding the Costanza SCIN**

**A. The Sixth Circuit’s version**

In October of 1992, at the age of 73, Duilio Costanza wanted to sell properties he owned in Michigan pursuant to his desire to retire to Italy. His attorney advised Duilio to sell his properties, worth $830,000, to his son, Michael, in exchange for an $830,000 SCIN. Michael signed the SCIN sometime in late December of 1992 or early January of 1993 and a mortgage on

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22 See generally *Musgrove*, supra, note 4 (granting summary judgment in favor of the United States where facts indicated no intent to repay the loan and decedent-parent died within four months of signing the self-canceling note).

23 See id. at 658.

24 See infra § IV.A. (imposing a gift tax on the transaction when the Tax Court deemed the Costanzas’ SCIN not to be a bona fide transaction, but not finding that Duilio retained incidents of ownership).

25 I.R.C. § 2035(a)(2).

26 See infra text accompanying note 45.

27 See *Costanza Appeal*, supra note 1, at 596.

28 See id.
the properties was recorded in February of 1993.\footnote{See id.} The term of the SCIN was for 11 years with monthly payments, but Duilio orally changed the terms to quarterly payments.\footnote{See id.} Michael made his first quarterly payment (for January, February and March) on March 8, 1993.\footnote{See id.} Duilio died unexpectedly on May 12, 1993 of complications resulting from heart bypass surgery.\footnote{See id.} Although he had been suffering from heart disease for fifteen years prior to his death, Duilio’s life expectancy at the time he executed the SCIN was between 5 and 13.9 years.\footnote{See id.}

\textbf{B. The Tax Court’s version}

In the interest of efficiency, I will only add facts that were absent from the Sixth Circuit’s facts section. The only facts that were included in the Sixth Circuit’s account, but not in the Tax Court’s findings of fact were 1) that Duilio orally changed the term of the SCIN to quarterly payments, and 2) that Duilio’s life expectancy was between 5 and 13.9 years.

Michael was the trustee of Duilio’s revocable trust, which owned the properties.\footnote{See Costanza Tax Court, supra note 3, at 1, 2.} Michael signed all of the documents, backdated to December 15, 1992, pursuant to the SCIN, both in his capacity as trustee of his own revocable trust and as trustee of Duilio’s revocable trust.\footnote{See id. at 2.}

Duilio successfully underwent his first heart bypass surgery in 1982.\footnote{See id.} Duilio had been suffering from severe heart problems since at least April of 1991.\footnote{See id.} In the winter of 1991 Duilio had to truncate a trip to California due to chest pains.\footnote{See id.} Duilio was hospitalized in Michigan in late January 1993 where he and his family were informed that his condition was poor and,
together with Michael, he decided to undergo a second heart bypass.\(^39\) The quitclaim deeds and mortgages were registered in February 1993.\(^40\) The interest rate for the SCIN started at 6.25% and increased by one-half percent over the eleven-year period to average out at 7.392% over the term of the SCIN.\(^41\) Michael made out three backdated checks on which he altered the dates to January 1, February 1, March 1 of 1993.\(^42\) He deposited the three checks for $8,710 each into Duilio’s trust account on March 8, 1993 and made no more payments before Duilio died on May 12, 1993.\(^43\)

**IV. Appealing on the facts: the clearly erroneous standard of review**

**A. The legal and factual basis for the Tax Court’s opinion**

In the Tax Court, the Service argued, successfully, that the SCIN was not valid, because it was not a bona fide transaction, and therefore, the Tax Court held that the transfer of the properties to Michael constituted a gift to the extent it exceeded Michael’s $26,130 in actual payments made.\(^44\) In doing so, the Tax Court was applying section 2512(b)\(^45\) which provides that

\[ \text{Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.} \]

Therefore, the Tax Court was not treating the transaction as part sale. Rather, it was interpreting the transaction as a gift and applying the inadequate consideration against the fair market value

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\(^39\) See id.

\(^40\) See id.

\(^41\) See id. The Applicable Federal Rates for monthly and quarterly long-term loans were 7.61% and 7.66% respectively when the SCIN was effected. Available at Pillsbury Tax Page http://pmstax.com/afr/ (follow “Search AFRs” hyperlink) (last visited May 18, 2009).

