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REPORTING GAIN ON SCINS AFTER DEATH
— by Neil E. Harl

A major concern from the beginning with self cancelling installment notes (SCINs) has been the treatment of the gain in the obligation cancelled at the death of the seller.¹ The recent decision by the Eighth Circuit Court of Appeals in Estate of Frane² has provided additional guidance on whether and when the gain is reported into income.

Consequences of using SCIN's

For many taxpayers desiring to dispose of property by sale or other taxable exchange, the installment contract, private annuity and self-cancelling installment note are viewed as alternatives to be considered in making a decision on how to structure the transaction.³ However, the three concepts have vastly different tax consequences.

For installment contracts, the cancellation or forgiveness of principal payments is reportable as gain whether cancelled before or after the death of the seller.⁴ The outcome is the same as a disposition of the obligation except that cancellation or forgiveness may involve less than the entire amount of gain in the obligation. The gain is calculated using fair market of the obligation but if the parties are related the fair market value of the obligation is not less than the face amount.⁵ IRS has ruled that cancellation of principal in a debt restructuring involving an installment sales contract does not result in income tax consequences to the seller if to help a financially troubled buyer.⁶

For transactions respected as private annuities, payments normally continue until the death of the annuitant ⁷ and there is no gain to the annuitant or annuitant's estate in the event of premature death.⁸

A self-cancelling installment note is a debt obligation which is extinguished at the death of the seller with the remaining note balance cancelled automatically by the terms of the note.⁹ However, with a SCIN the deferred gain is recognized by the decedent's estate on the estate's first income tax return.¹⁰ The Tax Court in Estate of Frane had held that the payments cancelled at death under a SCIN were reportable as gain on the decedent's final income tax return.¹¹

Effects of Frane

Whether the gain is reported on the decedent's final return or the estate's first income tax return has important implications for planning.

• Income tax from the decedent's final return is deductible for federal estate tax purposes.¹² Amounts reported in the estate's income tax return are not deductible.¹³

• If the gain reported on the estate's income tax return is actually taxed on the estate's return, the tax rate may be substantially higher than if included on the decedent's final return.¹⁴ The Revenue Reconciliation Act of 1993 increased sharply the tax liability of trusts and estates effective for taxable years beginning after December 31, 1992.¹⁵ The rates for trusts and estates are now as follows —

<table>
<thead>
<tr>
<th>Amount</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $1500</td>
<td>15%</td>
</tr>
<tr>
<td>1500-3500</td>
<td>28%</td>
</tr>
<tr>
<td>3500-5500</td>
<td>31%</td>
</tr>
<tr>
<td>5500-7500</td>
<td>36%</td>
</tr>
<tr>
<td>Over 7500</td>
<td>39.6%</td>
</tr>
</tbody>
</table>

• Depending upon the will or state law, the tax burden in terms of who ultimately pays the tax may be different depending upon whether paid on the decedent's final return, the estate's first income tax return or the beneficiary’s returns.

FOOTNOTES

² 93-2 U.S.T.C. ¶ 50,386 (8th Cir. 1993), aff'g and rev'g, 98 T.C. 341 (1992).
³ See N. Harl, Agricultural Law § 48.03 (installment contract), ch. 49 (private annuity); § 48.03[3][d] (SCIN) (1993).
⁴ I.R.C. § 453B(f).
⁸ Id.
⁹ See n. 1 supra.

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ANIMALS

COWS-ALM § 1.01[2]. The plaintiff was injured when the plaintiff’s truck struck several cows on a highway. The cows belonged to the defendants and had escaped from separate fenced pastures. The defendants had both moved for a directed verdict in the trial but the court allowed the case to go to the jury which awarded damages to the plaintiff. The plaintiff had presented evidence of prior escapes by the cows of both defendants and the poor condition of the fences. The plaintiff also provided expert testimony that the fences were inadequate because the fences allowed the cows to stick their heads through the fences, which encouraged the cows to attempt to break through the fences. The appellate court held that the evidence was sufficient to raise factual issues of the defendants’ negligence to allow the case to go to the jury.


