Fairness Over Deference: The Shifting Landscape of Creditors Rights to Claims and Debtor Protection Regarding the Issuance of Form 1099-C

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Introduction:

Issues surrounding the discharge of indebtedness with regard to Form 1099-C filings have recently become a difficult issue for bankruptcy courts. When a debtor cannot afford to pay a creditor an outstanding debt, a Form 1099-C is utilized to “discharge the debt.” The resulting cancellation is then reportable for tax purposes for both the debtor (as cancellation-of-debt income – “COD income”) and the creditor (as a deduction).\(^1\) Form 1099-C filings are made by creditors and issued to each “debtor for whom . . . $600 or more of a debt owed” had been cancelled.\(^2\)

Courts have had to consider what the terms “cancelled” and “discharged” mean with regards to a debtor’s payment obligations and a creditor’s collection rights. In connection therewith, courts have also had to consider whether issuing a Form 1099-C releases the debtor from payment obligations as a matter of law. The majority of courts have held that the issuance

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of a Form 1099-C to a debtor, without more, does not discharge the debtor from liability.\(^3\)

Therefore, under the majority approach, a creditor can continue to attempt to collect the debt after filing a Form 1099-C. The minority of courts, however, have concluded that issues of fairness and equity need to be addressed when deciding discharge of indebtedness after a Form 1099-C is filed.\(^4\) The rights of creditors to collect, and of debtors to be free from inequitable initial double payment, is the central discrepancy between the two camps.

The following is an exploration of each side and the ramifications for both creditors and debtors when facing the issue of a Form 1099-C filing. Part I of this Article discusses the rules and regulations that are currently in place with regards to Form 1099-C filings. Specifically it will explore the language of the Internal Revenue Code (“the IRC”) and the Code of Federal Regulations (“the CFR”). Part II of the Article will discuss the case law surrounding Form 1099-C filings that has been handed down by courts. The Part will be broken into two sub-parts. The first sub-part will explore the case law making up the majority position. The second sub-part will review more recent decisions that are establishing a theme that appears to be developing into a minority approach. Finally, Part III will analyze the practical effects that a Form 1099-C filing will have for both creditors and debtors when occurring within majority, minority and neutral jurisdictions.

I. The Internal Revenue Code and Federal Regulations

The IRC includes cancelled debt under its definition of “gross income.” Specifically, section 61(a)(12) of the IRC provides that “gross income means all income from whatever source


derived, including . . . income from discharge of indebtedness.” The CFR attempts to define what constitutes a “discharge of indebtedness,” and when such a discharge occurs. CFR section 1.6050P-1(a) provides “a discharge of indebtedness is deemed to have occurred . . . if and only if there has occurred an identifiable event.” Further, the CFR attempts to clarify what constitutes an “identifiable event” by listing certain scenarios that would qualify. Put simply, “[i]dentifiable events” that trigger the reporting obligation include “‘discharge through the debtor’s filing for bankruptcy’, ‘the expiration of the statute of limitations for collection’, ‘discharge by agreement of the parties’, a creditor’s decision ‘to discontinue collection activity and discharge debt,’ and ‘expiration of the non-payment testing period.’” The CFR mandates that once a discharge has occurred through an “identifiable event,” the applicable entity “must file an information return on Form 1099-C with the IRS.”

A contentious issue facing courts is whether a creditor can continue to seek collection after issuing a Form 1099-C filing upon a debtor. The majority of courts primarily view the filing as a mere reporting requirement, which alone has no bearing on the creditors continued ability to seek payment from a debtor. The minority opinion views the filing, coupled with other fact specific scenarios, as an identifiable event needed to trigger a discharge of a debt.

II. Court Decisions Regarding the Effect of Filing a Form 1099-C

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5 26 IRC § 61(a)(12).
6 See CFR § 1.6050P-1(a).
7 Id.
8 Id. § 1.6050P-1(b)(2).
9 Id.
10 26 CFR § 1.6050P-1(a).
The majority of courts favor a creditor’s rights to collect from a debtor even after the issuance of a Form 1099-C filing. The majority approach is based on two guidance letters published by the IRS to help clarify the issue.\(^\text{13}\) In the guidance letters the IRS advised “any applicable entity that discharges indebtedness of any person during a calendar year must file an information return reporting the discharge . . . [and] . . . must furnish a copy of the information return to the debtor.”\(^\text{14}\) The same letter also stated that “the [IRS] does not view a Form 1099-C as an admission by the creditor that it has discharged the debt and can no longer pursue collection.”\(^\text{15}\) A second letter published in conjunction further discussed the IRS’s position on the issue.\(^\text{16}\) This second letter answered a specifically posed question, as follows:

Q5. Does filing a Form 1099-C upon the occurrence of an identifiable event prohibit future collection activity on the amount reported?