\(^42\) See Costanza Tax Court, supra note 3, at 2.

\(^43\) See id.

\(^44\) See id. at 4.

\(^45\) Unless otherwise indicated, all statutory sections in this paper refer to the I.R.C.

\(^46\) I.R.C. § 2512(b)
of the property as prescribed by section 2512(b). Donative intent is no longer necessary to make a “gift” for gift tax purposes, and the Supreme Court has expressly recognized Congress’ “much more workable external test”\textsuperscript{47} of characterizing the difference between fair market value and amount paid by the donee as a gift.

After laying out the facts as enumerated in section III, supra, the Tax Court pointed specifically to irregularities in the transaction itself as evidence that this was missing the markings of a typical arms-length transaction. The particular irregularities in the opinion were: 1) Michael altered the check dates; 2) all payments were untimely; 3) Michael only made one payment, and; 4) Michael executed all of the documents for the transaction.\textsuperscript{48}

B. The clearly erroneous standard as applied to the Tax Court

Michael appealed the Tax Court’s findings of fact. The Sixth Circuit was bound to use the “clearly erroneous” standard of review, as the Supreme Court has held that

Where the trial has been by a judge without a jury, the judge's findings must stand unless ‘clearly erroneous.’ A finding is ‘clearly erroneous’ when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.’ The rule itself applies also to factual inferences from undisputed basic facts, as will on many occasions be presented in this area. And Congress has in the most explicit terms attached the identical weight to the findings of the Tax Court.\textsuperscript{49}

[T]he function of the Board of Tax Appeals is to weigh the evidence and declare the result as to matters properly before it. Upon review the [appellate] court may not substitute its judgment of the facts for that of the Board. When there is substantial evidence to support the conclusion of the latter this must be accepted.\textsuperscript{50}

1. Duberstein: when is a “gift” at trial a gift on appeal?

\textsuperscript{47} Comm’r. v. Wemyss, 324 U.S. 303, 306 (1945).
\textsuperscript{48} See Costanza Tax Court, supra note 3, at 4.
\textsuperscript{49} Comm’r. v. Duberstein, 363 U.S. 278, 291 (1960) (emphasis added) (citations and quotations omitted).
\textsuperscript{50} Helvering v. Kehoe, 309 U.S. 277, 279 (1940) (emphasis added).
Duberstein involved the Supreme Court’s review of two consolidated cases determining whether certain transactions constituted gifts or remuneration for the purposes of income taxes. In one of the two cases the taxpayer failed to include the value of a car, given to him by a business associate, as gross income.\footnote{See Duberstein, supra note 49, at 280-81.} The Service deemed a deficiency and the Tax Court Agreed.\footnote{See id. at 281.} The Sixth Circuit reversed.\footnote{See id.} In the second case, the taxpayer deemed money paid by his employer pursuant to his resignation from employment a gift and the Service deemed a deficiency for failure to report the money as income.\footnote{See id. at 281-82.} The taxpayer paid the deficiency and sued in the U.S. District Court for recovery.\footnote{See id. at 282.} The trial court made a simple finding from the bench that the payment was a gift.\footnote{See id.} The Second Circuit reversed.\footnote{See id.}

The Supreme Court placed heavy emphasis on the trial court’s role as trier of fact, considering all the factors involved in the case.\footnote{See id. at 289-90.} “Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case.”\footnote{Id. at 289 (emphasis added).}

A majority of the Duberstein Court agreed that the Sixth Circuit was erroneous regarding its reversal, because the Tax Court gave a reasoned basis for its finding of fact.\footnote{See Id. at 291-92.} In the case where the district court judge ruled from the bench, however, the Supreme Court remanded for further proceedings, ordering that the district court judge give a reviewable reasoned opinion.\footnote{See Id. at 292-93.}
Hence, as Duberstein reinforces, courts of appeal are bound to give a great deal of deference to
the trier of fact when applying the “clearly erroneous” standard of review to a reasoned opinion.

