



Will Power

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FORGIVENESS OF DEBT IN WILL MAY CAUSE TAXABLE INCOME

“Claire” came to me to make a new will and trust. She told me that several years ago she loaned one of her sons, “Dan” \$100,000 that he has not repaid, and she believes that he may not ever repay her the money. Claire told me that in her documents she would like to forgive the debt from Dan.

Claire would like to treat all three of her children equally, and instructed me that although she is forgiving Dan’s note, she wants that \$100,000 to come out of his share, so that when you consider what Dan has received and what he will receive from her estate, the other two children will receive equal amounts.

What Claire may not realize is that she might unknowingly create a taxable burden to Dan by forgiving his debt. This is due to the fact that part of the Internal Revenue Code imposes income tax on the value of debt that is forgiven. In other words, Dan might have to pay income tax on the value of the \$100,000 note that he would no longer owe his mother as of the date of her death.

How can this wind up costing Dan income tax? One must examine the Internal Revenue Code sections on point to find out the answer. Code §61(a) provides for taxation of income from all sources, including the discharge of indebtedness. Therefore, under the Code section, if Claire decides to cancel the note to Dan, under the tax law Dan is treated as having another \$100,000 of taxable income. If Dan pays an average of 32% in income taxes, he will owe \$32,000 more of

tax than he otherwise would have. Chances are, if Dan doesn’t have the money to pay back his mother, he probably doesn’t have the money to pay the taxes associated with this cancellation of debt.

There is a counter argument to §61(a), however. Code §102 excludes from income amounts received by way of gift or inheritance. Some commentators allege that §102 trumps §61(a) in a will or trust setting, citing an IRS ruling that states in part that a cancellation of intrafamily debt is an example of “detached and disinterested generosity, affection, respect, admiration or charity like impulses, that result in no inclusion to the beneficiary.

The lesson that may be learned from these laws is that one must be careful when debt is forgiven through a will or trust. The family should document that the forgiveness is gratuitous in nature and is not in consideration for some other benefit or obligation.

Forgiving debt in a will or trust also may lead to unintended consequences, including the difficulty in maintaining equality among the children of the family, disputes over the amounts outstanding or status of any loan, and uncertainly concerning the valuation of the note. These are all matters that should be addressed with estate planning counsel when family loans have been made.

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