**Q10. Under what circumstances is discharge of debt income excluded from gross income?**

Depending on the circumstances of the discharge, IRC Section 108 provides a number of discharge of debt exclusions from gross income. If applicable, in spite of the economic benefit of the debt forgiveness, the ensuing income escapes taxation. As discussed below, in some cases, however, IRC Section 108 requires the taxpayer to reduce certain tax attributes (specifically enumerated deductions or credits that would otherwise reduce the taxpayer’s tax liability) up to the amount excluded from gross income. Importantly, the exclusion is not conditioned on a dollar for dollar reduction of those specific tax attributes. In other words, it does not matter whether the taxpayer possesses any of those enumerated tax attributes or, if possessed, in an amount equal to the excluded discharge of debt income. In either case, the full amount of discharge of debt income is excluded.

On the other hand, to the extent a taxpayer does possess some or all of those specific tax attributes, the mandatory reduction transforms IRC Section 108 from an income exclusion section to an income deferral section. This is because reducing a tax attribute by an equivalent amount of excluded discharge of debt income effectively offsets the tax savings of the exclusion.

***Example:***In January 2014, Asher files a Chapter 7 bankruptcy petition. In September 2014, the bankruptcy court grants Asher a discharge of $10,000 of credit card debt. Pursuant to IRC Section 108(a)(1)(A), the discharge of the $10,000 debt in bankruptcy is excluded from gross income. However, pursuant to IRC Section 108(b)(2), Asher must reduce certain tax attributes (up to the amount of the excluded income) in the order listed. Consequently, Asher who has a $10,000 NOL (the first listed tax attribute) must reduce it to zero (by subtracting the excluded amount of discharge of debt income).

Subsequently, in 2015, Asher has $10,000 of taxable income. If the $10,000 NOL had remained intact, deducting it would have completely offset the taxable income resulting in no tax. Because the NOL was eliminated through a tax attribute reduction, however, Asher must pay tax on the full $10,000 of taxable income. Thus, the tax benefit of the excluding the $10,000 of discharge of debt income in 2014 is offset by the loss of the $10,000 NOL deduction in 2015.

**Q10A. What types of discharge of debt income are excluded from gross income?**

There are 5 types of discharge if debt income that are excluded from gross income. As discussed in more detail below, the 5 exclusions are:

* Discharge in bankruptcy;[[1]](#endnote-1)
* Insolvency discharge;[[2]](#endnote-2)
* Qualified farm indebtedness discharge;[[3]](#endnote-3)
* Qualified real property business discharge;[[4]](#endnote-4) and
* Qualified principal residence discharge**.[[5]](#endnote-5)**

**Q10A1. What is the discharge in bankruptcy exclusion and in what manner must the taxpayer reduce certain tax attributes?**

Clearly, because all debt discharged in any type of bankruptcy proceeding (i.e., Chapter 7, Chapter 11, Chapter 13) is excluded from gross income, it is the most generous of all the exclusions.[[6]](#endnote-6)

***Example***: On January 2, 2015, listing debt of $1,000,000, Asher’s files a Chapter 7 bankruptcy petition. In September of 2015, the bankruptcy court discharges the entire $1,000,000. Because the discharge occurred in bankruptcy, all of it is excluded from gross income.

The discharge in bankruptcy exclusion, however, comes with a potential cost. If the taxpayer has certain tax attributes (listed in IRC Section 108(b)(2)), the taxpayer must reduce those attributes in the listed order (with the option to change the order of reduction by election) up to the amount of the discharged of debt income excluded from gross income. The sequence of the reduction of the tax attributes is as follows:[[7]](#endnote-7)

* NOLs
* General Business Credit
* Minimum Tax Credit
* Capital Loss Carryovers
* Basis Reduction (Depreciable and Non-Depreciable Property)
* Passive Activity Loss and Credit Carryovers
* Foreign Tax Credit Carryovers

In the alternative, the taxpayer may elect to reduce basis in depreciable property as the first attribute reduced.[[8]](#endnote-8) In that case, the order of reduction of tax attributes would be as follows:

* Basis of Depreciable Property
* NOLs
* General Business Credit
* Minimum Tax Credit
* Capital Loss Carryovers
* Basis Reduction (Non-Depreciable Property)
* Passive Activity Loss and Credit Carryovers
* Foreign Tax Credit Carryovers

As noted above, the exclusion of the discharge of debt income is unconditional. So, if a taxpayer lacks some or all of the above listed tax attributes or they are not sufficient to offset the entire amount of discharge of debt income, the exclusion remains intact. Therefore, it is possible that a taxpayer with few or no tax attributes may exclude a substantial amount of discharge of debt from gross income with minimal or no collateral tax consequences.