C. The Sixth Circuit’s basis for reversing the Tax Court

The Sixth Circuit readily acknowledged that it was basing its review upon the facts, not
the law, and therefore the “clearly erroneous” standard applied.62 The Sixth Circuit based its
reversal primarily on two sources from the record: 1) Michael’s testimony explaining the
irregularities in the transaction, and 2) an expert’s conclusion that Duilio’s life expectancy was
13.9 years at the time of the SCIN’s execution.63

As the Eighth Circuit once said, “the [Tax Court] is not bound to accept testimony at face
value even when it is uncontroverted if it is improbable, unreasonable or questionable”64 Thus,
so long as the Tax Court was acting from a reasonable basis and there existed questionable
circumstances, there was no obligation for the Tax Court to accept Michael’s testimony.

The Sixth Circuit relied heavily on Michael’s testimony as well as the testimony of the
attorney who designed the SCIN as its basis for reversing the Tax Court. For example, regarding
the dispositive issue of whether there was an intention of repayment, the Sixth Circuit cited
Michael and the attorney’s testimony that there was such an expectation.65 For most of the
findings of fact in the Tax Court, the Sixth Circuit’s reason for reversal on the issue of whether
the transaction was bona fide was Michael’s testimony. The Sixth Circuit apparently ignored the
Tax Court’s concern that Michael was the trustee of both the purchaser and seller trusts.66

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62 See Costanza Appeal, supra note 1, at 597.
63 See id. at 597-98.
64 Banks v. Comm’r., 322 F.2d 530, 537 (8th Cir. 1963) (citations omitted).
65 See Costanza Appeal, supra note 1, at 597.
66 The Tax Court expressed concern that

Michael, as trustee of his father's trust, executed the documents necessary to transfer that trust's
interest in the restaurant and shopping center properties to himself. Although he did so with the
full understanding and consent of his father, the transfer took place without an objective showing
by either of them that they meant to enforce the payment provisions of the transfer. To the
Although the issue of Duilio’s life expectancy at the signing of the SCIN was only addressed through implication at the Tax Court, the Sixth Circuit mentioned it twice in its opinion. Once, curiously, the Sixth Circuit mentioned in its background section (i.e. as if it was an established fact) that Duilio’s life expectancy was somewhere between 5 and 13.9 years. Next the Sixth Circuit disclosed that it arrived at that fact by evaluating the testimony of at least two experts. Under the Federal Rules of Evidence, expert testimony is intended “to assist the trier of fact to understand the evidence or to determine a fact in issue[.]” This is to say that the trier of fact regards expert testimony in its reasoned decision, but not that the trier of fact must accept any particular expert’s testimony as conclusive evidence. Thus, the Sixth Circuit’s reliance on the experts’ testimony is inappropriate in the context of “clear error” review.

Finally, the Sixth Circuit appears to drive its conclusion home by opining that “the fact that the SCIN was fully secured by a mortgage on the properties further refute[d] any inference that the sale was not bona fide.” This is where the Sixth Circuit’s avoidance of the fact that Michael executed all the documents weakens its opinion. The mortgage was executed by Michael as trustee of his revocable trust and held by Michael as trustee of his father’s revocable trust. What if Michael were to default on his mortgage by missing 10 monthly payments for a deficiency of $87,000 plus interest and then his father died? It would have been up to Michael as executor of the estate to join with Michael as trustee of Duilio’s trust in a cause of action against

contrary, the haphazard and, at times, contradictory manner in which Michael undertook to make payments to his father falls short of establishing that there was a valid arm's-length sale of the commercial properties involved.

Costanza Tax Court, supra note 3, at 4 (emphasis added).

67 See Costanza Appeal, supra note 1, at 597.

13.9 years happens to be the exact life expectancy of a typical 73-year old per one of the Service’s actuarial tables. See Treas. Reg. § 1.72-5 (1986) (TABLE V—ORDINARY LIFE ANNUITIES ONE LIFE—EXPECTED RETURN MULTIPLES). This is one of the tables estate planning experts use for determining the proper value of a SCIN. See ALI Article, supra note 9.

68 See Costanza Appeal, supra note 1, at 598 (“Medical experts testified at trial that Duilio was expected to live somewhere between 5 and 13.9 years from the time that he signed the SCIN.”).

