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Drawing a Line: Information Reporting vs. Malicious Gossip

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If a loan is made and the resulting indebtedness is later forgiven or otherwise canceled, the amount forgiven is generally includible in the income of the borrower under Internal Revenue Code ("Code") section 61(a)(12) as income from the discharge of indebtedness ("cancellation of debt" or "COD" income).

In order to encourage taxpayer compliance with respect to discharged indebtedness, section 6050P was added to the Code in 1993 to require that, when an "applicable entity" discharges a debt in whole or in part and the amount discharged is at least $600, the applicable entity must file an information return (Form 1099-C) setting forth information including the name and taxpayer identification number of the debtor, the date of the debt discharge, and the amount of the debt discharged.[1] Two recent cases underscore the confusion and difficulty that can arise from this requirement, and discuss whether the debtor has any potential remedies in a situation where an information return relating to an alleged discharge of debt is issued with false information or is issued by a holder of indebtedness not required to issue such information returns.

Under section 6050P(c) "applicable entities" required to issue Form 1099-C are governmental agencies and "applicable financial entities," such as a bank or credit union, a corporation affiliated with such an entity, and "any organization a significant trade or business of which is the lending of money" (whether or not affiliated with a financial institution). A copy of each return required to be filed with the IRS must be provided to the debtor. Penalties may apply for failing to file an information return when required, for including incorrect information in a return, or failing to furnish a copy of a return to the debtor.

These information returns are not required to be filed with respect to the discharge of a loan by an individual, or by any other person that is not a financial institution or affiliate or governmental agency and is not otherwise engaged in a trade or business of lending. However, such information returns are, in fact, sometimes filed by persons not required to file the forms.

Voluntary filings can occur for a number of reasons. The person discharging the debt may not be fully aware of the rules as to when such a filing is required; there may be some question as to whether that person is an "applicable entity"; or the filing of a Form 1099-C, though not required, may be perceived as desirable to support a tax-related position of the creditor with which the IRS might take issue -- for example, that the creditor is entitled to a bad debt deduction in a particular taxable year.

While the creditor in such a situation may be acting in good faith, that is not always the case. Accordingly, Congress in 1996 determined to take action to protect taxpayers from "significant personal loss and inconvenience as the result of the IRS receiving fraudulent information returns, which have been filed by persons intent on either defrauding the IRS or harassing taxpayers," and enacted Code section 7434, which authorizes a civil action for actual damages sustained by the plaintiff, costs of bringing the action, and reasonable attorneys' fees at the court's discretion against the filer of an information return if that filer "willfully files a fraudulent information return with respect to payments purported to be made to any other person."

Recent Cases

In *Cavoto v. Hayes*,[2] Mary Lou Hayes, the former mother-in-law of the plaintiff Robert F. Cavoto, had allowed Cavoto and the daughter of Hayes to use charge cards issued on Hayes's American Express account. When Cavoto and his spouse were unable to pay their charges to the account, Hayes paid the charges at Cavoto's request, and Hayes asserted that she had done so with the understanding that she would be repaid by Cavoto.

Hayes made repeated, but unsuccessful attempts to collect these amounts from Cavoto. In December

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2006, Hayes concluded that the alleged debt to her was uncollectible, and she cancelled it. She then reflected the cancellation of debt on her income tax return as a capital loss, presumably under Code section 166(d), and also filed an information return on Form 1099-C reporting that she had cancelled Cavoto's $30,238.51 debt to her.

Cavoto maintained that there was never any agreement that he would repay the charges and apparently did not include the amount allegedly discharged in his income as reported on his Federal income tax return for 2006.

The IRS informed Cavoto in September 2007 that he might have additional tax liabilities on account of the cancellation of debt. Although the IRS thereafter informed Cavoto that no additional income tax would be sought from him for 2006, the IRS did not at any time challenge Hayes's filing of the Form 1099-C as improper.

Cavoto filed suit against Hayes in Federal district court claiming that the Form 1099-C was fraudulent and that he was therefore entitled to damages from her under Code section 7434. Cavoto asserted that Hayes's filing had been fraudulent and was actionable *per se* because Hayes was not an "applicable entity" required to file the form.

Hayes moved for partial summary judgment on the issue of whether a person other than an applicable entity commits fraud by filing a Form 1099-C even though not required to do so. Hayes conceded that she was not an applicable entity and therefore was not required by section 6050P to file the Form 1099-C, but argued that there was nothing in the law prohibiting her from filing the form.