A5. Section 1.6050P-1(a)(1) of the regulations provides that solely for purposes of the reporting requirements of section 6050P of the Code, a discharge of indebtedness is deemed to have occurred upon the occurrence of an identifiable event whether or not there is an actual discharge of indebtedness. Section 6050P and the regulations do not prohibit collection activity after a creditor reports by filing a Form 1099-C.\(^\text{17}\)

The majority of courts proclaimed that the language of the guidance letters, the IRC and the CFR were clear and unambiguous. The majority of courts deferred to the IRS guidance letters\(^\text{18}\), and used them as the cornerstone of their approach.


\(^{15}\) Id.


\(^{17}\) Id.

\(^{18}\) The majority ascribes a *Chevron* level of deference to the guidance letters, the IRC and the CFR. In *Chevron* the Supreme Court held that “[i]f the intent … is clear, that is the end of the
An example of the court adopting the majority approach occurred in *Capital One v. Massey*. In the case, borrowers executed a promissory note guaranteeing the full amount of the note to creditors. The borrowers subsequently defaulted on the notes. In response the creditors issued a Form 1099-C received by the borrowers. The borrowers disputed the amount of the creditors claim based on issuance of the Form 1099-C. The borrowers posited that “when [the creditors] issued a Form 1099-C . . . it created an issue as to how much debt was cancelled.”

The district court summarily dismissed the guarantor’s arguments. The court granted deference to the IRS guidance letters as the basis of its decision. The court opined, “a [Form] 1099-C is issued to comply with IRS reporting requirements. The IRS does not view a [Form] 1099-C as a legal admission that a debtor is absolved from liability for a debt. The IRS’s interpretation of regulations over which it has authority are given great deference.” The opinion continued, stating “a [Form] 1099-C does not discharge debtors from liability. Therefore, the fact that [creditors] issued a [Form] 1099-C in relation to the [guarantors] indebtedness is irrelevant.”

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20 *Id.* at *1.
21 *Id.*
22 *Id.* at *3.
23 *Id.* at *2.
24 *Id.*
25 *Id.*
26 *Id.*
27 *Id.*
28 *Id.*
Many other court have adopted the majority approach, using similar logic and reasoning as *Massey*, by granting deference to the IRS guidance letters. In these decisions, the guidance letters were seen as controlling on the issue and relied upon by the courts. As a result, the majority approach holds that, per IRS guidance and interpretation, the issuance of Form 1099-C filings alone do not constitute a discharge of indebtedness, and therefore, the creditor is free to try to collect the outstanding debt from the debtor.

**b. The (Growing) Minority – A Creditor May Not Continue to Seek to Enforce a Debt After the Creditor Issues a Form 1099-C**

While not unified with regards to the effect of Form 1099-C filings, the minority approach places more of an emphasis on fairness and equity when determining when a discharge of indebtedness has occurred. For example, in *In re Crosby*, the bankruptcy court held that once a creditor issues a Form 1099-C to a debtor, a creditor was no longer able to collect on the debt. There, a debtor entered into a loan agreement with a creditor and eventually defaulted. The creditors repossessed and sold a car that had been pledged as collateral. The sale left a significant deficiency and the creditors sought and won a default judgment in state court. The creditors then filed a Form 1099-C with the IRS. A copy of the Form 1099-C filing was sent to the debtor. Notwithstanding the fact that the creditor had issued a Form 1099-C, the creditor

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30 See id.
31 261 B.R. 470 (2001)
32 See Id. at 472.
33 See Id.
34 See Id.
35 See Id.
36 See Id.
continued to attempt to collect, even going so far as to commence wage garnishment.\textsuperscript{37} However, the debtor, relying on the Form 1099-C filing, reported the amount believed to be cancelled on her tax returns as cancellation-of-debt income.\textsuperscript{38}

The \textit{Crosby} court noted that “[w]ithout the forms, the debtors would not have had to report the discharge of indebtedness income to the IRS and pay tax on it.”\textsuperscript{39} The court held that it would be “inequitable to allow [creditor] to enforce its claims against the debtors . . . . [Creditor] cannot enforce its claim against the debtor, just as it would have no right to do so if it had assigned the debt.”\textsuperscript{40} The \textit{Crosby} decision laid the foundation generally for what would become a theme across the minority of courts: a focus on fairness and equity.

The \textit{Crosby} decision was handed down several years before the IRS issued the guidance letters that would become the cornerstone of the majority approach.\textsuperscript{41} Since the publication of the guidance letters several cases have been decided that shade toward debtor protection through fairness and equity. These decisions propelled the principals initially outlined in \textit{Crosby}, while simultaneously challenging the majority interpretation of the guidance letters.

