Self-Cancelling Installment Note

Prepared for: Sample

Prepared by: Brentmark

Self-Cancelling Installment Note

Transfer Date:	10/2022
Discount Rate:	4.00%
FMV of Property:	$1,250,000
Cost Basis:	$250,000
Recapture (Sec. 1245 or 1250):	$750,000
Down Payment:	$150,000
Lives:	2
Ages:	51, 53
Note Term:	37
Type of Note:	Amortized
Annuity Valuation:	Curtate
Payment Period:	Annual
Balloon Payment:	Yes
Amortization or Principal-Recovery Period:	76
No Risk Premium Market Rate:	3.00%
Mortality Table:	2010CM

	Pricipal	Interest
Mortality Risk Premium (Principal):	$487,926.77	N/A
Total Sales Price:	$1,737,926.77	$1,250,000.00
Principal Amount of Note:	$1,587,926.77	$1,100,000.00
Mortality Risk Premium (Interest):	N/A	$1.8619%
Total Interest Rate:	3.0000%	4.8619%
Annual Principal Payments:	Varies	Varies
Annual Interest Payments:	Varies	Varies
Total Annual Payments:	$53,272.55	$54,971.36
Balloon Payment at End of Note:	$1,215,051.78	$953,139.19
Total Interest to be Paid:	$1,598,209.36	$1,887,079.51
Total Capital Gain:	$737,926.77	$250,000.00
Profit Percentage (Capital Gain / Sale Price):	42.46%	20.00%
Capital Gain Recognized in Year of Sale:	$63,690.26	$30,000.00
Basic Recovery in Year of Sale:	$86,309.74	$120,000.00

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Repayment Schedule with Principal Risk Premium with Interest Rate: 3.0000%

Year	Balance of Notes	Gain	Principal Basis	Principal Total	Principal and Interest	Total Principal
1	$1,587,927	$47,638	$2,393	$3,242	$5,635	$53,273
2	$1,582,292	$47,469	$2,464	$3,339	$5,804	$53,273
3	$1,576,488	$47,295	$2,538	$3,440	$5,978	$53,273
4	$1,570,510	$47,115	$2,614	$3,543	$6,157	$53,273
5	$1,564,353	$46,931	$2,693	$3,649	$6,342	$53,273
6	$1,558,011	$46,740	$2,774	$3,759	$6,532	$53,273
7	$1,551,479	$46,544	$2,857	$3,871	$6,728	$53,273
8	$1,544,751	$46,343	$2,943	$3,988	$6,930	$53,273
9	$1,537,821	$46,135	$3,031	$4,107	$7,138	$53,273
10	$1,530,683	$45,920	$3,122	$4,230	$7,352	$53,273
11	$1,523,331	$45,700	$3,215	$4,357	$7,573	$53,273
12	$1,515,758	$45,473	$3,312	$4,488	$7,800	$53,273
13	$1,507,958	$45,239	$3,411	$4,623	$8,034	$53,273
14	$1,499,924	$44,998	$3,514	$4,761	$8,275	$53,273
15	$1,491,650	$44,749	$3,619	$4,904	$8,523	$53,273
16	$1,483,127	$44,494	$3,727	$5,051	$8,779	$53,273
17	$1,474,348	$44,230	$3,839	$5,203	$9,042	$53,273
18	$1,465,306	$43,959	$3,954	$5,359	$9,313	$53,273
19	$1,455,992	$43,680	$4,073	$5,520	$9,593	$53,273
20	$1,446,400	$43,392	$4,195	$5,685	$9,881	$53,273
21	$1,436,519	$43,096	$4,321	$5,856	$10,177	$53,273
22	$1,426,342	$42,790	$4,451	$6,031	$10,482	$53,273
23	$1,415,860	$42,476	$4,584	$6,212	$10,797	$53,273
24	$1,405,063	$42,152	$4,722	$6,399	$11,121	$53,273
25	$1,393,942	$41,818	$4,864	$6,591	$11,454	$53,273
26	$1,382,488	$41,475	$5,009	$6,788	$11,798	$53,273
27	$1,370,690	$41,121	$5,160	$6,992	$12,152	$53,273
28	$1,358,538	$40,756	$5,314	$7,202	$12,516	$53,273
29	$1,346,022	$40,381	$5,474	$7,418	$12,892	$53,273
30	$1,333,130	$39,994	$5,638	$7,641	$13,279	$53,273
31	$1,319,851	$39,596	$5,807	$7,870	$13,677	$53,273
32	$1,306,174	$39,185	$5,982	$8,106	$14,087	$53,273
33	$1,292,087	$38,763	$6,161	$8,349	$14,510	$53,273
34	$1,277,577	$38,327	$6,346	$8,599	$14,945	$53,273
35	$1,262,632	$37,879	$6,536	$8,857	$15,394	$53,273
36	$1,247,238	$37,417	$6,732	$9,123	$15,855	$53,273
37	$1,231,383	$36,941	$522,847	$708,536	$1,231,383	$1,268,324
Totals:		$1,598,209	$674,237	$913,690	$1,587,927	$3,186,136

