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Can the Issuance of Form 1099-C Cancel a Debt?

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It has long been clear that a taxpayer's gross income includes income from the discharge of indebtedness,[1] but for many years the Internal Revenue Code (the "Code") did not require lenders to file information returns with respect to discharged debt. In order to encourage taxpayer compliance with respect to discharged indebtedness and to enhance the ability of the Internal Revenue Service to enforce the discharge of indebtedness rules,[2] Congress amended the Code in 1993 to require that an "applicable financial entity," such as a bank, domestic building and loan association, or credit union,[3] that "discharges" the debt of any person must file an information return with the IRS and provide a written statement to the person whose debt was discharged. Significant civil penalties, ranging up to 20% of the amount of indebtedness discharged, may be imposed on an applicable financial entity that intentionally disregards the information reporting requirements.[4]

Treasury regulations provide that, "[s]olely for purposes of" these information reporting rules, indebtedness is "discharged" not only on the date of various events of cancellation or extinguishment arising in a judicial proceeding or by agreement between the creditor and the debtor, but also upon "a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt."[5] Moreover, a rebuttable presumption arises that debt has been discharged for these purposes "if a creditor has not received a payment on an indebtedness at any time during a [36-month] testing period ... ending at the close of the year."[6]

However, the presumption may be rebutted under various circumstances, including "if the creditor ... has engaged in significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year."[7] Accordingly, while some of the events that trigger an information reporting obligation are likely to be contemporaneous with an actual cancellation or extinguishment of the debt, a debt may be considered "discharged" before that time for purposes of the reporting requirement, and the information reporting requirement may thus be triggered with respect to a debt that is not yet unenforceable.

The IRS has issued guidance which seems to indicate that the government believes that the issuance of Form 1099-C (the form typically used to comply with these information reporting requirements) by a bank or other creditor should not be given the effect of discharging an otherwise enforceable debt. Notwithstanding this guidance, courts have questioned whether such an issuance of Form 1099-C, with respect to debt that has not otherwise become unenforceable under local law, may itself preclude the creditor from enforcing the debt.

Although some cases have upheld the enforceability of a debt after Form 1099-C was issued indicating discharge, one court appears recently to have ruled that a debt was unenforceable following the issuance of Form 1099-C, even without there being any other circumstance indicating cancellation or extinguishment of the debt as a matter of local law. This holding raises the stakes as to what may be lost by a bank if it issues a Form 1099-C with respect to a debt that has not otherwise become unenforceable, and makes it more difficult for the creditor to decide that it wishes to avoid any risk of penalties and will therefore issue Form 1099-C at the earliest possible time.

Given the myriad contexts in which cancellation of indebtedness income may arise, the volume of lending transactions in the national economy, and the significant penalties that may be imposed on a bank that fails to file information returns and payee statements as required, it is not surprising that Form 1099-C's are sometimes issued in error. It has long been clear that a debtor can contest with the IRS whether or not income from the discharge of indebtedness reported on a Form 1099-C was in fact properly includible in the debtor's income in the year for which the form was issued.[8]

Whether a debtor may use issuance of a Form 1099-C at a time when the

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debt would under local law have continued to be enforceable—whether as a result of an error by the creditor or because of the expansive listing of events that trigger the reporting requirement—as a shield to defend against a subsequent lawsuit to enforce the debt is less clear. The IRS itself has indicated that compliance with the reporting requirement with respect to a debt does not necessarily mean that the underlying debt has been discharged.[9] Further, when Form 1099-C was erroneously issued and the creditor subsequently took action to correct the error, it has been held in a bankruptcy context that the debt remained outstanding.[10] However, in a recent Bankruptcy Court case where no withdrawal or amendment of the initial Form 1099-C occurred, the court reached a more debtor-friendly result.

Two debtors, William Stanley Reed and Debbie Elaine Reed, signed in 2008 a promissory note in the principal amount of $304,000 in favor of First Tennessee Bank secured by real property in Tennessee. After a default by the Reeds, the bank foreclosed on the property in May 2010.

At the time of foreclosure the property had a market value of $262,500 and the principal balance of the Reeds' loan was $267,574. The bank filed with the IRS and sent to the Reeds a Form 1099-C showing the remaining principal amount of the loan after the foreclosure, $5,074, as having been cancelled about 30 days after the foreclosure, and the Reeds included that amount on the "other income" line of their Form 1040 for 2010.

In April 2011, the bank initiated a lawsuit against the Reeds seeking to collect the principal amount of $5,074, plus interest due after the foreclosure, attorneys' fees, and other collection costs. The Reeds filed for bankruptcy in January 2012 and, later in the year, the bank filed a proof of claim for $18,825 in the bankruptcy proceedings, which included the same principal amount plus interest, attorneys' fees, and collection costs that had continued to accumulate.

The Reeds filed an objection to the claim, and the bankruptcy court characterized the issue as "whether the Form 1099-C filed by First Tennessee Bank constitutes an admission by First Tennessee Bank that the debt it is owed by the Debtors under the Promissory Note was cancelled or discharged such that First Tennessee Bank is estopped from enforcing its debt against the Debtors."

The decision discusses at length the information return reporting requirement as interpreted by regulations and other IRS guidance, and case law dealing with the effect to be given to the Form 1099-C. The court observed that "once a debtor has, as required by the Internal Revenue Code, relied upon the Form 1099-C" by including the debt discharge amount shown thereon in gross income on the debtor's tax return, "[i]t is inequitable to require a debtor to claim cancellation of debt income . . . while still allowing the creditor, who has reported to the Internal Revenue Service and the debtor that the indebtedness was cancelled or discharged, to then collect it from the debtor."[11]

The court ultimately concluded that, although the issuance of a Form 1099-C here did not "as a matter of law" extinguish the debt, such an issuance "reflects" that a financial institution has discharged an indebtedness; and, accordingly, that the Reeds no longer owed the $5,074 amount. The court further observed that it was aware that, in so concluding, it had adopted a minority view as to the effect of a Form 1099-C, but that "in the interests of justice and equity" the court believed this to be the proper view.