One such case is \textit{In re Reed}.\textsuperscript{42} In \textit{Reed}, debtors executed a promissory note with creditors, putting up property as collateral.\textsuperscript{43} The debtors defaulted, and creditors foreclosed on the collateral property and sold it at auction.\textsuperscript{44} After the sale there was a deficiency balance owed to

\begin{footnotesize}
\textsuperscript{37} See \textit{Id}.
\textsuperscript{38} See \textit{Id.} at 474
\textsuperscript{39} \textit{Id}.
\textsuperscript{40} \textit{Id}.
\textsuperscript{42} 492 B.R. 261 (2013).
\textsuperscript{43} See \textit{id.} at 263.
\textsuperscript{44} See \textit{id}.
\end{footnotesize}
the creditors, who subsequently issued a Form 1099-C filing. The debtors included the amount owed to the creditors as cancellation-of-debt income on their tax returns in reliance on the Form 1099-C they received. The creditors then filed suit on the debtors, seeking the balance owed.

In Reed, the bankruptcy court held that the creditors could not seek payment from the debtors after the issuance of a Form 1099-C filing. The court conceded that the issuance of the Form 1099-C alone did not extinguish the indebtedness as a matter of law. Instead, the court opined that the issuance serves as a reflection that the creditor had discharged the indebtedness. The debt is converted into taxable income of the debtor after it is discharged, which must be reported as COD income. While debtor reliance was never explicitly stated as a requirement, the court decision alluded to debtor’s reliance in similar cases when reaching their decision. The reliance, in the form of the debtor reporting cancellation-of-debt income for tax purposes, became the “identifiable event” the court used to establish that the debt had truly been discharged. According to the court, the Form 1099-C filing combined with the identifiable event prevented the creditor from continuing to seek payment of the debt.

In handing down the decision the court also directly addressed the issue of the IRS guidance letters central to the majority approach. The Reed court challenged the majority approach regarding the unquestioned deference afforded to the IRS. The Reed court also

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45 See id.
46 See id.
47 See id.
48 See id. at 271.
49 See id. at 272.
50 See id.
51 See CFR § 1.6050P-1(a).
52 See In re Reed, 492 B.R. at 272 (quoting In re Crosby, 261 B.R. 470, 474 (2001)).
53 CFR § 1.6050P-1
54 See In re Reed, at 273.
55 See id., at 272.
disagreed with the courts adopting the majority approach that the applicable regulations were unambiguous.\textsuperscript{56} Instead, the Reed court viewed the applicable regulations as ambiguous and open to different interpretations.\textsuperscript{57} It decided that the IRS guidance letters should not be entitled to such unchallenged deference. The Reed court allowed a lower standard of deference, only to the extent that the guidance letters had the “power to persuade.”\textsuperscript{58}

Using this distinction, the court claimed that it was “not persuaded by the two information letters relied upon by [the majority] courts”\textsuperscript{59} due to a direct conflict between the IRC and the guidance letters. The IRC states that gross income includes cancellation of debt income\textsuperscript{60}, and “COD income is a term that is interchangeable with the term discharge of indebtedness.”\textsuperscript{61} “[I]n order for COD income to occur under [the IRC], the taxpayer must have been discharged from a liability.”\textsuperscript{62} The Reed court asks how can the taxpayer be required to report COD income after the discharge of a debt, if a Form 1099-C is “not . . . an instrument effectuating a discharge of debt?”\textsuperscript{63} The Reed court opined that the IRS interpretation was unreasonable due to the disconnect between the IRC and the IRS guidance letters.\textsuperscript{64} While the Reed court acknowledged that it was adopting the minority approach, the court found that such approach was “in the interests of justice and equity . . . [it was] the proper view.”\textsuperscript{65}

\textsuperscript{56} See id. at 269.
\textsuperscript{57} See id.
\textsuperscript{58} Based on the ambiguity it viewed in the guidance letters, the Reed court granted the letters only a Skidmore level of deference. There, the deference afforded the administrative agency is based on the agency’s “power to persuade,” a much lower standard than that of Chevron deference. See Skidmore v. Swift & Co., 323 U.S. 134 (1944).
\textsuperscript{59} See In re Reed, at 270.
\textsuperscript{60} See Friedman v. Comm’r, 216 F.3d 537, 545 (2000) (citing 26 U.S.C. § 61(a)(12)).
\textsuperscript{62} Friedman, 216 F.3d at 546.
\textsuperscript{63} See In re Reed, at 271.
\textsuperscript{64} See id. at 271.
\textsuperscript{65} Id. at 273.
The minority of courts have dealt with distinct scenarios and taken different paths to address the issue, and as such there is not yet a single unified approach. The various positions struck that oppose the majority approach, however, do have single unifying characteristics in common.\textsuperscript{66} The courts favoring the minority approach interpret the regulations and the IRC with an eye toward fairness and equity.\textsuperscript{67} The cases frequently cite the inherent inequity of requiring a debtor to claim cancellation-of-debt income while simultaneously allowing the creditor to seek payment.\textsuperscript{68} Despite discrepancies in the details of the cases, a growing number of courts are deciding that the filing of a Form 1099-C, in the interests of fairness and equity, can prevent a creditor from continuing to seek payment from a debtor.

