

GRAY AREA Hotline

Debt Forgiveness Is Not Always Taxable

When a debt is forgiven by the party to whom it is owed, taxable income generally—but not always—results to the debtor, says the IRS.

IRS legal opinion: When loan proceeds are received, they are not taxable income because of the obligation to repay them. But if that obligation is lifted, the proceeds that are kept rather than repaid comprise an economic gain that is taxable.

However, a debt may result from a cause other than receiving something that is to be repaid. In such a case, debt forgiveness does not produce taxable income because the debtor does not gain by keeping anything.

Example: An individual guarantees a loan received by another and becomes liable on the guarantee. Later, the obligation to pay on the guarantee is forgiven. Because the guarantor does not keep the loan proceeds, no taxable income results.

New case: A company that had made illegal overcharges was ordered by the United States Department of Energy to pay restitution. The company's sole owner was held personally liable for the restitution payment, jointly with the company.

But later, the agency released its judgment (for unspecified reasons) and issued Form 1099-C, reporting to the IRS that the owner of the company had received "discharge of indebtedness income."

IRS decision: The owner is similar to a loan guarantor. He is a separate taxpayer from the company and did not benefit personally from the overcharges. Thus, being released from the obligation to repay them did not produce taxable income to him.

IRS Legal Memorandum 200402004.

ESTATE PLANNING HOTLINE

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Protect Your Family for Generations with a Dynasty Trust

Properly structured trusts can provide several advantages, including tax savings and asset protection. However, those benefits may be lost when the trust terminates and the assets are distributed.

In recent years, nearly half the states have passed laws allowing trusts to last for hundreds of years, or even in perpetuity, something that was not allowed in the past. The benefits of such "dynasty" trusts may be extended over many future generations. Setting up a dynasty trust properly will eliminate gift and estate tax and shield the assets from creditors.

Caution: Highly publicized research indicates that \$100 billion worth of assets has flowed into personal trusts in those states in the past two years. In response, the staff of the Congressional Joint Committee on Taxation has proposed limits on these long-lasting trusts.

Strategy: There is no certainty that any legislation will pass. However, if you are interested in a dynasty trust, you may want to act before any restrictions are put in place.

tax tactics

A dynasty trust is an irrevocable trust, typically funded with a substantial amount of assets. Currently, each individual can transfer up to \$1 million to such a trust (assuming no other taxable gifts have been made), without having to pay a gift tax.

Example: John and Mary Smith are married. Each may transfer \$1 million

to the Smith Family Trust without paying gift tax.

If John does not have the ability or the inclination to make a gift to the trust, Mary can make a \$2 million gift. As long as John consents to a spousal gift, no tax will be owed.

Drawback: Any tax-free lifetime gifts will reduce the donor's eventual estate tax exemption, dollar-for-dollar. If Mary makes a \$1 million gift and dies when the estate tax exemption is \$3.5 million, her estate will have a \$2.5 million exemption remaining.

Exclusions: By using the annual gift tax exclusion, both gift and estate tax consequences may be avoided. In 2005, anyone can give up to \$11,000 worth of assets to any number of recipients.

In the case of gifts to a trust, the recipients are the trust beneficiaries. Special care is needed, though, if the gifts are to qualify for the annual gift tax exclusion.

Example: Suppose John and Mary Smith fund a trust, as described above. Their three children and six grandchildren are beneficiaries. John and Mary can give \$198,000 worth of assets to the trust this year—\$11,000 times two donors times nine beneficiaries—with no gift tax obligation.

Such tax-free gifts can be made each year. In fact, the number will

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increase as the annual gift tax exclusion is raised in order to keep pace with inflation.

Required: To qualify for the gift tax exclusion, each trust beneficiary must be notified of the gift. He/she must be given a time period in which the gifted assets can be withdrawn from the trust—\$22,000 per beneficiary in this example.

