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Debt Forgiveness and Taxation

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The complex intersection of debt forgiveness and tax law has become increasingly relevant in the modern financial landscape. As businesses and individuals grapple with economic uncertainties, debt forgiveness has become a common occurrence in nowadays proceedings. However, understanding the tax implications of debt forgiveness is crucial, as it can significantly impact the financial outcomes for both debtors and creditors. This article provides a comprehensive exploration of the multifaceted angles associated with debt forgiveness in various areas. It explains how forgiven debts are generally considered taxable income, which can result in unexpected tax liabilities for debtors. Furthermore, it delves into exceptions and exclusions that may apply, such as the insolvency exclusion and certain bankruptcy exemptions, which can mitigate the tax consequences. A critical aspect covered in this article is the tax treatment for creditors involved in debt forgiveness. In addition, this article will touch on the laws relating to the taxability of forgiven debt in other federal countries. In conclusion, this article serves as a valuable guide for individuals and businesses facing debt forgiveness. By shedding light on the complexities of tax law globally, it equips readers with the knowledge needed to make informed financial decisions and proactively manage their tax obligations. Ultimately, it underscores the importance of seeking professional advice to ensure that debt forgiveness does not lead to unintended tax burdens.

Keywords: *debt forgiveness, tax, insolvency, income, exemption.*

INTRODUCTION

In this world of rising inflation, a human hardly sustain without incurring any form of debt, be it a short or long-term one. Though the debt given to a company or an individual is for restructuring their financial shortcomings, things may not always turn out good always and their ability to pay back the debt may still be weak or nearly impossible. That is when the concept of Debt Forgiveness comes in. Out of negotiations with the lender or out of generosity, the debt owed by the debtor will be partly or fully forgiven but the subsequent question is whether the debt forgiven will be treated as income and go on to be taxed. Whether the escape from liability will lead to a tax burden?

Debt forgiveness within the realm of law encompasses a complex interplay of legal principles, contractual obligations, and regulatory frameworks. In legal terms, debt forgiveness refers to the intentional relinquishment or discharge of a debtor's obligation to repay a debt by the creditor or lender. This discharge can occur through various legal mechanisms, including formal agreements, court rulings, or statutory provisions. The legal landscape surrounding debt forgiveness is shaped by a combination of civil, commercial, and bankruptcy laws, as well as international conventions and treaties in some cases. These laws establish the rights and responsibilities of creditors and debtors, prescribe the procedures for debt restructuring and discharge, and safeguard the interests of all parties involved.

Debt forgiveness, while offering a lifeline to debtors burdened by financial obligations, often carries significant implications in the realm of taxation. This intersection of debt relief and tax consequences forms a critical aspect of fiscal policy and individual financial planning. In essence, debt forgiveness can trigger taxable events for the debtor, resulting in additional financial obligations even after the debt itself has been forgiven. Consequently, navigating the complexities of debt forgiveness and taxation requires a nuanced understanding of tax laws, accounting principles, and the specific circumstances surrounding the debt discharge.

Moreover, the legal implications of debt forgiveness extend beyond the debtor-creditor relationship to encompass tax law, accounting standards, and regulatory compliance.

UNDERSTANDING DEBT FORGIVENESS

The process of rearranging a borrower's debts to make them more manageable is known as debt forgiveness. Additionally, it may allow creditors to recover a minimum of part of their debt. A portion of the debt may be forgiven, the interest rate may be lowered, payments may be spread out over a longer time period, or several debts may be consolidated into one lower-interest loan. When the borrower's total default is the only option, creditors are frequently willing to accept debt forgiveness measures.[1] The idea behind debt forgiveness is straightforward, where a lender will forgive all or part of the remaining amount you owe on a loan. However, there are nearly always conditions associated with this incredibly alluring idea. In a few instances, the debt may not be fully forgiven but a huge part will be reduced so that the creditor may recoup at least a minimum amount of what the debtor owes. Rearranging a borrower's debts to make them more manageable is known as debt relief. Debt relief can come in several forms, such as debt reduction, debt reduction with a lower interest rate, and debt relief with an extended payback time. When the borrower's complete default is the only option, creditors frequently agree to explore debt-relief strategies. In India, there are a lot of areas where we stumble upon the term debt forgiveness. Agricultural loans getting waived off is one of the prime examples of debt forgiveness where the farmers who took loans for restructuring their agricultural livelihood, the whole debt gets waived off by the government leaving the farmers from the clutch of repaying the liability. While the question over the interest of creditors lies on one side, waiver of agricultural loans is a form of debt forgiveness.