Observations

The issue addressed in *In re Reed* is unsettled, and another court might decide the same case differently. Also, the circumstances of the particular "identifiable event" that triggers the information reporting obligation may influence the outcome.

Here, the Form 1099-C was issued in the context of a foreclosure, and it is possible to read the Regulations to provide that a Form 1099-C should be issued in such a context only if it is believed that the foreclosure discharged the debt. If the bank had that belief, its later action to collect payment appears hard to justify, although it is always possible that the person or unit in a large organization who, based on the completion of the foreclosure, caused the Form 1099-C to be issued had no idea that some other person in the bank had concluded that the debt remained enforceable and was planning further action to enforce the debt.

That being said, the decision has interesting implications for financial institutions and for borrowers who find themselves unable to repay their loans. The position of the bank would likely have been stronger if it had corrected the Form 1099-C shortly after it was issued or when the bank initiated a lawsuit to collect the balance it believed to be due. Also, so far as appears from the decision, the bank made no effort to persuade the court that the issuance of the Form 1099-C was reconcilable with the bank's position that the debt remained outstanding and enforceable.

The decision appears to underscore the need for a financial institution to evaluate in each situation whether the issuance of a Form 1099-C is appropriate, and whether—if one is issued—any decision to take further action to collect on a debt is reconcilable with the issuance of the Form 1099-C, or the Form 1099-C previously filed needs to be amended or withdrawn.

Conversely, from a borrower's perspective, *In re Reed* suggests that, if a debtor who has received Form 1099-C believes that the underlying debt may not have been discharged in a manner that requires income inclusion by the debtor,[12] the decision as to whether to contest the inclusion of the amount in income (by demanding a corrected Form 1099-C or by an appropriate statement in the borrower's tax return) or simply to reflect the income from discharge of indebtedness on the borrower's tax return may require a thoughtful balancing of non-tax and tax considerations.

[1] Since 1954, this rule has been stated explicitly in Internal Revenue Code section 61(a)(12), but the result was the same under pre-1954 law. *E.g.*, *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). Section 108 of the Code contains significant relief provisions under which income from the discharge of indebtedness may sometimes be wholly excluded from gross income or deferred until a future year, but those provisions generally have no impact on the information reporting requirements discussed in this article.

[2] *See* Senate Print 103-36, 103d Cong., 1st Sess. 213 (1993).

[3] Since 2000, "any organization a significant trade or business of which is lending money" has similarly been considered an "applicable financial entity." Moreover, certain affiliates of banks, domestic building and loan associations, and credit unions and certain governmental agencies (including the FDIC) are required to file information returns.

[4] Internal Revenue Code sections 6721(e)(2)(A) (10% penalty for intentional disregard of requirement to file information return), 6722(e)(2)(A) (10% penalty for intentional disregard of requirement to furnish copy of information return to debtor). Penalties are much smaller when disregard of the rules is not intentional, and they may be waived entirely upon a showing of reasonable cause and of an absence of willful neglect. IRC §§ 6721(a), 6722(a), 6724(a).

[5] Treasury Reg. §§ 1.6050P-1(b)(1), -1(b)(2)(i)(G). More conventional "identifiable events" that also trigger a reporting obligation include, among other things: a discharge of indebtedness in bankruptcy; a cancellation or extinguishment of debt resulting from foreclosure; and a discharge of debt by reason of an agreement between an applicable entity and a debtor to discharge debt for less than full consideration.

[6] Treasury Reg. §1.6050P-1(b)(2)(i)(H).

[7] Treasury Reg. §1.6050P-1(b)(2)(iv).

[8] See, e.g., *Owens v. Commissioner*, 91 AFTR 2d 2003-2575 (5th Cir.) (per curiam), affirming in part and reversing in part TC Memo 2002-253.

[9] See IRS Information Letter 2005-0207 (Oct. 7, 2005) ("[t]he Internal Revenue Service does not view a Form 1099-C as an admission by the creditor that it has discharged the debt and can no longer pursue collection"); see also the Instructions to Debtor accompanying the 2013 Form 1099-C ("[i]f an identifiable event has occurred but the debt has not actually been discharged, then include any discharged debt in your income in the year in which it is actually discharged, unless an exception or exclusion applies to you in that year.")

[10] See *In re: Sarno*, 109 AFTR 2d 2012-504 (Bktcy Ct MA 2011), and cases cited therein; see also *United States v. Reed*, 2010 WL 3656001 (E.D. TN 2010).

[11] If, however, a debtor in the situation postulated in the court's decision is ultimately compelled to repay the debt, the debtor may be able to file an amended return to claim a refund of any tax paid by reason of the earlier inclusion of CODI. See SCA 200235030 (June 3, 2002).

[12] In this regard, the court's suggestion that a debtor is necessarily "required" to conform his tax reporting with a discharge reported on a non-erroneous Form 1099-C appears overstated. While a formal cancellation or extinguishment of the debt may not be an absolute prerequisite in every case before the debtor must include an amount in income, the list of events that trigger an information reporting requirement seems broader than the circumstances that the courts have considered in determining the debtor's own tax consequences. This discrepancy is understandable in light of the compliance-encouraging function of the information reporting rules, and care should be exercised not to permit unwarranted inferences from the relatively recent information reporting requirements imposed on the creditor to change the debtor's substantive tax treatment.