1099-C Discharge without Debt Cancellation Not Consumer Protection Law Violation

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Once again, a borrower who argued his debt was cancelled when he received an IRS Form 1099-C was told by the court that it was merely discharged. The court says "discharge" is not "actual discharge." While acknowledging that a common consumer may not easily understand the distinction, the court held that "discharge" for IRS reporting purposes is not necessarily "actual discharge" of the obligation.

In *Gericke v. Truist, et al*, (cited as 127 AFTR 2d 2021-XXXX, (DC NJ), 03/26/2021), the United States District Court for the District of New Jersey Camden Vicinage, held that the lender's issuing of an IRS Form 1099-C, which stated that the lender essentially was discharging the debt because of a "decision or policy to discontinue collection" did not result in the debt being cancelled. In this case, the lender provided clear evidence that the borrower was aware that the lender provided the Form 1099-C solely to satisfy its obligations under the income tax regulations, and that the underlying debt was not cancelled or actually discharged.

As discussed below, the borrower alleged that the lender violated certain state consumer protection laws, and argued that the lender's failure to cancel the debt after issuing the Form 1099-C was an unlawful act in violation of those consumer protection laws. The borrowers' underlying position was that a lender should not issue a Form 1099-C unless the debt is actually cancelled by the lender. However, the lender argued that it was required by the Internal Revenue Code (Code) to issue the Form 1099-C, and that compliance with IRS reporting obligations did not force it to cancel the debt.

The court, having been presented with no evidence that the lender committed any unlawful practice or violated any clearly established legal rights, rejected the borrower's argument, and found for the lender because of a well-established (but often misunderstood) distinction between two terms: "discharge" for purposes of IRS reporting and "actual discharge," representing the cancellation of an underlying debt.

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Requirement to Issue Form 1099-C

A lender is obligated to issue to the borrower a Form 1099-C on the occurrence of one of seven "identifiable events." One of those events is "[a] discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt.[sic or]." When a lender issues a Form 1099-C for this reason, it is natural for a borrower to conclude that a debt has been cancelled by the lender. It also is natural for the borrower to assume that upon receiving a Form 1099-C, he or she has cancellation of indebtedness income, unless one of the exceptions under the (Code) applies.

Consider the following language on the Form 1099-C:

> *Instructions to Debtor*
>
> *You received this form because a Federal Government agency or an applicable financial entity (a creditor) has discharged (canceled or forgiven) a debt you owed, or because an identifiable event has occurred that either is or is deemed to be a discharge of a debt of $600 or more. If a creditor has discharged a debt you owed, you are required to include the discharged amount in your income, even if it is less than $600, on the "Other income" line of your Form 1040. However, you may not have to include all of the canceled debt in your income. There are exceptions and exclusions, such as bankruptcy and insolvency. See Pub. 4681, available at IRS.gov, for more details. If an identifiable event has occurred but the debt has not actually been discharged, then include any discharged debt in your income in the year that it is actually discharged, unless an exception or exclusion applies to you in that year.*

Notwithstanding the last sentence in paragraph above, it is difficult to fault a borrower who receives a Form 1099-C from thinking the debt has been cancelled and he or she may have cancellation of indebtedness income. Although in this case, both parties agreed that the lender had provided information with the Form 1099-C clarifying that the Form 1099-C did not represent actual discharge but rather a reporting obligation, a typical consumer might understandably fail to appreciate the distinction between "discharged" and "actually discharged."

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Facts in *Gericke*

In *Gericke*, the borrower had taken out a consumer installment loan sometime before 2012. In early 2012, the lender (a successor in interest to the original loan) obtained a judgment against the borrower and his wife for non-payment. The judgment was levied against the personal and real property of the borrower and his wife.

Over the next several years, the borrower failed to satisfy the judgment. When negotiations to reach a settlement failed, the lender determined that it would discontinue collection efforts. Because of this decision, the lender, in compliance with IRS reporting requirements, issued a Form 1099-C to the borrower in 2018 reflecting the amount of the debt as "discharged." The Form 1099-C indicated that the debt was being reported as discharged due to the lender's decision to discontinue collection efforts. When providing the Form 1099-C,

however, the lender made clear to the borrower that the Form 1099-C "does not release the client's judgment as it has not been settled or paid." There was no dispute by either party that the borrower understood that the lender had not, and did not intend to, actually discharge (or cancel) the debt.

