Consideration of IRS Form 1099-C in the Settlement of Disputed Debts

Collection attorneys are in the business of settling disputed debts. Typically, two factors drive these settlements: the settlement figure and the payment schedule. The parties negotiate their settlement, payments are made, and the debt is settled. Or is it?

In addition to honoring the settlement terms, certain creditors have federally imposed requirements to report settled debt to the IRS. These obligations exist even when the debtor disputes the debt and may result in additional tax consequences for the settling debtor. At the heart of this issue lies IRS Form 1099-C.

This article provides an overview of what the creditor's attorney needs to know about 1099-C filings, including exceptions and reporting obligations, when negotiating the settlement of a disputed claim.

What is the 1099-C and When is My Client Required to File One?

IRS Form 1099-C reports debt that is owed by a debtor but cancelled, discharged, or forgiven by a creditor for less than the full amount owed. IRS regulations require "applicable entities" such as banks, financial institutions, and debt buyers to file a Form 1099-C when forgiving $600.00 or more of a debt. Forgiven debt includes principal, interest, fees, penalties, administrative costs, and fines.

A creditor's obligation to file a 1099-C is triggered upon the occurrence of an "identifiable event". For purposes of this article, the "identifiable event" is the completion of a settlement agreement resulting in the relinquishment of all collection rights by the creditor. [1]

For example: let's say a bank files a lawsuit to collect $15,000.00 on a promissory note. After negotiations, the parties agree to settle the debt for $12,000.00. The settlement will be paid in six monthly installments of $2,000.00, beginning in October of year one and ending in March of year two.

In this scenario, the "identifiable event" is the completion of the settlement agreement. The debt is "cancelled" by the bank upon receipt and clearance of the final payment in March of year two. Therefore, the bank must issue a 1099-C in year two reflecting $3,000.00 in forgiven debt.

[1] The remaining "identifiable events" are defined in 26 CFR § 1.6050P-1(b)(1), and include bankruptcy, foreclosure, and out-of-statute debt.

Now, the filing of a 1099-C does not necessarily trigger a debtor's obligation to report cancelled debt as income. However, as discussed below, the IRS regulations provide for little discretion in an applicable entity's decision to file a 1099-C.

When is a 1099-C not required?

The Federal mandate to report forgiven or cancelled debt provides almost no discretion on the part of the creditor. Failure to report a forgiven debt can result in stiff penalties. From Uncle Sam's perspective, debt forgiven by a creditor is, in most cases, the equivalent of income to the consumer, and thus is ripe for the taxing.

However, as with any mandate, there are exceptions to the 1099-C filing requirements.[2] Outlined below are the two most common exceptions that arise from the settlement of disputed claims.[3]

The most common and most convoluted exception applies to the portion of the debt constituting interest. The IRS does not require an "applicable entity" to report interest at all. However, interest may be included at the election of the creditor and is itemized in a separate section (Box 3) of the 1099-C.

There is somewhat of a gray area surrounding what qualifies as interest. In certain situations, such as with credit card debt, it may be practically impossible to distinguish interest from principal since the debt likely consists of a balance that had been carried over for multiple billing cycles with compounding interest. It is for this reason that the entire amount due including interest, balance transfers, credit card charges, checks, operation charges, and penalties is commonly reported by the creditor on the 1099-C.[4]

The second exception applies to the release of one debtor, where a co-debtor remains liable for the same obligation. In such a situation, the creditor is not required to issue a 1099-C to the released debtor. Contrast this situation to where an underlying obligation is extinguished as to all debtors. In that scenario, a 1099-C will issue for each debtor for the total amount forgiven.

Conclusion

In conclusion, the issuance of a Form 1099-C can be unavoidable when settling a disputed debt. As we discussed, the 1099-C mandates typically are not discretionary and therefore cannot be viewed as negotiable or bargaining chips. Unfortunately, this

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[2] Department of the Treasury Internal Revenue Service 2013 Instructions for Forms 1099-A and 1099-C

[3] Note there are additional exceptions to 1099-C reporting that do not apply to the situation addressed in this article (i.e. certain bankruptcy filings and inheritances).

[4] AMOUNT OF CANCELLED INDEBTEDNESS, Federal Tax Coordinator, Second Edition ¶ J-7202 (1997). 1997 WL 502434

means the 1099-C can be the “fly in the ointment” to an otherwise viable settlement proposal.

Accordingly, when finalizing a settlement, it may be worthwhile to have an open, frank discussion about the Form 1099-C with the opposing party. It may seem counterintuitive to raise the *negative* consequences of a settlement with opposing counsel. Nevertheless, it is prudent to make such a disclosure, especially in the current climate of regulation and scrutiny over collections.

As your next case nears resolution, please keep in mind that there will be at least three parties to your next settlement agreement: your client, the debtor, and the IRS.

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