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CREDITOR REPORTING OF DEBT DISCHARGE

— by Neil E. Harl*

Since the mid 1980s, the problem of income tax liability on discharge of indebtedness has taken on added significance.¹ The focus on discharge of indebtedness has been partly because of the farm debt crisis of the mid 1980s,² partly because of the savings and loan problems beginning the same decade and partly because of the widespread decline in real estate values since the late 1980s.

To assure that the Internal Revenue Service learns of debt discharge in a timely manner, Congress has required lenders to report debt discharge to IRS.³ A new set of final regulations has added considerable detail to the reporting requirements.⁴ It is important to note that the new regulations are effective only for discharges of debt after December 21, 1996.⁵ Until that time, the temporary regulations⁶ and the interim relief from penalties⁷ continue to apply.

Reporting discharge of debt

Under the statute,⁸ a financial entity that discharges $600 or more of indebtedness is required to report the discharge to the Internal Revenue Service.⁹ The information is filed on Form 1099-C with the Internal Revenue Service.¹⁰ Five items of information are to be provided — (1) the name, address and taxpayer identification number of each person for which there was an "identifiable event"¹¹ during the calendar year; (2) the date on which the "identifiable event" occurred; (3) the amount of the discharged debt; (4) whether the "identifiable event" was a discharge of debt in bankruptcy; and (5) other information required by the Form 1099-C or revenue procedures.¹² Aggregation of multiple debt discharges of less than $600 generally is not required.¹³

The regulations point out that the discharged indebtedness must be reported regardless of whether the debtor is subject to tax on the discharged debt.¹⁴ In general, discharge of indebtedness is treated as ordinary income to the debtor.¹⁵ However, there are special relief provisions for debtors in bankruptcy,¹⁶ insolvent debtors not in bankruptcy,¹⁷ holders of real property business debt,¹⁸ solvent farm debtors¹⁹ and those who negotiate a purchase price adjustment involving the reduction of purchase money debt.²⁰

Financial entities are also required to report to the debtor.²¹ That can be done by copy B of the Form 1099-C to the debtor.²²

When debt is discharged

Under the regulations, debt is considered discharged on the date on which an "identifiable event" occurs.²³ Debt is considered discharged only if the following events occur—

- Debt is discharged in bankruptcy.²⁴
- Debt cancellation occurs as a result of a foreclosure or "similar proceeding,"²⁵
- The statute of limitations has run on the claim or on commencing a deficiency judgment claim,²⁶
- Debt cancellation has occurred under a creditor's election of foreclosure remedies,²⁷
- The debt becomes unenforceable as a result of a probate or "similar proceeding,"²⁸
- An agreement has been entered into between the financial entity and the debtor to discharge the debt at less than full consideration,²⁹
- The creditor made the decision to discontinue collection activity,³⁰ or
- The "nonpayment testing period" has expired.³¹ That is the period ending 36 months after the last payment received plus the months the creditor was precluded from engaging in any collection activity such as by the automatic stay in bankruptcy.³² There is a rebuttable presumption that the nonpayment testing period has expired if those conditions are met.³³ However, the presumption may be rebutted if the creditor or a collection agency has engaged in "significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year."³⁴

The term "significant, bona fide collection activity" does not include nominal actions such as automated mailings.³⁵ The presumption can also be rebutted if facts and circumstances existing as of January 31 of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged.³⁶ This can be shown through the existence of a lien or the sale or packaging for sale of the indebtedness by the creditor.³⁷

It is important to note that a guarantor is not considered a debtor for purposes of the reporting requirements.³⁸ That is the case whether or not there has been a default and demand for payment made on the guarantor.³⁹

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Reporting by secured lenders

Under another provision, secured lenders who acquire an interest in the property in full or partial satisfaction of the debt (or have reason to know the property was abandoned) are required to file a Form 1099-A with IRS and furnish a statement to the debtor. If the borrower is personally liable for repayment of the debt, the Form 1099-A is to state the fair market value of the property at the time the interest is acquired. In the absence of clear and convincing evidence to the contrary, the proceeds of sale on foreclosure, execution or other sale are considered to be the fair market value of the property.

The 1995 regulations make it clear that a financial entity is not required to file both a Form 1099-A and a Form 1099-C (showing discharge of indebtedness) for the same debtor. The filing requirements for secured lenders are satisfied if, in lieu of filing a Form 1099-A, a Form 1099-C is filed.

In conclusion

The new regulations, while effective only for discharges after December 21, 1996, will bring substantially greater certainty to this area. The facts and circumstances approach (with three identifiable events) of the temporary regulations left a substantial burden on creditors to ascertain when discharge had occurred. Under the final regulations, the list of eight identifiable events is an exclusive list.

FOOTNOTES
3 I.R.C. §§ 6050J, 6050P.
5 Treas. Reg. § 1.6050P-1(h).
8 I.R.C. § 6050P.
9 Treas. Reg. § 1.6050P-1(a)(1).
10 Id.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAXATION-ALM § 13.03[7].

CLAIMS. Although the IRS was sent a notice of the claims bar date, the IRS failed to file a claim in the case until 21 months after the bar date due to a mistake by an IRS agent. The IRS filed a request to file the late claim based on excusable neglect. The court allowed the claim because the wording of the notice was not completely clear and because the claim was filed before the plan was confirmed. Matter of Papp International, Inc., 189 B.R. 939 (Bankr. D. Neb. 1995).

DISCHARGE. The debtors had timely filed their tax returns for 1990. In October 1991, the debtors filed for Chapter 13 and the case continued for 169 days until it was dismissed in April 1992. In September 1993, the IRS assessed the debtors for unpaid taxes for 1990. The assessment occurred more than 240 days before the instant bankruptcy case was filed. The IRS argued that, under Section 108(c) and I.R.C. § 6503(h), the intervening Chapter 13 case tolled the provisions in Sections 507(a)(8) and 523(a)(8)(B) which provide that taxes due more than three years prior to the bankruptcy filing were dischargeable. The court held that I.R.C. § 108(c) and I.R.C. § 6503(h) apply only to nonbankruptcy law limitation periods and that the 1990 taxes were dischargeable. In re Gore, 96-1 U.S. Tax Cas. (CCH) ¶ 50,069 (Bankr. N.D. Ala. 1995).

CONTRACTS

EXCUSE. The defendant was a grain farm partnership which contracted with the the plaintiff to sell 300,000...