THE IMPACT OVER INDIAN TAXATION LAW

In general, if a taxpayer's personally liable debt is cancelled or forgiven, apart from in the case of a gift or bequest, the taxpayer is required to include the amount of the cancellation in income. Since the borrower had a duty to reimburse the lender, the taxpayer was exempt from income tax at the time the money was borrowed. The amount received as loan proceeds when that obligation is later forgiven is typically taxable as income as the taxpayer is released from the

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[1] Julia Kagan et al., 'Debt Relief: What it Is, how it Works, FAQs' (*Investopedia*, 23 January 2024) <https://www.investopedia.com/terms/d/debt-relief.asp> accessed 23 January 2024

responsibility to repay the lender.[2] In the Indian context, Debt Forgiveness has been happening for quite a long time and also in various scenarios but it is important to note that the forgiven debt is treated as income in India.

The government has come up with schemes to help the backward societies of the nation. One of the ways through which relief can be sought is by waiving the debt they owe. A major example is how amidst the COVID times, the Reserve Bank of India introduced the Restructuring processes for distressed businesses by making the creditor relax over the interest rates or extend the period or even a partial forgiveness where the process acts as a long-term relief.[3] A Lot of subsidies are also given to parts of the population which lessen the burden of liability and acts as a part of debt going off and results in a way of debt forgiveness too.

According to *Section 28(iv)*[4] of the Income Tax Act, any advantage or perquisite derived from a business or the practice of a profession, regardless of whether it may be exchanged for cash or not, is deemed income and is subject to income tax as business income. It was understood that only income that constitutes a non-monetary advantage would be liable to tax under this clause. Like the majority of income tax rules, this one was also the focus of a great deal of discussion and legal action. The matter came up before the Hon'ble Supreme Court in the case of *Mahindra & Mahindra Ltd. v CIT*[5] It was decided that although a loan waiver is typically recorded as income by crediting the profit and loss account, the rules of section 28(iv) would not apply since the benefit is received in cash or in the form of money. Therefore, the borrower is not able to tax these loan waivers as income.[6]

In addition, *section 194R* of the act, which allows for the withholding of tax on advantages or perks derived from a company or profession, was implemented last year. The wording

[2] Khorsed Alam, 'Cancellation of Debt (COD) Income' (*IndiaCurrents*, 06 September 2011) <https://indiacurrents.com/cancellation-of-debt-cod-income/> accessed 23 January 2024

[3] Sukanya Roy, 'RBI's loan restructuring scheme: Here's how it benefits you' *Business Standard* (09 September 2020) <https://www.business-standard.com/podcast/pf/rbi-s-loan-restructuring-scheme-here-s-how-it-benefits-you-120090900899_1.html> accessed 23 January 2024

[4] Income Tax Act 1961, s 28(iv)

[5] *Mahindra & Mahindra Ltd. v CIT* 404 ITR 1 (SC)

[6] *CIT v Alchemic (P.) Ltd.* (1981) 5 Taxman 55 (Guj)

employed in *section 28(iv)* of the Act was echoed in the requirements of *section 194R*. Therefore, it was generally accepted that only non-monetary advantages or perquisites would be subject to withholding tax under *section 194R*[7] of the Act. However because there remained uncertainty, the Central Board of Direct Taxes CBDT issued recommendations to give clarification on how *section 194R* of the Act should be applied. It was also stated that monetary perquisites and benefits would also be subject to *section 194R*'s rules and indicated that *section 194R* of the Act would cover the waived principal amount of the loan, which would be a benefit to the borrower.[8]

AGRICULTURAL LOAN WAIVER AND TAXATION

The majority of these loans are taken up by non-farmers, hence non-farmers gain from the benefits intended for farmers. The government no longer forgives these loans. Verification of the returned income of these account holders will reveal the number of non-agricultural millionaires benefiting from this alleged waiver for the impoverished.[9]

The tax viewpoint presents another problem. Is it the case that the waived principal and interest will be taxed as income from other sources, or that the principal returned will be considered as income from other sources and the interest that was previously charged and claimed would be handled as income from business? The money from our taxpayers is syphoned by dishonest masses, and the benefit does not reach the deserving farmers.[10] But, in the case of our country, the agricultural loan which is waived off is not considered as income.