***Example*:** On January 2, 2015, listing debt of $1,000,000, Asher’s files a Chapter 7 bankruptcy petition. In September of 2015, the bankruptcy court discharges the entire $1,000,000 of debt. Because the discharge occurred in bankruptcy, it is all excluded from gross income. Asher’s only listed tax attribute is a $50,000 NOL. So beyond reducing the NOL to zero, there are no further tax consequences to Asher. Bottom line: Asher excludes $1,000,000 of discharge of debt income and reduces his $50,000 NOL to zero. On the other hand, if Asher possessed any of the other listed tax attributes, they would have been reduced, accordingly.

**Q10A2. What is the insolvency exclusion and in what manner must the taxpayer reduce certain tax attributes?**

Pursuant to the insolvency exclusion, the discharge of debt income realized by an insolvent taxpayer is excluded from gross income to the extent of the taxpayer’s insolvency.[[9]](#endnote-9) So, if the discharge causes the taxpayer to become solvent, the amount of discharge that renders him or her solvent does not qualify for the exclusion. As determined immediately prior to the discharge, a taxpayer is insolvent to the extent his or her liabilities exceed the fair market value of assets.[[10]](#endnote-10)

In the following example, the debtor is insolvent before and after the liability is discharged. Therefore, the entire amount of discharged debt is excluded from gross income.

***Example*:** In 2015, a lender forgives Asher’s $200,000 recourse loan for no consideration. Prior to the discharge, the fair market value of Asher’s assets was $100,000 and the aggregate amount of his liabilities (including the $200,000 recourse loan) was $400,000. Therefore, prior to the discharge, Asher was insolvent to the extent of $300,000 ($400,000 liabilities minus $100,000 assets). Immediately following the discharge of the $200,000 loan, Asher remained insolvent to the extent of $100,000 ($200,000 liabilities minus $100,000 assets). Thus, the entire $200,000 discharged debt would be excluded from gross income.

Conversely, in the following example, the amount discharged causes the insolvent debtor to become solvent. As a result, only the amount of the discharged debt equal to the debtor’s pre-discharge insolvency is excluded from gross income. The balance (i.e., the extent of solvency) is included in gross income.

***Example*:** In 2015, a lender forgives Asher’s $200,000 recourse loan for no consideration. Prior to the discharge, the fair market value of Asher’s assets was $200,000 and the aggregate amount of his liabilities (including the $200,000 recourse loan) was $250,000. Therefore, Asher was insolvent to the extent of $50,000 ($250,000 liabilities minus $200,000 assets). Immediately following the discharge of the $200,000 loan, Asher became solvent to the extent of $150,000 ($200,000 assets minus $50,000 liabilities). As a result, only $50,000 (the extent of Asher’s pre-discharge insolvency) of the $200,000 discharged debt would be excluded from gross income. The other $150,000 (the extent of Asher’s post-discharge solvency) is included in gross income (as discharge of debt income) under IRC Section 61(a)(12).

Similar to a bankruptcy discharge, an insolvency discharge requires the taxpayer to reduce the listed tax attributes in the manner described in Q10A1, above.

**Q10A3. What is the qualified farm indebtedness exclusion and in what manner must the taxpayer reduce certain tax attributes?**

Subject to certain rules**,** all or part ofthe discharge of“qualified farm indebtedness” (indebtedness directly connected to the trade or business of farming), may be excluded from gross income.[[11]](#endnote-11) The requirements of the exclusion are as follows:

* For the 3 tax years immediately preceding the tax year of discharge, 50% or more of the taxpayer’s aggregate gross receipts must be from farming.
* The discharging party (i.e., the person or entity forgiving the debt) must be a *qualified person* – a federal, state or local government or agency or instrumentality thereof or an individual, organization, partnership, association, corporation, etc. regularly engaged in the lending of money. Qualified persons do not include persons related to the taxpayer, the person from whom the taxpayer acquired property or a person who receives a fee with respect to the taxpayer’s investment in the property.[[12]](#endnote-12)

