

Podcast: When Is Form 1099-C Required of Lenders?

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When debt is forgiven, as much of the funding lent through the CARES Act's PPP may be, a lender may be required to file IRS Form 1099-C with the IRS and to furnish a copy to the borrower. As a lender, do I need to file the 1099-C when I forgive a PPP loan, or when we finalize a restructuring or settle a case alleging a violation of state or Federal lending law?

Douglas Charnas: I'm **Douglas Charnas**, Member in McGlinchey's Washington DC office. I practice tax law. I'm joined by my partner, **Charles Adams**, from our Houston office, who practices with our Business and Corporate Transactions group, and has advised numerous financial institutions on reporting obligations and other matters.

Charles Adams: Doug, in my practice, I represent a number of lenders and I generally try to avoid tax lawyers like you, which I say with no offense intended. It seems like whenever the tax lawyers get involved, things get very complicated very quickly.

Douglas Charnas: Well, Charles, I'm sorry about that, but you can blame Congress for the complexity of the tax laws. We tax lawyers do our best to ensure that taxpayers comply with the ever-changing landscape of tax laws. Frankly, it is a thankless task. So, Charles, how are we complicating your life today?

Charles Adams: My tax issue du jour is IRS Form 1099-C. When does the lender have to issue it? The two questions I was asked today are: First, does a lender have to issue IRS Form 1099-C when it forgives a Paycheck Protection Program (PPP) loan? Second, does the lender have to issue Form 1099-C when it finalizes a restructuring or settles a case in which the borrower alleges that the lender violated a state or Federal lending law?

Douglas Charnas: Charles, there is the simple and safe answer, which is for a lender to issue IRS Form 1099-C whenever it cancels any debt. Then there is the answer that invokes the dreaded tax lawyer refrain – "it depends."

Charles Adams: I like simple and safe, but it does not work when the lender is negotiating a settlement with a borrower. Borrowers' counsel generally have an aversion to their clients receiving any type of information return from the lender, such as IRS Form 1099-MISC and IRS Form 1099-C.

Douglas Charnas: Well that's understandable because the information returns are filed with the IRS and alert the IRS to the fact that the borrower received a benefit that might constitute taxable income.

Before addressing your two questions, let's step back for a moment and review the rules that come into play with cancellation of debt and whether Form 1099-C must be issued. The Internal Revenue Service broadly defines income, and specifically provides that income includes the cancellation of debt. When someone borrows money and does not have to pay it back, that person's wealth has increased by the amount that is not required to be repaid. This accretion to wealth generally is income upon which tax must be paid. Of course, the Internal Revenue Code is full of exceptions, and there are certain exceptions that exclude cancellation of debt (COD) income.

To notify the Government that a borrower has cancellation of debt income, or COD income, the Internal Revenue Code generally requires the lender to notify the IRS that it has cancelled debt.

The income tax regulations list seven identifiable events and require the lender to file Form 1099-C with the IRS and furnish a copy to a borrower when one of these events occur.

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Charles Adams: Well I'm familiar with the identifiable events as they come up in discussions with borrower's counsel. The first three identifiable events do not apply when we are negotiating a settlement. Those are:

1. a discharge of debt in bankruptcy,
2. a cancellation or extinguishment making the debt unenforceable in a receivership, foreclosure, or similar federal non-bankruptcy or state court proceeding, and
3. a cancellation or extinguishment when the statute of limitations for collecting the debt expires, or when the statutory period for filing a claim or beginning a deficiency judgment proceeding expires.

The fourth identifiable event is a cancellation or extinguishment when the creditor elects foreclosure remedies that by law extinguish or bar the creditor's right to collect the debt. Sometimes this issue is discussed.

The fifth identifiable event is a cancellation or extinguishment making the debt unenforceable under a probate or similar proceeding. I don't recall a settlement negotiation when this event was discussed, but then again, most of my client's borrowers tend to be business entities or live people.

The sixth identifiable event is a discharge of indebtedness under an agreement between the creditor and the debtor to cancel the debt at less than full consideration (some people refer to these as "short sales"). This identifiable event is the one that generates the most discussion during settlement.

Douglas Charnas: Charles, I want to pause and note that this sixth identifiable event also has been examined in several IRS private letter rulings. I want to discuss these in a minute.

The income tax regulations list seven identifiable events and require the lender to file Form 1099-C with the IRS and furnish a copy to a borrower.

Charles Adams: Splendid. The seventh identifiable event is a discharge of indebtedness because of a decision or a defined policy of the lender to discontinue collection activity and cancel the debt. This doesn't come up in settlement negotiations because the lender is, at the time, pursuing collection of the debt. It has not cancelled the debt.