69 Fed R. Evid. 702.

70 Costanza Appeal, supra note 1, at 598 (emphasis added).
Michael as purchaser of the property.\footnote{See supra note 48 (regarding Michael’s testimony at trial about this type of scenario).} Therefore, I fail to see how the mortgage further refutes any inference that the sale was not bona fide when examined in the totality of the circumstances.

The Sixth Circuit cited testimony and evidence tending toward a reasonable argument for concluding that Michael and Duilio entered into a bona fide transaction when they executed the SCIN. A reasonable jurist could look at the record and glean explanations regarding the backdating of the checks, the change to quarterly payments and the fact that only one (quarterly) payment was actually made. Moreover, the Sixth Circuit was correct when it rejected the Service’s argument that Michael and Duilio entered into the deal expecting Duilio to predecease the term of the SCIN.\footnote{See Costanza Appeal, supra note 1, at 598.} Ultimately, the parties to a SCIN are betting that one party will die before the note terminates – this is expected with SCINs.\footnote{See id.; Drake, supra note 11.} However, none of the Sixth Circuit’s reasonable arguments rise to overcome the fact trier’s findings under a “clearly erroneous” standard of review.

\textit{V. The risk premium in intrafamily SCINs}

The Sixth Circuit cites an article by Banoff & Hartz for its proposition that there is no problem with the fact that family members are essentially betting that one of them will predecease the term of the SCIN.\footnote{See Costanza Appeal, supra note 1, at 598 (citing, generally, Banoff & Hartz, supra note 14).} Both the Sixth Circuit and the Tax Court missed what I think is an important issue with regard to whether the intrafamily SCIN is a bona fide transaction. That issue is the so-called \textit{risk premium} prominently featured in the Banoff & Hartz article.\footnote{See Banoff & Hartz, supra note 14, at 332-33.} The centrality of the risk premium is this author’s opinion and not binding law per se. Therefore, neither court was obliged to include such considerations in its opinion. Nevertheless, the
premium issue would hopefully be addressed on remand regarding the bargain sale issue, or in similar future cases.

The Banoff & Hartz article asserts that a valid SCIN must include a risk premium in order to compensate the seller for the risk of cancellation by death. Banoff & Hartz point out that the risk premium is what differentiates the realities of a SCIN from a traditional installment note, which does not terminate until the term of years is completed. In his article, Drake, cites Estate of Musgrove v. U.S. for the proposition that the risk premium must take the “terminating life’s” health into account in order to constitute a bona fide transaction. The risk premium comes in two forms: an elevated interest rate, known as “SCIN-INT” or an elevated principal, known as “SCIN-PRIN.” This is not clearly discussed in either the Tax Court or the Sixth Circuit appeal for Costanza.

A. Estate of Musgrove v. U.S.: a caricature of the lacking risk premium

Musgrove illustrates just about everything one could do wrong in creating intrafamily SCINs. The primary players in Musgrove are Sebe Musgrove (the decedent), Stanley Musgrove (decedent’s son and executor) and Naomi Ruth Stevens (Sebe’s predeceased daughter). Stanley was Naomi’s estate’s personal representative. After informing Sebe that Naomi’s estate would owe some $300,000 in estate taxes, Sebe and Stanley wanted to come up with a way to pay the taxes without selling property in Naomi’s estate. On September 5, 1980, Stanley and Sebe signed an interest-free promissory note for $300,000 with a cancel-upon-death

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76 See Id. at 332; Drake, supra note 11.
77 See id. at 333.
78 Generally it is the parent/seller whose death cancels the obligation on a SCIN. I use the term “terminating life” in this instance to illustrate the fact that, really, any person’s life may be used in such a way in a SCIN so long as the terms are valid and equitable.
79 See Drake, supra note 11 (citing Estate of Musgrove, supra note 4, at 658).
80 See Banoff & Hartz, supra note 14, at 332; ALI Article, supra note 9, § V.B.3.
81 See Musgrove, supra note 4 at 658.
82 See id.
83 See id.
clause. On December 16, 1980, after becoming aware of the actual estate taxes owed on Naomi’s estate, Sebe arranged the availability of $251,540 pursuant to the note in order for Stanley to pay the estate taxes. Sebe died on January 2, 1981. The Service included the full $251,540 in Sebe’s estate and the estate paid the estate taxes on the money and brought action in the Court of Claims to recover $99,381.94 overpaid taxes.