HORSES-ALM § 1.01[2]. The plaintiff was injured when the plaintiff’s car struck a horse owned by the defendants. The plaintiff sued the defendants for negligently, willfully and wantonly allowing the horse to run at large on a highway. The trial court granted the defendant summary judgment. The appellate court reversed holding that Ala. Code § 3-5-14(a) (making it unlawful for persons having custody of livestock to allow the livestock to run at large in the police jurisdiction of a city) created a duty in the defendant not to negligently allow the horse to run at large and that the plaintiff had presented sufficient evidence of prior escapes by the horse to raise a fact issue as to whether the defendant was negligent in fencing the horse. The court noted that the degree of care required is dependent upon the animal involved and the nearness of the enclosure to public highways.

Lollar v. Poe, 622 So.2d 902 (Ala. 1993).

BANKRUPTCY

GENERAL

AVOIDABLE TRANSFERS-ALM § 13.03[3]. The debtor was a cotton merchant who stored cotton in the creditor’s warehouse. The creditor’s billing procedure was to invoice the cotton owners for storage and shipping costs when the cotton was removed from the warehouse. The invoices stated that payment was due in seven days but the creditor presented evidence in the industry and between the creditor and debtor that late payments of nine to 19 days were ordinarily allowed before more stringent payment terms were imposed. The trustee had sought recovery of payments made by the debtor to the creditor within 90 days prior to the petition as preferential. The creditor claimed that the payments were eligible for the Section 547(b)(2)(C) exception for payments made in the ordinary course of business. The trustee had argued that the most extreme incidents of late payments in the pre-preferential period should be excluded from consideration but that the most extreme incidents of late payments during the preferential period were not in the ordinary course of business. The court held that the entire history of payments between the creditor and the debtor and the creditor and the other clients was relevant to the issue and the history demonstrated that the late payments made by the debtor were within the ordinary course of business practiced by the creditor to all clients; therefore, the late payments made during the 90 days before the petition were not preferential.


EXEMPTIONS-ALM § 13.03[3].

AMENDMENT. The debtors originally filed for Chapter 11 and claimed the federal homestead exemption to the extent of the debtors’ equity in the house. The case was converted to Chapter 7 and the debtors amended the exemption to claim the exemption under the Washington homestead exemption. During this time, the home increased in value by almost $80,000. The trustee objected to the amendment as in bad faith and prejudicial to creditors. The court held that the amendment would be allowed because the initial exemption claimed prevented the sale of the house and all appreciation in the house belonged to the debtors.

In re Hall, 1 F.3d 853 (9th Cir. 1993).

AVOIDABLE LIENS. The debtor claimed a homestead exemption and sought to avoid judicial liens which impaired the exemption. The court held that under Illinois law, judicial liens cannot attach to the debtor’s exemption amount; therefore, the judicial liens could not impair the debtor’s homestead exemption rights.


CONVERSION OF ASSETS. One month prior to filing for bankruptcy, the debtor consulted with an attorney and converted non-exempt property into an exempt annuity. The trustee objected to the annuity exemption as improper pre-bankruptcy planning. The court held that because no evidence was presented that the conversion occurred under imminent threat of levy, attachment, garnishment or execution, the conversion was not improper.


CONVERSION OF CASE. The debtor had filed a Chapter 13 case in which the plan was confirmed. The debtor had claimed, as exempt, interests in two IRA’s. The debtor converted the case to Chapter 7 and the trustee

10 Est. of Frane v. Comm’r, 98 T.C. 341 (1992), aff’d and rev’d, 93-2 U.S.T.C. ¶ 50,386 (8th Cir. 1993).
11 98 T.C. 341 (1992) (cancellation of installment note treated as disposition; reported on decedent’s final return).
12 Treas. Reg. § 20.2053-6(f).
13 Id.
14 I.R.C. § 1(e).