**8510. Is a taxpayer’s discharge of indebtedness taxable?**

If a creditor of a taxpayer discharges all or part of a debt for no consideration, the amount of debt discharged is potentially taxable to the taxpayer.[[1]](#footnote-1) However, such debt discharge is excluded from gross income; and, thus not taxable, if the discharge: (1) occurs in a bankruptcy; (2) occurs when the taxpayer is insolvent and the discharge does not render the taxpayer solvent; (3) the indebtedness discharged is “qualified farm indebtedness;”[[2]](#footnote-2) (4) in the case of a taxpayer other than a C corporation, the indebtedness discharged is “qualified real property business indebtedness;” or (5) the indebtedness discharged is “qualified principal residence indebtedness” (see “Mortgage Forgiveness Debt Relief Act of 2007,” below) that is discharged before January 1, 2014.[[3]](#footnote-3) So unless Congress reinstates the exclusion for the discharge of “qualified principal residence indebtedness,” it would not apply.

Importantly, as stated above, “discharge of debt income” is triggered when a debt is forgiven for no consideration. So, if any consideration is involved, it would not be considered discharge of indebtedness income. Significantly, under those circumstances, the so-called discharge is completely taxable as none of the above exclusions would apply.

Example: Asher borrows $10,000 from his employer. Instead of repaying the loan, his employer forgives the debt after Asher works 200 hours of overtime. In other words, it is as if the employer paid Asher $10,000 for his services; which, Asher, in turn used to repay the loan. Thus, the discharge of the loan is essentially compensation for services, or taxable wage income (not discharge of debt income).

In some cases, even though consideration is involved, the discharge of debt may not necessarily be taxable. For example, suppose a shareholder of a corporation loans $10,000 to the corporation. Subsequently, the shareholder forgives the loan for no consideration. Because the loan comes from someone with shareholder status, the proceeds of the forgiven loan that remain in the corporation are essentially a capital contribution to the corporation. It is as if the corporation repaid the loan to the shareholder, who, in turn, made a capital contribution to the corporation. Contributions to a corporation are not taxable to the corporation. So in this case, discharge of debt that is the equivalent of a capital contribution does not trigger taxable income.[[4]](#footnote-4)

1. . IRC Sec. 61(a)(12). [↑](#footnote-ref-1)
2. . See IRC Section 108(g)(2), as amended by ATRA. [↑](#footnote-ref-2)
3. . IRC Sections 108(c)(3), 108(a)(1)(A), 108(a)(1)(B), 108(a)(1)(C), 108(a)(1)(D); IRC Sec. 108(a)(1)(E). [↑](#footnote-ref-3)
4. . Treas. Reg. §1.61-12(a). [↑](#footnote-ref-4)