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ARI B. GOOD, JD LLM

THE INS AND OUTS OF THE 1099-C AND CANCELLATION OF DEBT INCOME

My clients express some concern about whether they will suffer income tax consequences - or "cancellation of debt" income - where a bank or other lender discharges, or writes off, part of their debt. The general rule under the tax code is that a taxpayer is considered to have income in the amount of any loan that is forgiven by the lender. This makes some sense. If I borrow money from a bank and the bank tells me I do not have to pay it back it's basically the same as if the bank just gave me the money, so says the tax code. Unless an exception applies, the taxpayer must show this amount as income, as if received from an employer, and pay tax on that amount.

Mortgage foreclosures and credit card debt settlements are the two most common events that can give rise to cancellation of debt income. As it turns out, however, relatively few people in serious financial distress that have their mortgages written off will suffer this result. As a preliminary matter, receiving a 1099-C is not the end of the story when it comes to whether the debt has been cancelled by the lender. The law states that an "identifiable event" must occur before a taxpayer can be deemed to have cancellation of debt income. What this legal requirement means, in plain English, is that one of certain specified events must occur before the debt is legally "cancelled". Some examples include where the statute of limitations for collecting on a judgment has expired, or where the debt is charged off according to the lender's internal policies, as is often the case with credit card companies. What all of these events have in common is that they render the debt uncollectible to that lender.

Second, in order for a taxpayer to suffer COD income the lender must actually write off the debt. This means that if the lender is still trying to collect on a judgment, for example, the debt has not actually been cancelled, and the taxpayer does not have COD income even if he or she received as 1099-C.

So what of collection agencies? Lenders frequently sell off their debts to third parties for collection. Can these agencies issue a 1099-C to the debtor if they cannot collect? I would argue no. As stated, what all of the "identifiable events" have in common is that the debt is no longer enforceable or collectible by that lender, and therefore the taxpayer must account for the amount of the loss. Selling off the account to a third party agency is a form of collection - the lender simply gets paid up front in exchange for right to continue to pursue the debtor. The debt remains, in theory, collectible by that buyer. While there is no statutory prohibition on non-"traditional" lenders (e.g. banks, credit unions, credit card companies and so on), the debtor could invoke yet a second defense - that he or she never received any value for the obligation the collection agency is seeking to enforce. The law provides that you don't have COD income from a party from whom you never took a loan or received anything of value. The taxpayer has never done business with or probably heard of this collection agency, which simply bought a right to sue. As such, that agency probably has no right to issue a 1099-C if they can't collect on the account.

EVEN THEN, if indeed the lender writes off a portion of the loan (the amount owed less what they were able to get for the account), the taxpayer will not have COD income if the debt relates to the purchase or improvement of a personal residence (up to a specified amount), if the debt is discharged in bankruptcy, or if the taxpayer is insolvent immediately prior to the cancellation.

All told, while COD income gives rise to a tax obligation as a general matter, the taxpayer's larger financial picture, how the debt is handled and when it is written off have a lot to do with whether the taxpayer will actually owe money to the government.

Ari B. Good, Esq.

Ari Good, Esq is Shareholder of Good Attorneys At Law, P.A. of Naples, Florida. Mr. Good received his LL.M. in taxation from the University of Florida in 2005. Mr. Good counsels clients throughout the world in income, sales and use, excise and other tax issues and compliance matters in industries ranging from aviation to hospitality.

239.216.4106 – www.goodattorneysatlaw.com – info@goodattorneysatlaw.com