The district court granted Hayes's motion for partial summary judgment, noting that Cavoto did not cite any authority prohibiting the filing of the form in these circumstances. The court's opinion drew support from an IRS Service Center Advice issued in 1998 (no. 1998-020) that addressed the question of whether persons other than applicable entities could file Form 1099-C's. The Service Center Advice (which is not binding on the IRS as precedent, but may be indicative of its thinking in this area) stated that such voluntary reporting "may encourage voluntary tax compliance and proper gross income inclusions," and noted that there are other instances where information returns may be filed voluntarily -- for example, to report mortgage interest received of less than $600. The Advice concluded that persons not obligated to file the Form 1099-C may voluntarily file that return "in appropriate circumstances," provided that the form is completed in accordance with the applicable regulations and instructions.

The court further reasoned that, if Hayes had canceled a bona fide and now uncollectible debt, her filing of the Form 1099-C could hardly be said to constitute a willful filing of a fraudulent information return; and that, so long as the disclosure on the information return was truthful and accurate, there was no apparent harm that would result by reason of the filing of the form, apart from, possibly, "the potential filing of some unnecessary papers" by the IRS.

The court made clear in its decision that the sole question it decided was whether the mere filing of a Form 1099-C by someone not required to do so constituted itself a form of fraud actionable under Code section 7434. The questions of whether the information shown on the return was intentionally false or erroneous or otherwise fraudulent, and (if so) the consequences of the filing of such a return, were not before the court on this motion and were preserved for further proceedings.

In *Gorbaty v. Portfolio Recovery Associates LLC*,[3] the Court of Appeals for the Third Circuit affirmed, in a *per curiam* decision, an unpublished order of the United States District Court for the District of New Jersey dismissing an action brought by Dmitri Gorbaty against Portfolio Recovery Associates LLC ("Portfolio") on account of the filing of two Form 1099-C's by Portfolio with respect to Gorbaty in early 2009. Gorbaty had sent a letter to Portfolio disputing information set forth in the 1099-C's and requesting verification of the alleged debt.

When Portfolio failed to respond to the letter, Gorbaty brought suit in Federal district court alleging that the Form 1099-C's contained false information and that sending the forms with false, unverified information constituted a breach of various provision of the Fair Debt Collection Practices Act (the "FDCPA"). The district court dismissed the complaint for failure to state a claim, and Gorbaty appealed.

The Court of Appeals observed that Gorbaty alleged that Portfolio was a "debt collector" as defined in a provision of the FDCPA, but had not alleged that Portfolio had attempted to collect a debt from Gorbaty. Also, Gorbaty did not offer any evidence in support of his allegations that Portfolio had used false, unconscionable, or deceptive forms in the collection of a debt.

Accordingly, the Court of Appeals concluded that Gorbaty had no claim against Portfolio under the FDCPA. The court noted that, if the Form 1099-C's contained false information, Gorbaty could still dispute with the IRS the amount of cancelled debt properly entering into any determination of a tax deficiency against Gorbaty and might have other remedies against Portfolio under other provisions of law.

Observations

With regard to considerations of tax policy, the holding in *Cavoto* seems sound in avoiding the imposition of damages on a person discharging a debt merely by reason of the person's filing a form when not required to do so. The conclusion in *Gorbaty*, that the mere act of filing the form when not required is not actionable under the FDCPA, does not seem surprising either (at least under the circumstances alleged in that case).

As these two cases suggest, there are likely to be numerous situations involving a cancellation of debt where the original lender or other person discharging a debt issues a Form 1099-C that contains information relating to the debtor or its indebtedness that differs from the actual circumstances as known to the debtor, or (perhaps less commonly) issues a Form 1099-C where not

required to do so. Once a Form 1099-C is issued, the borrower may incur a lengthy correspondence with the IRS and significant professional fees to correct or avoid adjustments resulting from any mistaken information on the form, and the debtor may have little or no practical legal recourse to force the lender to correct the form in a timely manner or to compensate the borrower for costs incurred by reason of mistaken information.

As a planning manner, then, some lessons seem reasonably clear: it is generally helpful to focus on the intended tax reporting of the transaction in the transactional documents, such that the parties' reporting positions are reconcilable with each other; but, as the IRS will not be bound by any agreements or understandings between the lender and the borrower, it is also important to make sure that the parties comply with the relevant legal requirements.

Wherever possible in the context of an anticipated discharge of indebtedness, it behooves the debtor to consider what information return(s) should or may be issued by the creditor in connection with the debt discharge or related event, and with what information, and to attempt to agree -- within the bounds of the law, of course -- with the person discharging the debt as to what information return(s) will be issued and what information will be set forth on the forms.

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1 *See* S. Rep. 103-36, 103rd Cong., 1st Sess., concerning revenue provisions of the Omnibus Budget Reconciliation Bill of 1993 (S. 1134), at 213-214 (1993).

2 104 AFTR 2d 2009-6962 (D. Ill., Oct. 19, 2009).

3 Docket No. 09-3327 (3d Cir., Dec. 9, 2009).