Here, the motive behind the government's action to come to a decision of forgiving the loan should be brought in and that is to help the farmers who are the backbone of the country, to improve their livelihood. Especially during the pandemic, it was the farmers who got hit the

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[7] Income Tax Act 1961, s 194 R

[8] Amit Ganatra, 'Amendment to Section 28(iv) – Impact on Taxation of Loan Waivers' (*Taxsutra*, 27 February 2024) <https://www.taxsutra.com/dt/experts-corner/amendment-section-28iv-impact-taxation-loan-waivers> accessed 23 January 2024

[9] 'Farm Loan Waiver' (*Drishti IAS*, 11 February 2022) <https://www.drishtiias.com/daily-news-analysis/farm-loan-waiver-2> accessed 23 January 2024

[10] Muthiah Lakshmanan, 'Myth and Reality of Agri Loan Waiver' (*Taxguru*, 06 April 2022) <https://taxguru.in/finance/myth-reality-agri-loan-waiver.html#google_vignette> accessed 23 January 2024

most and there came in the debt forgiveness which helped them economically. Thus, States provide tailored programs called farm loan exemptions in an effort to assist the rural population. A bad monsoon or a natural disaster may make it difficult for farmers to repay debts. In these cases, rural suffering frequently leads States or the Center to provide relief, such as a decrease in loan amount or a full waiver. The States or the Center assume farmers' debt and reimburse the banks.

Generally speaking, waivers are restricted; only specific loan kinds, farmer classifications or more like small and medium farmers are given the foremost preference. However, during the last 20 years, these programs have been introduced more often, indicating the ongoing problems facing India's agriculture industry.

CORPORATE DEBT RESTRUCTURING (CDR)

Corporate debt restructuring is the process of realigning a company that is experiencing financial difficulties as a result of its existing debts and obligations in order to provide liquidity to the company's activities and keep it afloat. The management of the struggling firm and its creditors typically handles this procedure. A firm may need to undertake corporate debt restructuring if it is experiencing financial difficulties and is finding it difficult to meet its financial commitments and responsibilities, such as loan repayment. If a creditor forgives or remits a debtor's obligation, such as debt, the debtor company will be required to declare it as income in accordance with *Section 41(1)*[11] of the Income Tax Act. However, if a corporate debt is restructured according to the rules laid out by the Reserve Bank of India (RBI), it might be exempt from being classified as income under this clause. *Section 2(24)*[12] of the Income Tax Act defines income as any amounts that are deemed income under Section 41(1).[13] Therefore, unless specifically excluded, income from debt forgiveness or cancellation may be subject to taxation.

[11] Income Tax Act 1961, s 41(1)
[12] Income Tax Act 1961, s 2(24)
[13] Income Tax Act 1961, s 41(1)

Corporate debt restructuring is a better option than declaring bankruptcy. This is due to the fact that filing for bankruptcy can be costly and that most small businesses will find the process challenging. As a result, they would prefer to use corporate debt restructuring to give up some of their ownership stakes in the company to their lenders in the form of stock. In a nutshell, CDR acts as a lifeline for the struggling businesses.

POSITION IN FOREIGN LANDS

According to *Section 61* of the Internal Revenue Code,[14] gross income is any money that a taxpayer receives constructively during the year and is not required to repay, regardless of where it comes from.

