**Q13. Are there any other instances in which discharge of debt income is not taxable?**

In addition to the 5 exclusions of discharge of debt income discussed in Q10, there are 4 other types of discharge of debt that are not included in gross income.

**Student Loans**

Subject to certain conditions, the discharge in whole or in part of a student loan is excluded from gross income. To qualify, a provision in the loan document must condition the forgiveness of all or part of the student loan on the borrower working for a certain period of time in certain professions for any broad class of employers.[[1]](#endnote-1)

***Example***: In 2015, Asher takes out a student loan to attend law school. Pursuant to the terms of the loan, a certain amount of the student loan would be forgiven if Asher works for a minimum period of time in a law-related public service position. Upon graduating law school, Asher works at such a position and receives the corresponding loan forgiveness. Pursuant to IRC Section 108(f), the student loan debt forgiveness would be excluded from gross income.[[2]](#endnote-2)

**Discharged Debt Otherwise Deductible**

If the discharged debt would be deductible if paid by the taxpayer, the amount of forgiven debt is excluded from gross income.[[3]](#endnote-3) In other words, the income from the discharge of debt is offset by the deduction the taxpayer would have been allowed to claim had the discharged amount been paid.

***Example:***In 2014, Asher borrowed $100,000 from a lender to be used to pay operating expenses in his moving business. In 2015, when the amount owing is still $100,000 plus $6,000 of unpaid interest, Asher defaults on the loan. The lender forgives the entire balance including the unpaid interest. Because if paid, the interest would be deductible under IRC Section 163, the $6,000 of unpaid interest is excluded from gross income. As to the discharged $100,000 principal balance of the loan, unless some other exclusion applies, that amount would be included in gross income.

**Purchase Money Debt Reduction for Solvent Debtor**

Provided the discharge does not occur in bankruptcy or when the purchaser is insolvent, the reduction of purchase money debt is not included in the purchaser’s gross income. Instead, it is treated as a non-taxable purchase price adjustment.[[4]](#endnote-4)

***Example***: In 2014, Asher purchases an automobile from a car dealer for $20,000. In paying for the automobile, Asher makes a $10,000 downpayment and finances the remaining $10,000 with a purchase money note. In 2015, the car dealer agrees to reduce the purchase money note from $10,000 to $8,000. Assuming the reduction did not occur in a bankruptcy and Asher is not insolvent, the $2,000 “discharge” would be treated as a purchase money price reduction rather than discharge of debt income. In other words, it is as if the purchase price of the automobile was $18,000 rather than $20,000. Therefore, the amount of the reduction would not be included in gross income.

**Pay-for-Performance Success Payments**

Pursuant to the Home Affordable Modification Program (“HAMP,” a federal government program), certain financially distressed homeowners can receive the benefit of a pay-for-performance success payment. Under HAMP, homeowners who make timely payments on modified loans are eligible to have incentive mortgage payments made on their behalf. Such a payment reduces the homeowner’s principal mortgage balance.

Although IRC Section 108 does not provide a specific exclusion for the resulting reduction of mortgage indebtedness, the IRS does recognize another exclusion. Payments under general government social benefit programs are excluded from gross income.[[5]](#endnote-5) In Rev. Rul. 2009-19,[[6]](#endnote-6) the IRS recognized that pay-for-performance success payments qualify as a general welfare exclusion benefit, and, thus, are not included in gross income.

**Q13A. Can the forgiveness of a loan be treated as a gift?**

As stated above, the forgiveness of debt is an economic benefit equivalent to the receipt of money by the debtor. Therefore, similar to a gift of money, depending on the circumstances, the discharge of a debt could also be a gift.

***Example:*** Several years ago, Asher loaned his son Samuel $100,000. On Samuel’s birthday, Asher forgives the loan. Because of their relationship (father and son), the debt forgiveness is the equivalent of a $100,000 income tax-free gift.[[7]](#endnote-7)

1. IRC Section 108(f)(1). [↑](#endnote-ref-1)
2. Rev. Rul. 2008-34, 2008-2 C.B. 76. [↑](#endnote-ref-2)
3. IRC Section 108(e)(2). [↑](#endnote-ref-3)
4. IRC Section 108(e)(5). [↑](#endnote-ref-4)
5. Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 98-19, 1998-1 C.B. 840. [↑](#endnote-ref-5)
6. 2009-2 C.B. 111. [↑](#endnote-ref-6)
7. IRC Section 102(a). [↑](#endnote-ref-7)