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TEN TREMONT STREET, SUITE 600 – BOSTON, MASSACHUSETTS 02108
Telephone: 617.720.6040 – Facsimile: 617.720.1919
www.bovelanga.com

Tax Planners Know They Must Use The Right Tool For The Right Job

By Alexander A. Bove, Jr.

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Every specialty, it seems, has its own peculiar language, often expressed in acronyms (words made up of three or more initials from a phrase), and estate planning is no exception. We have GRATS and GRUTS, QPRTS and QDOTS, ILITS and FLIPS. All of these are designed to save estate taxes and, in many cases, income taxes, and each is or at least should be a readily accessible tool in your tax planner’s workshop. This bag of tools should also include PANS and SCINS, as they can be similarly effective in saving income and estate taxes, when properly used.

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 with an annuity contract purchased from an insurance company. These are regarded as commercial annuities. A private annuity is one which is entered into between “private” parties, neither of whom is an insurance company or a large pension plan. Though it may sound complicated, it is, in fact, quite simple.

For instance, Dad transfers \$100,000 to Daughter in return for Daughter’s written agreement to pay Dad \$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 Dad receives must be carefully

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 at all.

The advantage of the private annuity is that on Dad's death, the contract is considered to be 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. Dad could, for instance, transfer a home or other property to Daughter on the same basis. So long as the payments are properly computed based on Dad'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 Dad transfers \$200,000 of real estate to Daughter in return for an annuity of \$1600 per month for Dad's life. Daughter begins payments and three months later Dad dies. The property belongs to Daughter completely free of estate taxes in Dad's estate.

Of course, there is another side to this coin. Since Daughter only paid \$4800 for the property (3 months x \$1600/month), that is what her cost will be for tax purposes, so if she sells the property for \$200,000, she will have a \$195,200 gain. However, since the capital gains rates can be about half of the estate tax rates (and perhaps going lower), the PAN can produce substantial savings under the right circumstances. The "problem" would be, of course, if Dad outlives his life expectancy. If that happens, Daughter could end up paying more than the property is worth. If this is a concern, Dad could consider a SCIN.

SCIN is an acronym for self-canceling installment note. Attractive in its simplicity, a SCIN is merely 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 Dad sells his \$200,000 property to Daughter for a ten year installment note, payable \$20,000 per year plus interest. If Dad 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 in Dad's estate. Unlike the private annuity, however, 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 Daughter.

But this coin also has another side. The "price" to pay for Daughter's new cost basis is that the unpaid balance which is canceled at Dad's death is considered income to Dad'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 Dad 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 deductible to Daughter, while no part of the PAN payments are deductible. Another advantage to the SCIN is that payments may be secured (to protect Dad), but payments on a PAN must unsecured.

Of course there are more rules to follow when using these tools, and the IRS has a near zero tolerance for improper measurements and poor fits. And remember that as with any expert tools, when used in the hands of accomplished craftsman they can produce a marvelous result, while an amateur may have a problem even selecting the right tools.

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