The *United States v Kirby Lumber Co.* case[15] established the notion that the debtor receives revenue upon cancellation of their debt. In that case, it was decided that income is realised when liabilities are decreased without also reducing assets. The rationale for this is that the debtor's assets are released from liabilities to the degree of the reduction, which is equivalent to receiving money or other assets. This landmark case also specifies 3 main theories on the taxation of cancelled debt. They are[16]:

Kerbough Theory: A debt is incurred as payment for the acquisition of money or property. During a business transaction, the money or property is lost, and the debt is eventually settled for less than what it was originally worth. When the gain from the settlement of the debt exceeds the loss from the disposition of the property or money that was initially obtained, no revenue is realised because the transaction as a whole was negative.[17]

Hirsch Theory: When property is bought, a portion of the purchase price is represented by a debt, just as it is when a portion of the purchase price is covered by a note and mortgage. After

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[14] Internal Revenue Code 1939, s 61

[15] *United States v Kirby Lumber Co.* 284 U. S. 1, 76 L. Ed. 131 (1931)

[16] Edmund Powell, 'Federal Taxation: Taxation: Tax Problems in Debt Cancellation problems in Debt Cancellation' (1948) 31(4) Marquette Law Review <https://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=3446&context=mulr> accessed 23 January 2024

[17] *Ibid*

that, the value of the property decreases to less than the whole amount of the outstanding loan. The debt is paid down below face value while the property is still owned. Such a transaction results in no revenue because the debt reduction is considered to be equivalent to a reduction in the property's purchase price.[18]

Dental Co. Theory: Through direct negotiations, the debtor is able to reduce his debts; the creditors who forgive the loans do so freely and voluntarily without receiving any payment in exchange. The debt cancellation is considered a gift from the creditor to the debtor, with no income being realised. The cancellation is still considered a gift even though the creditor may have acted selfishly in the hopes of doing business with the debtor in the future. Rather than being a sign of a lack of charitable purpose, the creditor's self-interest will be taken into account as the reason for cancelling the debt.[19]

This decision is codified in *Section 61(a)(12)*, which states that 'income from discharge of indebtedness' is included in gross income. The reasoning behind this treatment is that the borrower benefits economically when the obligation is reduced or cancelled because borrowing does not result in taxable income.[20] *Section 108(d)(1)* defines 'any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property' in this context. The general rule states that cancellation of debt income is recognised even in the absence of actual cash proceeds. This means that a debtor may experience liquidity problems due to the tax liability associated with the cancellation of debt income.[21]

THERE ARE EXCEPTIONS TO THIS RULE

Insolvency: Insolvency is defined as the excess of liabilities over the fair market value (FMV) of assets, as assessed immediately before the debt discharge and including the debt to be discharged, for the purposes of *Section 108(d)(3)*[22]. According to *Section 108(a)(3),* the amount of

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[18] *Ibid*

[19] *Ibid*

[20] *Ibid*

[21] Randy A. Schwartzman, 'Tax Considerations for Cancellation-of-Debt Income' (*Tax Advisor*, 01 May 2015) <https://www.thetaxadviser.com/issues/2015/may/tax-clinic-06.html> accessed 22 January 2024

[22] *Miller v Commissioner* 1267 TC Memo 2006-125

a debtor's insolvency that is excluded from income cannot be greater than the debtor's insolvency. It is the taxpayer's responsibility to demonstrate that they fit the requirements for insolvency[23]. When determining a taxpayer's insolvency, nonrecourse debt is regarded as a liability up to the full market value (FMV) of the collateral. Only the portion of nonrecourse debt that is discharged that exceeds the fair market value of the property is considered a liability.[24]

Bankruptcy: When a debt is discharged, cancellation of debt revenue is not included in gross income as per *Section 108(a)(1)(A)*. This exclusion only takes effect if the debt is paid off through a plan that has been approved by the court or by an order from the court *(Sec. 108(d)(2))*. Even if one of the other exceptions would have applied, the bankruptcy exclusion rules apply when debt is discharged in bankruptcy *(Sec. 108(a)(2)(A))*. This treatment is significant because the necessary reduction of tax attributes varies depending on which cancellation of debt income exclusion applies.

