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Is a Form 1099-C Always Required When Settling Disputed Debts?

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The potential tax consequences to a debtor and tax reporting obligations of a creditor can become a contentious issue when settling disputed debts, although the issue often arises as an afterthought once the primary settlement terms (amount and timing of payment) have been negotiated. On one side, the debtor does not want its lender to issue a Form 1099-C because the debtor wants to avoid tax liability for imputed income resulting from debt cancellation. On the other side, the lender wants to avoid penalties for failure to file a form required by federal law. The dilemma can be resolved if either a regulatory exclusion for filing or the judicially created "disputed debt" (or "contested liability") doctrine clearly applies to the particular situation.

This Insight covers the Form 1099-C requirements and mechanics, exceptions thereto, and takeaways for collection attorneys and their lender clients.

Form 1099-C Requirements and Mechanics

Generally, a creditor must file a Form 1099-C if: (1) debt in the amount of $600 or more has been discharged; (2) the creditor is an applicable entity; and (3) an identifiable event has occurred. A Form 1099-C must be filed in the year following the calendar year in which the identifiable event occurs (January 31st to debtor; February 28th to the IRS if paper-filed, and March 31st to the IRS if e-filed). Finally, the only cancelled or discharged debt that must be reported on a Form 1099-C is the principal amount of the debt owed; however a creditor may report the interest and penalties forgiven if it so chooses.

The pertinent Treasury Regulation defines "indebtedness" for Form 1099-C reporting purposes as "any amount owed to an applicable entity, including stated principal, fees, stated interest, penalties, administrative costs and fines. The amount of indebtedness discharged may represent all, or only a part, of the total amount owed to the applicable entity." Treas. Reg. § 1.6050P-1(c). An "applicable entity" includes government agencies

(including the Small Business Administration) and "applicable financial entities," which consist of financial institutions (their subsidiaries), credit unions, the Federal Deposit Insurance Corporation, and any organization a significant trade or business of which is the lending of money. IRC § 6050P(c).

An "identifiable event" generally triggering a Form 1099-C reporting obligation includes: (1) a bankruptcy discharge; (2) a cancellation/extinguishment that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding; (3) a cancellation upon the expiration of the statute of limitations for collection of an indebtedness or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding; (4) a cancellation pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness; (5) a cancellation that renders a debt unenforceable pursuant to a probate or similar proceeding; (6) a discharge pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration; and (7) a discharge pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt.

The failure by a creditor to file a Form 1099-C may result in penalties under IRC §§ 6721 and 6722. The amount of penalty for the failure to file a correct Form 1099-C by the due date (IRC § 6721) is based on when the Form 1099-C is filed:

- → $50 per form if you correctly file within 30 days (by March 30 if the due date is February 28); maximum penalty $571,000 per year ($199,500 for small businesses, defined below).
- → $110 per form if you correctly file more than 30 days after the due date but by August 1; maximum penalty $1,713,000 per year ($571,000 for small businesses).
- → $280 per form if you file after August 1 or you do not file required information returns; maximum penalty $3,426,000 per year ($1,142,000 for small businesses).

The amount of the penalty for the failure to furnish correct payee statements (IRC § 6722) is determined in the same manner as the IRC § 6721, but it is a separate and distinct penalty.

Exceptions to the Form 1099-C Filing Requirements

As with almost every tax-related reporting mandate, the applicable regulations provide some exceptions to the Form 1099-C filing requirements. And, over time, courts created a judicial exception referred to as the "contested liability" or "disputed debt" doctrine.

Regulatory Exceptions

A Form 1099-C is not required to report the following discharges of debt: (1) certain bankruptcy discharges typically involving consumer debt; (2) interest; (3) in a lending transaction, the discharge of an amount other than stated principal; (4) debt that is acquired by a related party, unless the purpose is to avoid the reporting requirements; (5) debt where a co-obligor remains liable for the full amount of the unpaid liability; and (6) guaranteed debt, i.e., guarantors and sureties are not considered "debtors" for purposes of the reporting requirements. Treas. Reg. § 1.6050P-1(d).