Douglas Charnas: Yeah, it is important to note that the requirement to issue a Form 1099-C is tied to the occurrence of an identifiable event, not whether the borrower has cancellation of debt income.

Charles Adams: So what does this mean for the forgiveness of a Paycheck Protection Program loan – a PPP loan?

Douglas Charnas: Well the good news here, Charles, is that I can give you a definite answer for forgiveness of PPP loans. On September 22, 2020, IRS issued Announcement 2020-12. It provides that lenders should not file IRS Form 1099-C with the IRS or furnish it to borrowers to report the amount of qualifying forgiveness with respect to covered loans made under the Paycheck Protection Program.

In addition to PPP loans, the CARES Act added a provision relating to the existing Small Business Administration (SBA) Emergency Injury Disaster Loan program. Emergency Injury Disaster Loan is often abbreviated as EIDL. Under this new provision, taxpayers could apply for an emergency grant up to \$10,000. If the grant is spent for permissible purposes, it is forgiven. Unfortunately, Notice 2020-12 does not address the forgiveness of an EIDL emergency grant. If you ask me if a Form 1099-C must be filed and furnished when an emergency grant is forgiven, I'll give you another favorite tax lawyer answer, "I don't know." I was hoping the IRS would address EIDL emergency grants when it addressed PPP loans. The Announcement does not provide any rationale for why Form 1099-C is not required for the forgiveness of PPP loans other than to note that the CARES Act excludes from gross income forgiveness of PPP loans as long as the loan was used for permissible expenses. This specific exclusion from income is likely the basis for not requiring a Form 1099-C when a PPP loan is forgiven. The CARES Act does not explicitly exclude from income forgiveness of an EIDL emergency grant, but Section 139 of the Internal Revenue Code excludes from income any amount received by an individual as a qualified disaster relief payment. It's unclear, however, whether an emergency grant that is forgiven constitutes a qualified disaster relief payment. The fact that the Announcement does not address forgiveness of an emergency grant suggests the IRS may treat an emergency grant that is forgiven as a qualified disaster relief payment excluded from income under Section 139 that does not require the lender to file Form 1099-C. Unlike PPP loans, which are issued by commercial lenders, EIDL emergency grants are issued by SBA.

IRS Announcement 2020-12 provides that lenders should not file IRS Form 1099-C with the IRS or furnish it to borrowers to report the amount of qualifying forgiveness.

Charles Adams: Well, Doug, you're right, that is a significant difference from PPP loans. Maybe IRS simply didn't think it necessary to provide guidance to the SBA.

Douglas Charnas: Well, that's a good point. Remember, whether the borrow has income from cancelation of debt does not control whether the lender must issue a Form 1099-C. The question is whether there has been an identifiable event. As I interpret the identifiable events, forgiveness of a PPP loan or emergency grant is not the result of an identifiable event that requires the filing and furnishing of Form 1099-C. Forgiveness is dependent on the borrower using the money for the permissible purposes under the CARES Act. While the issue is unclear for the forgiveness of an emergency grant, a persuasive argument can be made that there is no requirement to file or furnish Form 1099-C because no identifiable event has occurred. So Charles, I do not know what position the IRS is going to take with respect to the forgiveness of emergency grants, but my money is on there being no requirement to file or furnish Form 1099-C.

Charles Adams: Understood. You know, Doug, when Congress is throwing pitches no one can hit, experience and judgment take the sting out of this sort of uncertainty.

Douglas Charnas: Oh, by the way Charles, I should add that the IRS may be providing more guidance on PPP loans. Michael Desmond, the former IRS Chief Counsel, recently said during an American Bar Association tax conference that the IRS is focused on the forgiveness of the loans, which are not included in businesses' taxable income, and, I quote "giving some consideration as to whether guidance can be issued on that."

Charles Adams: Let's see how you do on my second question. Can I get better than an "I don't know?"

Douglas Charnas: Yes I can. The answer is "it depends."

Charles Adams: Well, can you give me a memorandum that I can stick in my file for that?

Douglas Charnas: Sure, sure, but I'll have to charge you for the time it takes me to prepare the memorandum.

The reason it depends is that state laws vary in the legal consequences when a lender fails to follow the rules. You know better than I, but my understanding is that most states require specific procedures to be followed before a borrower's property pledged to secure a debt can be repossessed or sold.