The Musgrove Court provided a well reasoned analysis in its opinion. First the Court pointed out that the Supreme Court has made it clear that common law consideration often illustrated in first-year Contract Law classes by Hamer v. Sidway is not what Congress intended when contemplating tax-related transactions like SCINs. The Court then held out a “smoking gun” with regard to Sebe holding incidents of ownership, which resulted in the money being pulled back into the estate via I.R.C. § 2035. The “smoking gun” was a letter written by Sebe’s attorney addressing an understanding that the son would “not use any of the monies for any other purpose without prior approval from [the father.]” The Musgrove Court concluded that there was no intent of repayment citing, among other facts, Sebe’s health when the note was executed. Thus, there was no consideration given for the note, the decedent held an interest in the money, and there was never an intent of repayment. These facts seem to caricature the lack of a bona fide transaction discussed in Section II, supra.

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84 See id.
85 See id. at 659.
86 See id.
87 See id. at 658-59.
88 27 N.E. 256 (N.Y. 1891). In Hamer the court found that an agreement between an uncle to pay his nephew $5,000 in exchange for the nephew’s forbearance from otherwise legal activities (e.g. drinking alcohol and gambling) for a term of years was enforceable as a contract with adequate consideration. While the uncle in Hamer felt that the satisfaction of knowing his nephew was living a “clean” life was worth $5,000 to him, the IRS today would not consider this an exchange for gift and estate tax purposes.
89 See Musgrove, supra note 4 at 663-64.
90 See id. at 666.
91 Id.
92 See id. at 669.
This is not to say that a bona fide transaction was not possible for the Musgroves. To say that the Musgroves lacked a risk premium is an understatement. The Service expects the typical eighty-two-year old to live another 8.4 years.\textsuperscript{93} This could have been a starting point for the Musgroves. Given Sebe’s health, the Musgroves should have to have added a premium to the loan in order to create a bona fide transaction. By using the SCIN-PRIN or SCIN-INT and removing all incidents of ownership, the Musgroves may have been able to create a bona fide transaction. Sebe Musgrove’s health may have been so poor as to eliminate any reasonable expectation of repayment, in which case there may have been no way for him to avoid gift or estate taxes. But, as Costanza illustrates, the fact that Sebe Musgrove happened to have died shortly after executing the transaction is not dispositive of a bona fide transaction for full and adequate consideration. I submit that for the amount of money spent in creating the loan and prosecuting the case against the Service, the Musgroves may have been able to create a bona fide SCIN-INT or SCIN-PRIN with a real expectation of repayment, and full and adequate consideration.

\textit{B. The lacking risk premium in the Costanza SCIN}

What stronger evidence is there for a bona fide transaction than the consideration bargained for in a contract? The Sixth Circuit indirectly (and perhaps inadvertently) brought the risk premium issue up by citing the Banoff & Hartz article.\textsuperscript{93} It is possible that the Tax Court would have been able to avoid a reversal by making more of the lack of a risk premium. However, given the Sixth Circuit’s interpretation of “clear error” in this case, it is also possible that the Sixth Circuit would have disregarded analysis of a risk premium in the appeal.\textsuperscript{94} The Costanzas’ SCIN offered neither a SCIN-INT nor SCIN-PRIN taking into account the risk that

\textsuperscript{93} See supra note 67.
\textsuperscript{94} See, e.g., supra § III.B., IV.C.
Duilio would die within eleven years. The Tax Court did enumerate the interest rate, but it didn’t mention expressly that the rate was below market. The Tax Court also noted that the principal for the SCIN, $830,000, was the assessed fair market value of the properties around the time of its execution. Again, there was no direct mention of a risk premium. The Tax Court’s omission of this discussion was reasonable, because, as discussed in § VI, infra, full and adequate consideration is a separate issue; nevertheless consideration in the form of adequate premiums is related to the determination of whether an intrafamily SCIN was bona fide and the Tax Court would have done a service by including such discussion, because it could have forced the Sixth Circuit to address the issue head on.