The borrower argued that the issuance of the Form 1099-C should have resulted in the debt being forgiven and/or the judgment being voided. The lender, on the other hand, argued that the debt was not forgiven, nor the judgment voided, by the Form 1099-C because the Form "1099-C was filed in accordance with IRS regulations (IRS code section 6050P) to report unpaid debt as income. The bank's filing of the 1099-C in compliance with IRS regulations does not release [lender's] judgment as it has not been settled or paid."

The borrower alleged that the lender had violated certain consumer protection laws by engaging in an unlawful practice or violating a clearly established legal right. The borrower contended that the lender's unlawful practice or violation was the issuance of a Form 1099-C reporting the discharge of the debt without actual discharge or cancellation of the debt or judgment in question. In this motion to dismiss, where facts are construed for the plaintiff (borrower), the issue for the court to decide was whether there were sufficient facts pled to support the plaintiff's contention that the issuance of a Form 1099-C requires a lender to treat the underlying debt as actually cancelled or forgiven with accompanying voiding of the underlying judgment.

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Court's Analysis

Ultimately, the court determined that the facts did not support the borrower's contention and that, even construed most favorably to the borrower, the lender would prevail as a matter of substantially settled law because the lender's reporting obligation to the IRS using the IRS term of art, "discharge," did not force a contractual obligation to cancel the debt in accordance with the common use of the term. In explaining why the borrower had fundamentally misunderstood the ramifications of the issuance of a Form 1099-C, despite the lender's clarification, the court addressed the distinction between "discharge" and "actual discharge" under the Internal Revenue Code (Code) and regulations. The court noted that, under the Code, "discharge" of a debt occurs when it becomes clear that the debt will never be repaid, and that the determination of whether a discharge of indebtedness has occurred for tax purposes is extremely fact sensitive, often turning on the subjective intent of the lender as manifested by an objectively identifiable event. The court went on to say that this realization that a debt will not be repaid, however, is distinct from the cancellation or actual discharge of the debt, and that the Code contemplates the multiplicity of the meaning of "discharge" in the tax context.

The court found that the regulations that implement the Code's requirement to issue Forms 1099-C are consistent with the Code. The regulations also distinguish "discharge" and "actual discharge," according to the court. Citing case law, the court found that the Form 1099-C was filed to conform with IRS regulations, in satisfaction of a reporting requirement for tax purposes that arose regardless of whether an actual discharge of indebtedness had occurred. The court noted that a majority of courts that have considered the significance of issuing Form 1099-C have concluded that the Form 1099-C itself does not operate to legally discharge or otherwise cancel the underlying debt, but rather is simply the fulfillment of a reporting requirement to the IRS. The court did note, however, that a small minority of courts have found that the issuance of a Form 1099-C may

be prima facie evidence of cancellation of debt, which the lender may rebut with evidence showing that when it issued the form, it did not intend to forgive the obligation.

> *The court found that the plain language of the regulation led it to conclude that filing a Form 1099–C is a lender's required means of satisfying a reporting obligation to the IRS; it is not a means of accomplishing an actual discharge of debt, nor is it required only when an actual discharge has already occurred.*

The court granted the lender's motion to dismiss the borrower's complaint, noting that its decision is in line with the majority of courts in the country. However, the court determined even under the minority rule, which considers the Form 1099-C prima facie evidence of actual discharge, here, the prima facie evidence was rebutted by the lender's clarification.

Importantly, in its holding, the court noted that it appreciates that these statutory and regulatory definitions and technical rules are not easily understood by the common consumer, but that ultimately the borrower's issue is with Congress rather than the lender. "The fact of the matter is that the issuance of a Form 1099-C is not the end of the road in terms of the actual discharge of a debt. Frustrating though that may be, it is clear that [lender] was required by law to issue the Form 1099-C in this case. Doing so did not result in the actual discharge of borrower's debt."

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Comment

In fact, the prevalence of such cases underscores that the discrepancies between the IRS definition of discharge and the common meaning of the word create real consumer confusion, as well as increasing costs for both borrowers and lenders. The court here highlighted the unfortunate truth: that those discrepancies and confusion were created by Congress and cannot be reconciled by the court. Further, while consumers may remain blissfully ignorant of many potentially confusing legal terms of art, the term "discharge" as associated with the Form 1099-C reporting requirement is thrust upon borrowers and lenders alike in many foreseeable scenarios.

In 2016, the regulations requiring the issuance of Form 1099-C were amended to eliminate an eighth identifiable event. Under that identifiable event, a rebuttable presumption arose that an identifiable event occurred requiring the issuance of a Form 1099-C if a lender did not receive a payment within a 36-month testing period. The lender could rebut the presumption if it engaged in significant bona fide collection activity at any time within the 12-month period ending at the close of the calendar year, or if the facts and circumstances existing as of January 31 of the calendar year following the expiration of the non-payment testing period indicate that the indebtedness had not been discharged. A lender's decision not to rebut the presumption that an identifiable event had occurred pursuant to the 36-month rule was not an indication that it had discharged the debt, but the lender was nonetheless required, for information reporting purposes, to report amounts on a Form 1099-C to the borrower.