Issues involving the determination of what constitutes interest and the amount of interest often arise when the debt in issue is subject to compound interest and a balance due has been carried over for multiple periods. Thus, many creditors (particularly credit card companies) tend to report the entire amount due on the Form 1099-C.

Judicial Exception

Given the historic lack of a precise definition of "indebtedness" in the Internal Revenue Code and applicable regulations, courts developed the "contested liability" or "disputed debt" doctrine, which stands for the proposition that the settlement of a claim does not result in cancelation of indebtedness income if there is a bona fide dispute regarding the debtor's liability for the amount claimed by the creditor. See *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939), *nonacq*. 1940-1 C.B. 8. Under the contested liability doctrine, if a debtor, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute will be treated as the amount of debt cognizable for tax purposes. The excess of the original debt over the amount determined to have been due is disregarded in calculating gross income; thus eliminating any reporting obligations on the part of the creditor. To rely on the contested liability doctrine the debtor must raise a legitimate dispute concerning the amount of the debt and provide evidence of that dispute, but need not present a valid defense. See *Zarin v. Commissioner,* 916 F.2d 110, 113 and 117 (3d Cir. 1990)(settlement for $500,000 of $3.4 million gambling debt did not result in cancellation of indebtedness income where the debtor contested enforceability under state law).

Practical Considerations and Takeaways

Creditors that satisfy the definition of an "applicable entity" and collection attorneys working for them should generally operate from the point of view that debt cancellation as a result of a settlement with a debtor will trigger a Form 1099-C reporting requirement for the creditor. Many of the regulatory exceptions to the Form 1099-C reporting requirements cannot be used as bargaining chips when negotiating with the debtor, and, of course, the failure to file a Form 1099-C will likely result in penalties assessed against the creditor. Finally, the burden is on the debtor/taxpayer to show that an exclusion to IRC § 61(a)(12) applies to prevent the inclusion of cancelled debt in the debtor's taxable income; the creditor does not need (and generally cannot) make this determination. Thus, even if the creditor files a Form 1099-C, the debtor will have an opportunity to convince the IRS that an exclusion applies.

However, when a settlement proposal has stalled or the debtor has a bona fide dispute concerning the amount of the debt owed, these practical considerations may be useful:

1. Principal v. Interest Classification and Where to Apply Partial Payments – since interest does not need to be reported a Form 1099-C, collection attorneys may be able to negotiate with debtor's counsel as to: (1) how much of the balance due to be forgiven constitutes principal versus interest; and (2) whether and what amount any partial (or remaining) payments will be credited to principal versus interest. The more payments attributable to principal will decrease the amount of debt forgiven that needs to be reported on a Form 1099-C. However, these negotiations may impact the accounting obligations of the creditor, so alert the accountants as needed.

1. Tax Considerations Not Explicit – If a settlement agreement does not specifically address the tax considerations, namely the creditor's reporting obligations as to the discharged or cancelled debt, the creditor should file a Form 1099-C. See McClusky v. Century Bank, 598 Fed.Appx. 383, 387 (6th 2015)(finding that since the Settlement Order did not address the tax considerations or reporting issues, it could not be read as precluding the issuance of a

Form 1099-C; thus there was no breach by the creditor).

1. BonaFide Disputed Debt – If the settlement negotiations concern the resolution of what thepartiesagreeisabonafide disputed debt where the debtor has some evidence of a legitimate dispute as to the amount owed, counsel should include a “contested liability” or “disputed debt” clause in the settlement agreement that addresses the following at minimum:
    1. The agreement reflects the settlement of a bona fide disputed debt;
    2. Does not involve the discharge or cancellation of any debt; and
    3. Creditor will not report the settlement to the IRS and will not issue a Form 1099-C.

Ultimately, communication is key in settlement negotiations, and to avoid potential future conflicts the parties should address and memorialize the tax consequences of the discharged debt as part of the settlement. For more detailed information and guidance please reach-out to David M. McCallum or Lisa P. Sumner at Nexsen Pruet, PLLC.