RESOURCES

Does the Issuance of IRS Form 1099-C by a Lender to its Borrower Discharge the Debt?

Does the issuance of an IRS Form 1099-C by a lender to its borrower constitute a cancellation of the claim and a discharge of the liability of the borrower? In other words, once a lender issues an IRS Form 1099-C to its borrower, for whatever the reason, may it thereafter seek to collect the debt?

The Internal Revenue Code requires that a lender that discharges the debt of any person must file a return containing certain information about the borrower and the discharged debt.[1] Treasury regulations also require that the return be filed when there has occurred any "identifiable event" which includes, among other things, the discharge of the debt, cancellation of the debt in some kind of insolvency proceeding that renders the debt unenforceable, discharge pursuant to an agreement between the borrower and the lender, and discharge as a result of the lender's decision to discontinue collection activity and discharge the debt.[2] Interpreting its own regulations, the IRS has issued interpretative guidance that the delivery of a Form 1099-C does not constitute an admission by the lender that it has discharged the debt or bars collection activity.[3]

The United States District Court for the Western District of North Carolina in the case of FDIC v. Cashion, 2012 WL 1098619 (W.D.N.C. 2012), citing a string of other cases from other part of the country, held that a Form 1099-C does not itself operate to legally discharge a debtor's liability. It based its decision in part upon the IRS's decision not to view the Form 1099-C as an admission that the lender has cancelled the debt and surrendered its ability to pursue collection.

Recently, the United States Bankruptcy Court for the Eastern District of Tennessee has taken a contrary view. In the case of In re Reed, decided May 14, 2013, that court held that once the lender has delivered the Form 1099-C, its claim for the principal of the debt was discharged and sustained the debtor's objection to the claim filed by the lender for the discharged debt.[4] There, after foreclosing upon the collateral securing the debtor's promissory note, the bank filed with the IRS, and sent to the debtor, a Form 1099-C stating that the loan had been cancelled. Based on that form, the debtor included the discharged debt as "other income" in his tax return. Notwithstanding its delivery of the Form 1099-C, the bank filed suit to recover the deficiency. On the day of a scheduled hearing on the bank's motion for summary judgment, the debtor filed a chapter 13 case. The bank subsequently timely filed a claim in the case, and the debtor objected to its allowance, contending that the bank, by the issuance of the Form 1099-C, had earlier discharged the debt.

The bankruptcy court sustained the debtor's objection and disallowed the bank's claim. Recognizing that it had adopted a "minority view", the bankruptcy court nonetheless felt that in the interests of justice and equity, it was the proper view. In the bankruptcy court's view, it was inequitable to require the debtor to incur the tax liability as a result of the cancellation of the debt, and concurrently allow the bank to collect on the debt. Thus, it rejected the interpretative private letter rulings by the IRS as being in direct conflict with the Internal Revenue Code, and held that the issuance of the Form 1099-C "reflects" that the bank has discharged the debt.

The take away from this case is that lenders need to be careful when they are required to file Forms 1099-C. The form should not be issued solely because a lender has voluntarily elected to write off, or write down, a loan on its books and records. It should only be delivered when the lender has irrevocably elected not only to cancel the debt but also not to pursue any collection activity to recover the debt. While a lender's compliance officer may, out of an abundance of caution, think it prudent to issue the Form 1099-C in order to comply with the IRS regulations, that apparent compliance may have the unintended consequences of barring forever the collection of the debt.

[1] 26 U.S.C. §6050P entitled “Returns relating to the cancellation of indebtedness by certain entities”.

[2] 26 C.F.R. §1.6050P-1.

[3] ITS Ltr. Rul. 2005-0207, 2005 WL 3561135; IRS Ltr. Rul. 2005-0208, 2005 WL 3561136.

[4] Because the Form 1099-C did not, and was not required to, report any cancellation of interest, collection costs and attorneys’ fees, the bankruptcy court allowed that portion of the lender’s claim.

Carruthers & Roth, P.A.
(336) 379-8651
235 North Edgeworth Street
P.O. Box 540 (27402)
Greensboro, NC 27401