In the preamble to the regulations eliminating the 36-month rule, the IRS noted that borrowers receiving Forms 1099-C may have concluded that the debts had, in fact, been discharged, causing the borrowers to erroneously

include in income the amounts reported on Forms 1099-C, even though lenders may have continued to attempt to collect the debt after issuing a Form 1099-C as required by the 36-month rule. Issuing a Form 1099-C before a debt had been actually discharged also could cause the IRS to initiate compliance actions even though an actual discharge had not occurred. If a Form 1099-C is issued, the regulations provide that no additional reporting is required if a subsequent identifiable event occurs that actually discharges the debt. Therefore, in cases in which the Form 1099-C was issued because of the 36-month rule but before the debt was actually discharged, the IRS did not subsequently receive third-party reporting when the debt was actually discharged. According to the preamble to the regulations, this potentially diminished the IRS's ability to enforce collection of tax on the cancellation of indebtedness when the information reporting (the Form 1099-C) did not reflect an actual cancellation of indebtedness.

The regulations were amended to eliminate the 36-month rule because it confused borrowers (was the debt actually discharged requiring the borrower to report cancellation of indebtedness income?) and it made it difficult for the IRS to know whether a debt had actually been discharged. The problems created for borrowers and the IRS by the 36-month rule also are present with the identifiable event that required the lender in the *Gericke* case to issue a Form 1099-C. The lender properly determined that an identifiable event had occurred requiring the issuance of a Form 1099-C, but did not actually discharge the debt. While the lender in *Gericke* made clear to the borrower that the Form 1099-C "does not release the client's judgment as it has not been settled or paid," it is likely that this type of language also was provided by some lenders issuing Forms 1099-C under the 36-month identifiable event. Nevertheless, the IRS acknowledged that borrowers remained confused about whether the debt was actually discharged.

In support of his position, it appears that the borrower in *Gericke* raised the fact that the IRS had amended the regulations to eliminate the 36-month rule, presumably because of the confusion it created. The court dismissed this argument as irrelevant because *Gericke* involved a different identifiable event. Apparently, the court was unwilling to interpret the identifiable event in *Gericke* as requiring the lender to issue a Form 1099-C only when the lender has decided to actually discharge the debt – an interpretation that would eliminate borrower confusion.

> *Considering that this identifiable event, which is based on the lender's decision that a debt is uncollectable, also confuses taxpayers and makes it difficult for the IRS to know whether a debt has actually been cancelled, the IRS should consider amending the identifiable event to require a Form 1099-C to be issued only when the lender decides to actually discharge the debt.*

The IRS might be concerned that, if a lender was required to issue a Form 1099-C only when it has decided to actually discharge a debt, its failure to do so would mean there would not be an event triggering cancellation of indebtedness income for the borrower. The statute of limitations on collections would eventually bar collection activity (and potentially result in cancellation of the debt under state law), but the regulations rightly take the position that a Form 1099-C is required to be issued due to the expiration of the statute of limitations on collections only if and when a debtor's affirmative statute of limitations defense is upheld in a final judgment. Thus, if the lender never makes a decision to actually cancel the debt, the borrower arguably never has cancellation of indebtedness income. While this is a potential result if the lender never makes a decision to actually discharge a debt, it would be the exception as most lenders make a decision to actually discharge a debt

at some point. (When the decisions is made will vary depending on the facts (e.g., has the lender obtained a judgment against the borrower)).

Ultimately, the true policy question for the IRS is whether the benefits of requiring lenders to issue a Form 1099-C before they have actually discharged a debt outweighs the same type of confusion for borrowers and problems for the IRS created by the 36-month rule.

There are valid business reasons why a lender might determine that a debt is uncollectible before it has made a decision to actually cancel a debt. Most courts understand this and are on the side of lenders when it comes to issuing Forms 1099-C without actually discharging a debt. Nevertheless, it places lenders in a difficult position with their borrowers. Further, it unnecessarily exposes lenders to litigation and a possible adverse judgment from a court that follows the minority view (that the issuance of a Form 1099-C is prima facie evidence of cancellation of debt) where, unlike this case, the lender is deemed not to have sufficiently documented its attempts to clarify ambiguity created through no fault of its own.

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Douglas W. Charnas