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Repayment Schedule with Interest Risk Premium with Interest Rate: 4.8619%

Year	Balance of Notes	Gain	Principal Basis	Principal Total	Principal and Interest	Total Principal
1	$1,100,000	$53,481	$298	$1,192	$1,490	$54,971
2	$1,098,510	$53,408	$313	$1,250	$1,563	$54,971
3	$1,096,947	$53,332	$328	$1,311	$1,639	$54,971
4	$1,095,308	$53,253	$344	$1,375	$1,719	$54,971
5	$1,093,589	$53,169	$360	$1,442	$1,802	$54,971
6	$1,091,787	$53,082	$378	$1,512	$1,890	$54,971
7	$1,089,897	$52,990	$396	$1,585	$1,982	$54,971
8	$1,087,916	$52,893	$416	$1,662	$2,078	$54,971
9	$1,085,838	$52,792	$436	$1,743	$2,179	$54,971
10	$1,083,659	$52,686	$457	$1,828	$2,285	$54,971
11	$1,081,374	$52,575	$479	$1,917	$2,396	$54,971
12	$1,078,977	$52,459	$503	$2,010	$2,513	$54,971
13	$1,076,465	$52,337	$527	$2,108	$2,635	$54,971
14	$1,073,830	$52,209	$553	$2,210	$2,763	$54,971
15	$1,071,067	$52,074	$579	$2,318	$2,897	$54,971
16	$1,068,170	$51,933	$608	$2,430	$3,038	$54,971
17	$1,065,132	$51,786	$637	$2,549	$3,186	$54,971
18	$1,061,947	$51,631	$668	$2,672	$3,341	$54,971
19	$1,058,606	$51,468	$701	$2,802	$3,503	$54,971
20	$1,055,103	$51,298	$735	$2,939	$3,673	$54,971
21	$1,051,430	$51,119	$770	$3,082	$3,852	$54,971
22	$1,047,578	$50,932	$808	$3,231	$4,039	$54,971
23	$1,043,539	$50,736	$847	$3,388	$4,236	$54,971
24	$1,039,303	$50,530	$888	$3,553	$4,441	$54,971
25	$1,034,862	$50,314	$931	$3,726	$4,657	$54,971
26	$1,030,204	$50,087	$977	$3,907	$4,884	$54,971
27	$1,025,320	$49,850	$1,024	$4,097	$5,121	$54,971
28	$1,020,199	$49,601	$1,074	$4,296	$5,370	$54,971
29	$1,014,829	$49,340	$1,126	$4,505	$5,631	$54,971
30	$1,009,197	$49,066	$1,181	$4,724	$5,905	$54,971
31	$1,003,292	$48,779	$1,238	$4,954	$6,192	$54,971
32	$997,100	$48,478	$1,299	$5,195	$6,493	$54,971
33	$990,606	$48,162	$1,362	$5,447	$6,809	$54,971
34	$983,797	$47,831	$1,428	$5,712	$7,140	$54,971
35	$976,657	$47,484	$1,497	$5,990	$7,487	$54,971
36	$969,170	$47,120	$1,570	$6,281	$7,851	$54,971
37	$961,319	$46,738	$192,264	$769,055	$961,319	$1,008,057
Totals:		$1,887,026	$220,000	$880,000	$1,100,000	$2,987,026

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This scenario is a hypothetical illustration based on the assumptions you entered via the inputs inside the program. It is to be used solely as a conceptual guide to understand and quantify your planning needs. It would be wise to consider this illustration together with all other information you deem necessary in making your investment decisions. This illustration is not a guarantee of the performance of any specific investment. Actual performance from your investments and assets may vary. This illustration is not legal or tax advice. You should consult with your attorney and accountant to review this information and determine its appropriateness for your particular situation. The provider of this illustration provides no guarantee and assumes no responsibility or liability for the accuracy of the information provided (including whether the interest rate you have selected is in fact "reasonable") or for your reliance based on this information.

Self-Cancelling Installment Note

An installment note is a promissory note (evidence of debt) usually issued in conjunction with the sale of property where at least one payment is to be received by the seller after the close of the taxable year in which the sale occurs. A self-canceling installment note is an installment note that contains a provision under which the buyer's obligation to pay automatically ceases in the event a specified person, called the measuring or reference life (usually the seller), dies before the end of the term of the note.