VI. Remand on the bargain sale determination for the Costanzas

Because the Tax Court had determined that the transaction was not a bona fide transfer, it never addressed the Service’s alternative argument that the SCIN was a bargain sale. The essence of the Service’s alternative argument was that the value of the SCIN was so far below fair market value for the properties as to constitute inadequate consideration pursuant to section 2512. Whereas the issue in the Tax Court was whether the SCIN was a bona fide transaction between Michael and Duilio with regard to the expectation of repayment, the issue on remand will be whether the consideration for the SCIN was adequate and full. Thus, the primary difference between the Tax Court’s conclusion discussed throughout this paper and its conclusion on remand, should it find that a bargain sale existed, will be the formula used for determining the amount of gift taxes owed on the transfer. For example, if the note is

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95 See Costanza Tax Court, supra note 3, at 2; see also supra note 41 (AFR was 7.61% (monthly) or 7.66% (quarterly) while the Costanza’s SCIN averaged to 7.392% over the eleven-year term); Cf. Frane, infra note 100 (similar facts to Costanza, but the parties identified a SCIN-INT pursuant to their agreement).
96 See Costanza Tax Court, supra note 3, at 1.
97 See Brief for Appellee, supra note 48, at 30 n. 10; supra text accompanying note 46.
determined to have been worth one-half the value of the properties, that difference (less the money Michael paid Duilio) will be taxed as a gift (after deductions and credits are applied).

It seems clear to me that there was a lack of full and adequate consideration, because of the lack of a risk premium. This is especially true under the circumstances regarding not only Duilio’s age, but also his poor health. As I argued in Section V, supra, the issue of adequate and full consideration should go to whether the transaction was bona fide where the presumption is that the intrafamily SCIN was not a bona fide transaction. Although the two issues are separate, they are not unrelated. This is why the Tax Court implemented section 2512(b) after determining that the SCIN was not a bona fide transaction between Michael and Duilio.98

Nevertheless, the Sixth Circuit has bifurcated the issues of evaluating bona fide transactions and evaluating valuation, because they truly are separate issues. At its heart, the determination of whether a transaction was bona fide inserts a state of mind element to the transaction, because it requires courts to determine whether there was an “intrafamilial wink” regarding the deal. On the other hand, a bargain sale determination requires no investigation into the parties’ state of mind. The court simply looks at the deal and subtracts the amount of the transaction from the fair market value of the property to arrive at the value of the gift.99 In Costanza, I see the inadequate consideration as important evidence, in addition to the circumstances, of a transaction that was not bona fide. However, I can imagine a situation where the terms and value of an intrafamily SCIN are, say, 10% less than fair market value and the deal had all the other markings of an arms-length transaction. That 10% may represent an honest and reasonable difference in valuation techniques, especially when valuing a closely held business.

98 See Costanza Tax Court, supra note 3, at 4 (“Under these circumstances, we believe that the provisions of section 2512(b) are dispositive . . . decedent’s transfer to Michael was a gift to the extent that it exceeded the consideration actually paid.”).

99 See supra text accompanying note 47. (discussing how Congress removed donative intent as an element for determination of gifts pursuant to tax cases).
In such a case, it would be unjust to construe the “gift” as the difference between the consideration actually paid and the fair market value of the property, if the “terminating life” happened to end early.

VII. Income tax treatment of the SCIN for Duilio’s estate

As Costanza stands, Duilio successfully removed the property from his estate in exchange for a SCIN that was cancelled at his death. Therefore, at his death he held a SCIN that was worth nothing. His estate reports the SCIN as having no value and he received $26,130 in gross income for his $830,000 worth of properties. Does this mean that Duilio’s estate (or Duilio himself) owes no income taxes on the worthless note? “No!” says Congress as it implements sections 453B and 691. Estate of Frane v. C.I.R. addresses the inquiry of how the Duilio Costanza’s cancelled SCIN will be treated for income tax purposes.

