

## The Family Money

*Tax planners know they must use right tool for right job.*

Every specialty, it seems, has its own peculiar language, often expressed in acronyms (words made up to three or more initials from a phrase), and estate planning is no exception. Two important tools in a tax planner's workshop are PANS and SCINS.

PAN stands for private annuity. In simple form, an annuity is a regular annual payment for a person's lifetime. Most of us associate an annuity with a pension plan or an annuity contract purchased from an insurance company. These are regarded as commercial annuities. A private annuity is one that is entered into between private parties, neither of whom is an insurance company or a large pension plan.

For instance, a 64 year old transfers \$100,000 to his daughter in return for his daughter's written agreement to pay her father \$800 per month for the rest of his life. This is a private annuity. To withstand an IRS attack, there should be a written contract, and payments that the father receives must be computed based on IRS tables and prescribed interest rates, otherwise you could have a taxable gift, or worse, you may not have a valid annuity contract. The advantage of the private annuity is that on the father's death, the contract is considered paid in full, so there is no balance to be included in his estate for estate tax purposes.

Further, the annuity can be purchased with assets other than cash. The father could, for instance, transfer a home, securities, or other property to his daughter on the same basis. So long as the payments are properly computed based on the father's life expectancy and the fair value of the property, the annuity will be valid and estate taxes can be saved. For instance, say that the father transfers \$200,000 of real estate to his daughter in return for an annuity of \$1,600 per month for the father's life. The daughter begins payments and three months later her father dies. The property belongs to the daughter free of estate taxes.

Of course, there is another side to this coin. Since the daughter only paid \$4,800 for the property (3 months x \$1,600/month), that is what her cost will be for tax purposes, so on dad's death, she will have a \$195,200 gain.

However, since the capital gains rates can be less than half of the estate tax rates, the PAN can produce savings under the right circumstances. The problem would be, of course, if the father outlives his life expectancy. If that happens, the daughter could end up paying more than the property is worth. If this is a concern, the father could consider a SCIN.

SCIN is an acronym for self-canceling installment note. A SCIN is an installment note with a provision that cancels any unpaid balance if the seller dies before the note is paid off. For instance, say that the father sells his \$200,000 property to his daughter for a ten-year installment

note, payable \$20,000 per year plus interest. If the father dies after the first year's payment, no further payments are due, and like the private annuity, the balance of the \$200,000 is free of estate taxes. Unlike the private annuity, however, the daughter is treated as if she paid the full \$200,000 for the property, so a later sale at \$200,000 will produce no capital gain to her. But this coin also has another side. The price to pay for the daughter's new cost basis is that, any attributed to the unpaid balance, which is canceled at the father's death, is considered income to her father's estate, on which an income tax (or capital gains tax if that's what Dad would have paid during his life) must be paid. Still, the rates are generally much lower than the estate tax rates.

While the father is receiving payments on either the PAN or the SCIN, part of each payment is considered to be return of his cost, part capital gain (if any), and part interest. Payments on the SCIN that are attributable to interest is generally deductible to the daughter, while no part of the PAN payments is deductible. Another advantage to the SCIN is that payments may be secured (to protect the father), but payments on a PAN must be unsecured.

Of course there are more rules to follow when using these tools, and the IRS has near zero tolerance for improper measurements. Remember that an accomplished craftsman with expert tools can produce a marvelous result, while an amateur may have a problem even selecting the right tools.

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This article by Alexander A. Bove Jr. appeared in the Boston Globe, February 9th, 1995.