When Is It Used?
An installment note is useful when a client owns a highly appreciated asset he would like to sell and wants to spread the recognition of and taxation on the gain over a term of years. (However, any gain attributable to excess depreciation that is subject to recapture under IRS §1245 or §1250 is fully recognized in the year of sale. Also, under installment sale rules, all gain is recognized in the year of sale, even if payments on the note extend over several years, if the subject of the note is publicly traded stock.) Installment notes with a self-canceling provision are especially useful when one family members, typically a parent or grandparent, wishes to transfer property to another family member, typically a child or grandchild, with minimal gift and estate tax consequences.

What Are the Estate and Gift Tax Consequences?
In general, the fair market value of any unpaid installment obligation on the date of death is included in the estate of the seller. However, if the note contains a properly designed self-cancellation provision, the buyer is under no obligation to make any further payments after the seller's premature death, which leaves no unpaid balance to be included in the seller's estate. The self-canceling feature can be an effective means of transferring property to family members without estate or gift tax consequences in the event of the death of the seller-transferor before the last potential payment has been made under the terms of the installment note.

How Should a SCIN Be Structured?
A SCIN will avoid adverse gift and estate tax treatment only if the self-cancellation provision is properly designed. The courts have held that:

- The cancellation provision must be bargained for as part of the consideration for the sale.
- The purchase price must reflect this bargain either with a principal risk premium (above market sales price) or an interest rate premium (above market interest rate).
- The seller may not retain any control over the property being sold after the sale.

If the self-cancellation provision is not properly designed, the seller may be deemed to have made a part-sale part-gift. If any of the transfer of the remainder interest (the canceled payments) is considered a gift, the entire value of the property sold, less the consideration actually paid, will be included in the decedent's gross estate. This problem can be avoided by structuring the note as much like a market note as possible, except for the principal or interest rate premium. Although not all issues of valuation and proper design have been resolved by regulation or by the courts, most authorities feel the debt instrument and the sales contract should both include the self-cancellation clause. To avoid retained controls, the sales contract and/or note cannot place any restrictions on the use of the property by the buyer, including any restrictions on subsequent sales. (In general, a subsequent sale of the property by the buyer within 2 years of the original sale will trigger recognition of any remaining deferred gain by the original seller, even if the note has not been fully repaid.) Furthermore, it is advisable to avoid using the property sold as collateral for the note so the seller has no right to reacquire the property sold under any circumstances.

What Interest Rate or Discount Rate Should be Used in a SCIN?
Selecting the appropriate market rate of interest is perhaps the most difficult step in the process of designing and implementing a SCIN.

For income tax purposes, self-canceling installment notes are subject to the installment sale rules. Although these rules are complex, the general rule is that the interest rate on an installment sale note must at least equal the appropriate applicable federal rate (AFR) with semiannual compounding. Failure to follow these rules may result in reapportionment of interest and principal of scheduled payments and imputation of interest income to the seller, even in periods in which he or she may not have received payments.

The choice of whether to reflect the risk premium as an increase in the sales price (principal risk premium) or as an increase in the interest rate (interest rate risk premium), depends on the relative tax situations of the buyer and seller. If the risk premium is reflected in the sales price (principal risk premium), the seller will report more of each payment as capital gain and less as interest income. The buyer will pay less interest (which is deductible if the interest is investment or trade or business interest and not personal interest), but his or her basis will be higher. If the property is depreciable and the buyer and seller are in similar tax brackets, the principal risk premium may be preferred to give the buyer a larger depreciable base.

However, if the property is not depreciable, the buyer may prefer the interest rate premium where the basis is lower but deductible interest payments are higher.

Theoretically, some appropriately weighted combination of principal risk premium and interest risk premium would be acceptable. A weighted combination risk premium may be determined using the program in a two-step fashion.

- Compute the principal risk premium and interest rate risk premium using the appropriate market rate of interest.
- Choose an interest rate risk somewhere between the market rate and the risk-premium-adjusted interest rate computed in the first pass and enter it as the market rate of interest in the data input section (leave the §7520 as it is). The resulting principal risk premium will be lower than that computed originally using the market rate of interest. The summary statement and repayment schedule for the installment note with principal risk premium will now reflect the combined risk premiums. The interest rate premium is equal to the difference between the market rate and the second (higher) rate entered. The revised and lower principal risk premium is reflected on the summary statement. The repayment schedule will show the effects of each risk premium the allocation of interest, gains and basis recovery.