Key: After the withdrawal window closes, the assets can remain in the trust and no gift tax will be assessed, provided the proper formalities have been followed.

generation skipping

In the above example, grandchildren have been named as trust beneficiaries. That's often the case with a dynasty trust.

Trap: If grandchildren or great-grandchildren are trust beneficiaries, the generation-skipping transfer (GST) tax must be considered.

This is an extra level of transfer tax levied on bequests or gifts that "skip" at least one generation. In 2005, the GST tax rate is 47%!

Fortunately, each individual now gets a \$1.5 million exemption from the GST tax.

Thus, if John and Mary Smith transfer \$2 million to a trust, they can each designate \$1 million worth of their GST tax exemption. No GST tax will be paid.

Transfers to such trusts that exceed the \$1.5 million-per-person ceiling will incur the GST tax, though.

seeking shelter

By following the above rules, substantial amounts can be transferred to a trust, with little or no tax obligation. If the trust is irrevocable, created in a state that allows long (or perpetual) trust terms, the assets can remain in trust for many

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A democratic government is the only one in which those who vote for a tax can escape the obligation to pay it.

—Alexis De Tocqueville, French historian, 1805-1859.

years. *Reasons for creating and funding such trusts...*

•**Eliminate estate tax.** Once assets are properly transferred to a trust, they don't belong to any individual. Thus, they won't be taxed at anyone's death.

Example: John and Mary Smith fund a trust with \$2 million, as above. At John's death, suppose the trust fund has grown to \$4 million.

No estate tax will be due.

Key: The same is true at Mary's death, the deaths of their children, etc. Their original \$2 million gift could grow to \$20 million, even \$200 million over the years, and never be reduced by gift, estate, or GST tax.

•**Curbing creditors.** Just as assets that don't belong to any individual will be out of the reach of transfer taxes, they also will be protected from the creditors of John, Mary, and the other trust beneficiaries.

Thus, the trust assets won't be exposed to divorce settlements, bankruptcy, judgments, etc.

a benevolent banker

Just because the assets are beyond the reach of creditors and tax collectors doesn't mean that John's family will get no benefit from the trust assets.

In dynasty trusts, the trustee typically has the discretion to distribute trust assets among the beneficiaries.

These assets might be available to help a child pay medical expenses, fund a grandchild's college education, purchase a home (to be retained in the trust) for a great-grandchild, and so on.

Motivating beneficiaries: One popular wrinkle is the "incentive trust." The trust can include language saying that trust beneficiaries will receive distributions based on certain achievements, such as educational degrees or reaching specified amounts of earned income.

fine points

If dynasty trusts remain in existence for decades (even

centuries), they may grow unmanageable, as future beneficiaries are added. If one trust has to provide for 50 beneficiaries in 22 states (just a hypothetical instance), that might be hard for one trustee to handle.

Solution: The original trust may be designed to divide into "sub-trusts" at some future date, perhaps one for each of the grantor's children. Then those subtrusts can subdivide further, as more beneficiaries arrive on the scene.

State selection: You don't have to live in a state that offers long-term trusts in order to create one. Generally, all that's necessary is that you use an in-state trustee and keep some trust assets in the state.

Strategy: When choosing among states for a dynasty trust, you may want to consider the lack of a state income tax (Alaska, Delaware, Florida) or a long history of settled trust law (Delaware). (While these trusts are estate, gift, and GST tax free, they're subject to income tax on trust income.)

Eight states—Alaska, Delaware, Missouri, Nevada, Oklahoma, Rhode Island, South Dakota, and Utah—permit the grantor of a dynasty trust to be a beneficiary. Thus, assets may be returned in case of a financial setback. Such "self-settled trusts" might be affected by legislation now before Congress, though. The bill might extend the waiting period before assets placed in such trusts are protected from creditors.

In any case, be sure to consult with an attorney experienced in trusts and estate planning if you are considering a dynasty trust. **TH**



"They're not fighting over the check—it's over the receipt."