A taxpayer’s tax attributes serve two purposes. First, the amount of forgiven qualified farm indebtedness excluded from gross income is limited to the sum of the taxpayer’s “adjusted tax attributes” plus the adjusted bases of “qualified property” held by the taxpayer as of the beginning of the tax year following the tax year of the discharge. The term “adjusted tax attributes” includes all the listed tax attributes (see Q10A1) with the exception of basis. “Qualified property” is property held for use in a trade or business or for the production of income. Any discharged debt in excess of that amount is included in gross income.[[13]](#endnote-13)

*Example*: Asher has $200,000 of qualified farm indebtedness that the lender (a qualified person) forgives. The sum of Asher’s adjusted tax attributes ($100,000) and the basis of his farm ($50,000) equals $150,000. Consequently, only $150,000 of the forgiven qualified farm indebtedness is excluded from gross income. The amount in excess, $50,000, is included in gross income under IRC Section 61(a)(12).

Second, once the amount of the excluded discharge of debt income is determined, the taxpayer must reduce his or her tax attributes in the manner described in Q10A1 with the exception of a special rule for basis reduction. The basis reduction is limited to qualified property to be reduced in the following order:

* Basis of depreciable qualified property
* Basis of qualified property which is farm land
* Basis of other qualified property[[14]](#endnote-14)

**Q10A4. What is qualified real property business indebtedness exclusion?**

Unlike the other discharge of debt exclusions, a taxpayer must affirmatively elect to exclude qualified real property indebtedness from gross income. “Qualified real property business indebtedness” is secured debt that meets the following requirements:[[15]](#endnote-15)

* It was incurred or assumed in connection with real property used in a trade or business; and
* It was incurred or assumed prior to January 1, 1993, or, if incurred or assumed after December 31, 1992, is “qualified acquisition indebtedness.”

*Qualified acquisition indebtedness* is:

* Debt incurred or assumed to acquire, construct, reconstruct or substantially improve real property used in a trade or business (including debt incurred in connection with refinancing to the extent that the ensuing debt does not exceed the amount of debt being refinanced); or
* Refinanced debt incurred before 1993 (any secured debt) to the extent that the amount of the ensuing debt does not exceed the amount of debt being refinanced.

If elected by the taxpayer, subject to 2 limitations, all or part of the discharged qualified real property business indebtedness is excluded from gross income. By being elective, the taxpayer can weigh the relative tax consequences of making or not making the election.

The following example illustrates the tax consequences of a taxpayer who elects to exclude discharged qualified real property indebtedness in the aftermath of a short sale:

***Example***: In 2015, Asher is in default of an $800,000 loan secured by a warehouse used in his moving business. Assume that the warehouse is the only depreciable property Asher owns and the $800,000 loan is Asher’s only qualified real property business indebtedness. At that time, the fair market value of the warehouse is $500,000 and Asher’s overall basis in the property is $750,000 (depreciable basis in the warehouse was $550,000 and $200,000 in the underlying land (non-depreciable)). On September 17, 2015, the secured lender approves a short sale of the warehouse to Ashley for $500,000. On December 31, 2015, after receiving the proceeds from the short sale and applying it to the loan, the lender forgives the remaining $300,000 balance of the loan.

Per the first limitation, the amount of the forgiven qualified real property business indebtedness excluded from gross income cannot exceed the difference between the outstanding balance immediately before the discharge ($800,000) and the fair market value of the secured real property ($300,000). So in this example, the first limitation would be $300,000 which is the full amount of the forgiven debt.

Per the second limitation, the amount of excludable discharged qualified real property business indebtedness is further limited by the aggregate bases of all the taxpayer’s *depreciable real property* held by the taxpayer immediately before the discharge.[[16]](#endnote-16) In this example, Asher’s basis in the warehouse (his only depreciable property) was $550,000 – greater than the amount of the $300,000 discharged debt.

So after applying both limitations, the full amount of the discharge of debt income would be excluded from gross income. As a consequence of the exclusion, however, the basis of the warehouse would be reduced by the amount of the discharged debt. Prior to the discharge, Asher’s basis in the property was $750,000 ($550,000 for the warehouse plus $200,000 for the underlying land). As a result of the basis reduction of $300,000, the overall basis of the qualified property would be adjusted down to $450,000.

