**INCOME FROM DISCHARGE OF INDEBTEDNESS**

**Q1. Why is discharged debt potentially includible in gross income?**

The tax concept of gross income is broad enough to include any economic benefit enjoyed by a taxpayer.[[1]](#endnote-1) When a taxpayer borrows funds, he or she enjoys an economic benefit, I.e., to pay for a vacation, purchasing property, etc. As long as the taxpayer has a corresponding obligation to repay the loan, however, the economic benefit of the borrowing is not taxable. In other words, the taxpayer’s obligation to repay the loan from his or her own funds offsets the economic benefit of the borrowing.

*Example*: In 2015, Asher borrows $10,000 to take a two week European vacation. The loan bearing market interest is payable in full, 2 years later. Two years later, Asher repays the loan. Although the loan enabled Asher to pay for a vacation (clearly an economic benefit), his obligation to repay the loan with his own funds negates any inclusion in gross income.

On the other hand, if prior to repayment, the creditor forgives the debt, the rationale for not taxing the economic benefit of the borrowing is no longer applicable. Because at that point, it is clear that the taxpayer is no longer required to repay the debt, the amount of the discharge is treated like any other economic benefit enjoyed by the taxpayer – included in gross income.

Example: In 2015, Asher borrows $10,000 to take a two week European vacation. The loan bearing market interest is payable in full, 2 years later. Two years later, when the loan is due, Asher defaults. Rather than pursuing a legal collection action, the lender forgives the entire debt. As a result of the discharge, Asher is no longer obligated to repay the loan. Thus, the economic benefit of the use of $10,000 that Asher will never repay is includible in gross income.

1. IRC Sec. 61(a). [↑](#endnote-ref-1)