Discharge of debt is another word for debt cancellation. The court held in *Jones v Cendant Mortg. Corp.,*[25] that the terms 'cancellation of debt' and 'discharge-of-indebtedness' are synonymous in *Section 61(a)(12)*. The obligation is discharged for the purposes of *Section 61(a)(12)* as soon as it is evident that it will not be paid. A practical evaluation of the facts and circumstances pertaining to the likelihood of repayment serves as the basis for the test used to determine whether such an event has happened. When a taxpayer's debt is discharged or rendered unenforceable and it seems unlikely that they will be able to make payments on it, they are typically considered to have realised taxable income.[26]

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[23] *Hill v Commissioner of Internal Revenue* T.C. Memo. 2009-101

[24] *Ibid*

[25] *In re Jones* 396 B.R. 638

[26] 'Cancelling Debt: Practicalities and Tax Results' (*Stimmel Law*) <https://www.stimmel-law.com/en/articles/cancelling-debt-practicalities-and-tax-results> accessed 22 January 2024

IMPACT ON THE CREDITORS

If a taxpayer obtains a benefit in the form of cessation or remission of an obligation that they had previously claimed as an expense or loss in any previous year, such benefit is already subject to tax under *Section 41* of the IT Act. Nevertheless, under *Section 194R* of the IT Act, the taxpayers had the option to assert earlier that the supplier of such a benefit would not be obliged to withhold tax. Following the revision, the creditor forgiving the debt could now be required by *Section 194R* of the IT Act to withhold tax at the rate of 10% of the debt waiver. The creditor may bear a heavier burden as a result. The aim of the recently introduced *Section 194R* is to prevent potential tax revenue leakages, often known as tax evasion, in enterprises and professions. A few businesses used *Section 37* of the Income-tax Act, 1961 to claim business promotion expenses while providing gifts, perks, perquisites, or benefits to their distributors, dealers, or channel partners (upon fulfillment of agreement conditions or in accordance with customs/dominant practices followed by the business entity over the years). Here though, an unfortunate catch is, in addition to incurring losses from unpaid debts, the creditor could also be liable for withholding taxes as the creditor might not be able to get the agreed-upon amount of TDS back from the debtor. Because the amount of tax withheld would undoubtedly not be collected from the corporate debtor due to poor financial health, the issue is particularly problematic in situations where proceedings have been started against the corporate debtor under the Insolvency and Bankruptcy Code (IBC).

Here, *section 194R* is an example of dual blows. One, the creditor loses all the debts he should be receiving and two, he/she also has to pay for the repayment of any withholding tax obligations out of their own pocket. The creditor can also argue how 194R won't get attracted in a few cases as the section only applies where the benefit or perquisite is 'arising from business or profession' that the receiver of the benefit engages in or exercises. It may be claimed that the alleged benefit did not originate from the debtor's business or occupation if, at the time of the debt waiver, the receiver of the benefit is not engaged in any business.

So, the creditors here are on the edge of a situation where they not only risk the lent amount but also have a burden on taxation liability all that arises out of the concept of Debt Forgiveness.

CONCLUSION

A Prima Facie impression of Debt Forgiveness is how it is really helpful and a saviour of people and companies who are deeply struck by financial hardships. The next page though would give a double-edged sword impression of how it affects the creditors who lent the debt will not get anything in return and they will face the burden of the financial loss they will incur due to the non-procurement of their money. From a taxation point of view too, how even in the case of escape from the debt, it still can be realised as an income and be taxed and get crippled with a tax burden instead of another liability. The Creditor too, gets affected by the section 194R which was explained in the above article.

The whole concept of Debt Forgiveness too did not reap many benefits as it is getting taken for granted by the people for whom it was created. Many of India's small and marginal farmers have had their loan repayments forgiven on multiple occasions. However, farmers have not benefited in the slightest from loan forgiveness. Farmer loans for small and medium farmers have been often waived by the government. This cycle of debt forgiveness and repayment favours the small percentage of borrowers who are willing and able to manipulate the system while decreasing the general flow of agricultural finance.

Thus, the double-edged sword of Debt Forgiveness is a measure that should be used properly and cautiously as the economy gets affected and the forgiven debts should be treated as income in most areas except when it really cannot be done in one way or another, the forgiven debt becomes a gain to the debtor and it gives a vision of unjust and unfair treatment or an advantage.