In Frane the decedent, at age fifty-three, sold his family business to each of his children in exchange for twenty-year SCINs at 12% interest, payable annually. Frane died after receiving only two of the annual payments from his children and his estate recognized only the income from the payments themselves on his income tax returns. The Service issued a notice of deficiency, claiming that a gain from the SCINs should have been reported either on Frane’s final income tax return or on his estate’s income tax return. The Tax Court concluded that a gain was recognized upon Frane’s death for the notes, and held that Frane (as opposed to the estate) was liable for the income tax owed on the SCINs. The Eighth Circuit agreed with the Tax Court that income was realized on the SCINs, but held that the income should be recognized

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100 998 F.2d 567 (8th Cir. 1993).
101 See id. at 568-69. The Frane children expressly mentioned that 12% was an above-market-rate premium. See id.
102 See id. at 569.
103 See id.
104 See id.
by Frane’s estate, rather than Frane himself. This distinction is important, because income
taxes paid by a decedent are recognized as a deductible claim against the estate under section
2053(a)(3), but income taxes paid by the estate are not so recognized.

The Frane children argued that no income was realized as a result of the worthless
cancelled note. The Eighth Circuit disagreed with the children, because the “Internal Revenue
Code specifically provides that ‘if any installment obligation is canceled or otherwise becomes
unenforceable,’ and the obligee and obligor are related persons, it shall cause the obligee to
recognize income equal to the difference between the basis of the obligation and its face
value.” Thus, the Frane Court reasoned, income is clearly recognized by statute for the
difference between the face value of the SCIN and any remuneration received per the SCIN.

With regard to who should realize the gain (Frane or his estate), the Court turned to
section 691, which is given effect in section 453B.

If a right . . . to receive an amount is transferred by the estate of the decedent . . .
by reason of the death of the decedent . . . there shall be included in the gross
income of the estate . . . for the taxable period in which the transfer occurs, the
fair market value of such right at the time of such transfer plus the amount by
which any consideration for the transfer exceeds such fair market value.

The Frane Court looked at this provision in conjunction with section 691(a)(5)(A)(iii), which
provides, “In case of an installment obligation reportable by the decedent on the installment
method under section 453, . . . any cancellation of such obligation occurring at the death of the
decedent shall be treated as a transfer by the estate of the decedent . . .”. Since the transfer is

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105 See id. at 572.
106 See Banoff & Hartz, supra note 14, at 335. Note here
107 See Frane, supra note 100, at 569.
108 Id. (citing 26 U.S.C. §§ 453B(a),(f) (Supp. III 1991)).
109 See Id. at 572.
110 Section 453B(c) provides, “Except as provided in section 691 . . . this section shall not apply to the transmission
of installment obligations at death.” Thus, it is apparent that Congress had SCINs in mind when they authored these
provisions. Note that in § 453B(f)(2) Congress expressly recognizes a bias regarding intrafamilial installment notes.
made by the estate and the statute provides that the income is reported in the estate’s gross income, the Eighth Circuit concluded that the estate must report the gain as income.\(^\text{112}\)

**VIII. Conclusion**

Intrafamily SCINs are an excellent tool for getting property out of an estate, provided they are done right. First of all, a planner must determine whether a SCIN is the proper tool for getting property out of the potential taxpayer’s estate. In doing so, the planner should consider issues like income tax versus estate tax rates, keeping in mind that, absent superseding legislation, in 2010 the highest marginal gift tax rate is thirty-five percent. The highest marginal rate for the estate tax is still forty-five percent. There have been periods in the history of the United States when income taxes were much higher than they are now – as high as ninety-four percent during World War II. The United States is currently involved in two wars and though there have been proposals to raise the highest marginal income tax rates, such proposals are still below forty percent. Thus, for the foreseeable future, SCINs should make sense for at least some potential estate taxpayers desiring to get certain properties out of their estates while minimizing tax consequences. Should the highest marginal income tax rates approach fifty percent or higher, however, planners will have to reconsider the viability of the intrafamily SCIN.

The Costanza estate was lucky that the Sixth Circuit came to the wrong conclusion, because the Sixth Circuit improperly applied the “clear error” standard of review. Although I disagree with the Sixth Circuit’s findings, the law on SCINs is clear: for an intrafamily SCIN to overcome the presumption of a gift, there must be a bona fide transaction with an affirmatively demonstrated expectation of repayment, supported by full and adequate consideration. If a court finds the transaction was not bona fide, the parties risk pulling the entire property back into the estate for estate tax purposes. This may happen if a court finds that there were incidents of

\(^{112}\) See Frane, *supra* note 100, at 572.
ownership by the party selling the property (usually the parent) and the SCIN was executed within three years of the terminating life’s death. Otherwise, a court may find that a SCIN lacking the indicia of a bona fide transaction was a gift and the donor (or her estate) may be liable for gift taxes on the difference between any consideration received and the value of the property at death.