Charles Adams: Well that's certainly true. For example, many states require a lender to issue a Notice of Sale before property securing a debt can be sold when the borrower has defaulted on the debt. If a balance remains on the debt after the property is sold, some states treat the remaining debt as extinguished if the proper Notice of Sale procedures are not followed. That is, the borrower would have no liability, and, therefore, nothing to collect. In other states, the debt is not extinguished, but the lender is barred from seeking a deficiency judgment for the remaining balance on the debt.

Form 1099-C is required only if one of the seven identifiable events occurs. A cancellation of debt by court order is not an identifiable event so no Form 1099-C is required.

Douglas Charnas: Yes, it's those types of differences in state law as well as the specific facts of each case that will determine whether a Form 1099-C must be issued when a borrower's debt is cancelled.

There is very little case law on when a Form 1099-C must be issued. As I mentioned earlier, the IRS has issued some private letter rulings or PLRs on the subject. PLRs can be relied upon only by the

person to whom they are issued. Nevertheless, they provide good insight into how the IRS interprets the law. Whether a Form 1099-C must be issued depends on how the decision to forego collection on the debt arises. Some PRLs address the Form 1099-C filing when a court order prohibits a lender from collecting an amount due when the lender failed to provide a required notice. A court order is not an identifiable event. Thus, the lender is not required to issue a Form 1099-C when a court order either extinguishes the debt or bars its collection. Other PLRs address an independently-negotiated settlement agreement in which the lender agrees to write-off amounts owed by the borrower. This type of agreement is an identifiable event. For example, when the parties entered into a settlement agreement regarding the write-off of balances and charges, the IRS ruled that the agreement was an identifiable event. Although the terms of the agreement were incorporated into a final court order, the voluntary discharge of the debt was not converted into one forced by operation of state law. The agreement also was deemed a decision by the lender to discontinue its collection activity as part of settling the litigation, thereby also qualifying as an identifiable event. In this PLR, the lender was required to issue Form 1099-C.

Charles Adams: Well, okay, I'm getting the drift here. Form 1099-C is required only if one of the seven identifiable events occurs. A cancellation of debt by court order is not an identifiable event so no Form 1099-C is required. What if a lender knows it violated the law and that the violation results in a cancellation of the debt? That is, under the facts, the operation of state law cancels the debt. If the lender acknowledges that it violated the law and that the violation results in cancellation of debt, does it have to issue Form 1099-C when it cancels the debt? In that instance, there would've been no court order finding that there was a violation of law that resulted in the debt being cancelled.

Douglas Charnas: Well, Charles, that's a great question. Guess what. I don't know what position the IRS would take on these facts. However, the tax law generally does not require taxpayers to engage in meaningless acts. If the lender knows it violated state law and admits to the violation, it should not be required to go to court to have the court issue an order confirming that the lender violated state law.

Charles Adams: Are you saying that when debt is cancelled by operation of law, rather than by agreement of the parties or the lender's decision not to pursue collection of the debt, Form 1099-C does not have to be issued?

Douglas Charnas: Well, I'm almost saying that, but not quite. Some of the identifiable events include cancellation of debt by operation of law. For example, debt of a business that is discharged in bankruptcy or a cancellation when the statute of limitations for collecting the debt expires, or when the statutory period for filing a claim or beginning a deficiency judgment proceeding expires – these events must be reported on Form 1099-C. That's because they are specifically listed as identifiable events. However, these rules are to be narrowly interpreted. The preamble to the final regulations that require Form 1099-C makes clear that cancellation of debt by operation of law that is not enumerated in the identifiable events is not required to be reported on Form 1099-C.

The preamble to the final regulations that require Form 1099-C makes clear that cancellation of debt by operation of law that is not enumerated in the identifiable events is not required to be reported on Form 1099-C.

Charles Adams: Alright, I see your point that whether a Form 1099-C must be issued depends on the applicable state or Federal law and the specific manner in which the debt is cancelled.

Douglas Charnas: You got it. Looks like I didn't strike out on your second question.

Charles Adams: Completely agree. What's clear is that despite our desire for quick simple yes/no answers, the laws regarding cancellation of debt and the facts under which debt is cancelled often are complicated and the answers are neither simple nor clear. In those instances, there is just no substitute for an understanding of the facts, the law, and the application of experience and judgment.

Douglas Charnas: To help lenders wade through the rules regarding when IRS Form 1099-C must be issued, we have prepared a handbook that explains the law; provides 40 scenarios addressing whether, and, if so when, a Form 1099-C must be issued; and contains the relevant statutory and regulatory provisions, as well as IRS forms, instructions, and other guidance. This handbook can be [downloaded by using the link provided](#) on the webpage for this podcast, or by searching 1099-C on Mcglinchey.com.

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