Importantly, like any other sale or exchange, the gain or loss from a short sale must be computed. By reducing the basis to $450,000, Asher would realize a $50,000 capital gain ($500,000 minus $450,000).

Bottom line: Asher would exclude $300,000 of discharged debt (treated as ordinary income) and recognize a capital gain of $50,000.

On the other hand, if Asher had not elected to exclude the discharged debt, the $300,000 would be included in gross income. Consequently, the basis of the warehouse would not be reduced. Therefore, with respect to the short sale, Asher would have recognized a $250,000 loss ($750,000 basis minus $500,000 short sale proceeds).

Bottom line: The overall transaction would result in a $250,000 loss and $50,000 of discharge of debt income.

As to whether Asher should make the election depends on an analysis of Asher’s overall tax picture to determine which alternative is more benerficial. Such an analysis could be quite detailed and is beyond the scope of this discussion.

Finally, other than the basis reduction, there is no further reduction of a taxpayer’s tax attributes.[[17]](#endnote-17)

**Q10A5. What is qualified principal residence indebtedness and does it require a reduction of tax attributes?**

Pursuant to the Mortgage Debt Relief Act of 2007, the discharge of *qualified principal residence indebtedness* of up to $2 million dollars is excluded from gross income. Although the relief was due to sunset in 2010, it was subsequently extended to 2012 and 2013, and, most recently to 2014.

“Qualified principal residence indebtedness” is a secured loan used to acquire, construct or substantially improve a principal residence. For this reason, it does not include a home equity loan that is not used to substantially improve the principal residence. A refinanced loan is also considered qualified principal residence indebtedness to the extent of the outstanding balance of the loan it is to replace. Any additional borrowing from the refinanced loan is not considered qualified principal residence indebtedness unless the proceeds are used to substantially improve the principal residence.[[18]](#endnote-18)

***Example*:** In 2014, the lender approved a short sale of Asher’s principal residence for $700,000. Asher’s home was secured by recourse debt of $1,000,000 of which only $800,000 was qualified principal residence indebtedness and the balance was a home equity loan used to pay off personal debt. After applying the $700,000 proceeds from the short sale to the outstanding loan, the lender forgave the remaining $300,000. Under this scenario, only $100,000 of the discharged debt (the qualified principal residence indebtedness) is excluded from gross income. As to the remaining $200,000, unless some other discharge of debt exclusion applies, it would be included in gross income.

Finally, if both the qualified principal residence indebtedness exclusion and insolvency exclusion apply, the taxpayer can elect to use the insolvency exclusion. Also, a taxpayer who takes advantage of this exclusion is not required to reduce any tax attributes unless he or she retains the principal residence.[[19]](#endnote-19) If so, the basis of the principal residence must be reduced by the amount of the excluded discharge of debt income.

1. IRC Section 108(a)(1)(A). [↑](#endnote-ref-1)
2. IRC Section 108(a)(1)(B). [↑](#endnote-ref-2)
3. IRC Section 108(a)(1)(C). [↑](#endnote-ref-3)
4. IRC Section 108(a)(1)(D). [↑](#endnote-ref-4)
5. IRS Section 108(a)(1)(E). [↑](#endnote-ref-5)
6. IRC Section 108(a)(1)(A). [↑](#endnote-ref-6)
7. IRC Section 108(b)(2)(A)-(F). [↑](#endnote-ref-7)
8. IRC Section 108(b)(5). [↑](#endnote-ref-8)
9. IRC Section 108(a)(1)(B). [↑](#endnote-ref-9)
10. IRC Section 108(d)(3). [↑](#endnote-ref-10)
11. IRC Section 108(g). [↑](#endnote-ref-11)
12. IRC Section108(g)(1)(B). [↑](#endnote-ref-12)
13. IRC Section 108(g)(3)(B). [↑](#endnote-ref-13)
14. IRC Section 1017(b)(4). [↑](#endnote-ref-14)
15. IRC Section 108(c)(3). [↑](#endnote-ref-15)
16. IRC Section 108(c)(2). [↑](#endnote-ref-16)
17. IRC Section 108(b)(1). [↑](#endnote-ref-17)
18. IRC Section 108(h)(2). [↑](#endnote-ref-18)
19. IRC Section 108(b)(1). [↑](#endnote-ref-19)