A real debtor-creditor relationship between the family members is necessary in order to pass the first hurdle of scrutiny in a court determining whether the SCIN transaction was bona fide. There must be objective evidence that the debtor has the means, intent and plan to repay the loan.

Intrafamily SCINs must include full and adequate consideration for money or money’s worth. Courts should put strong emphasis on consideration when evaluating whether an intrafamily SCIN is bona fide. Common law consideration is not sufficient for the Service to consider the transaction to be bona fide. In fact, because of the statutory presumption that intrafamily SCINs are gifts, an intrafamily SCIN may have to be more “bona fide” than a true arms-length SCIN might be between strangers. Whereas a stranger might offer a discount to a buyer if the buyer makes certain guarantees (e.g. only use local suppliers for a term of years), such an offer may and should be viewed as evidence of a less than bona fide transaction between family members due to the risk of an “intrafamilial wink.”

The opinions in both Costanza cases notwithstanding, the risk premium is key to evaluating whether an intrafamily SCIN is a bona fide transaction, because consideration is the heart of a contract. There is no stronger evidence of a bona fide business transaction than the consideration exchanged in an agreement. A risk premium must account for the risk that the terminating life will expire before the term of the SCIN is over. Otherwise there is no difference
in consideration from a regular installment note, in which case the SCIN is actually discounted—lending evidence toward a less-than bona fide transaction with less than adequate and full consideration. Thus, without a SCIN-PRIN or a SCIN-INT, the SCIN is lacking in adequate and full consideration and is, therefore, not indicative of the arms-length business transaction that should identify an intrafamily SCIN.

Adequate and full consideration is also central to another important issue regarding the scrutiny of intrafamily SCINS. That issue is determination of whether the SCIN will be considered a gift pursuant to I.R.C. § 2512(b). Though adequate and full consideration is related to the bona fide transaction, it is also separate when considering such issues for purposes of evaluating a possible bargain sale. It is unlikely that the Costanza estate would be as lucky with the bargain sale determination on remand for the bargain sale issue on remand. Paranthetically, I presume the Costanza estate settled the matter with the Service, because I found no record of the remand and it seems logical that a settlement would have been more efficient than further legal proceedings. Duilio’s estate benefited from the Sixth Circuit’s opinion, because the value of the SCIN at Duilio’s death (upon which Duilio’s estate should pay income tax) should be added to the money Michael paid in determining the amount of the gift pursuant to section 2512(b).

There is no problem with “betting” that one party will die before the termination of the SCIN. This is actually the point of a SCIN and courts have upheld the legitimacy of SCINs in this regard. The key, again, is that the risk of death factored into the value of the note, either via SCIN-PRIN or SCIN-INT. Factors like the terminating life’s age, health and lifestyle are the primary considerations for making such determinations. A ten year SCIN for a healthy fifty-year old who does not smoke and eats well should carry a lower risk premium than the same note for a seventy-year old smoker with severe heart disease. Nevertheless, there should be no problem
creating the note for the seventy-year old and, as Costanza indicates, courts will uphold bona fide SCINs in such situations so long as there is objective evidence that a bona fide transaction was executed between the family members.

If one fails to create a bona fide transaction via proper valuation and risk premiums, she risks paying more for the transfer than she would have if she had just given the property away and paid full gift taxes. This is because she will have added the cost of creating the SCIN to the accrual of both gift and income taxes due to a poorly drafted SCIN.

Finally, a valid SCIN that is cancelled as a result of death is taxable to the estate as income. Because the estate, as opposed to the decedent, is taxed, the income tax on an intrafamily SCIN cancelled by the terminating life’s death is not deductible against the estate tax. This is another consideration planners must take into account when deciding whether an intrafamily SCIN is proper for a potential taxpayer.