\textbf{III. Ramifications for Creditors and Debtors}

After establishing the two distinct sides of the issue it is important to examine what these positions mean for creditors and debtors who may face similar circumstances. The following will explore the practical implications of the majority and minority positions on creditors/debtors who find themselves in a Form 1099-C dispute. Which jurisdiction a creditor is in, as well the ultimate goal with regards to the outstanding debt, will greatly effect the decision whether or not to file a Form 1099-C. For debtors, the jurisdiction in which they find themselves will also affect

\textsuperscript{66} \textit{In re} Crosby, 261 B.R. 470 (2001) ("[B]y filing forms with IRS, credit union exposed debtors to possible tax liability on account of this ‘cancelled’ debt and could not as matter of equity be granted allowed claim for this same indebtedness."); \textit{In re} Welsh, 2006 WL 3859233 (2006) ("It would be inequitable . . . to require that [the debtor-defendant] report the discharge of debt as income on his federal tax return or face the potential tax consequences and hold that the plaintiff may continue to hold him liable on the debt . . . ."); Franklin Mgmt. Corp. v. Nicholas, 2001 WL 893894 (2001); \textit{In re} Reed, 492 B.R. 261 (2013) ("It is inequitable to require a debtor to claim cancellation of debt income as a component of his or her gross income and subsequently pay taxes on it while still allowing the creditor, who has reported to the Internal Revenue Service and the debtor that the indebtedness was cancelled or discharged, to then collect it from the debtor.").

\textsuperscript{67} \textit{See id.}

potential strategies and recourse actions when faced with the possibility of receiving a Form 1099-C filing.

a. Implications for a Creditor

Having the majority approach in their favor is an advantage for creditors. A creditor has several options when deciding whether to issue a Form 1099-C when a debtor is in a jurisdiction that adopts the majority approach. Specifically, a creditor could confidently file a Form 1099-C and still pursue collection based on the established majority approach, which holds that the filing of a Form 1099-C does not discharge a debt as a matter of law.69 On the other hand, if the paramount goal was to collect the debt the creditor could decline to issue the Form 1099-C until absolutely necessary (for tax reporting purposes).70 Overall, under the majority approach, the creditor is in the advantageous position of being able to collect the debt even after issuing a Form 1099-C to a debtor.

The minority of courts have held that the filing of a Form 1099-C does in fact discharge a debt.71 Accordingly, if the debtor is located in a jurisdiction that adopts the minority approach, the strategy that a creditor would employ would likely change. There, a creditor would probably refrain from issuing a Form 1099-C filing if the creditor still intended to collect the debt.

Finally, if a debtor is located in a jurisdiction that has yet to decide the issue, a creditor has a decision to make. If collection is the most important thing, then a creditor may elect to play it safe and refrain from filing a Form 1099-C until the creditor determines that is has to under the IRC. Alternatively, a creditor could choose to file a Form 1099-C and continue to

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70 26 IRC § 61(a)(12).
pursue collection. The creditor would then argue that the majority approach to a court should a dispute arise.

Since the location of the debtor, and not the creditor, ultimately determines where claims are brought, single a creditor may be subject to both majority and minority jurisdictions when dealing with Form 1099-C claims. Should creditors have uniform policies in place for dealing with Form 1099-C actions and outstanding claims, either to issue or refrain? Or should the approach be case specific depending on the jurisdiction where the claim falls? This is a decision that must be based on the business model and internal policies of individually effected companies. What is certain is that entities that may face Form 1099-C filings would be wise to address the matter before hand.

b. **Debtor Implications**

Receiving a Form 1099-C filing has different ramifications for debtors depending on the jurisdiction in which they receive the filing. In a majority jurisdiction the receipt of the filing should not be accepted as an automatic cancellation of debt. The majority stance has shown that receipt of Form 1099-C filings does not discharge the indebtedness as a matter of law.\(^72\) Instead, a debtor in receipt should proceed as if the creditor will still seek collection, until confident that the debt has been cancelled. The debtor would need to wait for an identifiable event signifying that the debt has been cancelled before proceeding as if there has been a true discharge of indebtedness.\(^73\) In majority jurisdictions the debtor could very well be subjected to an initial double payment, via mandatory COD income reporting for tax purposes and a creditor still seeking collection on the debt included in the Form 1099-C filing. Importantly, if the creditor is


\(^{73}\) *See*, CFR § 1.6050P-1(a).
successful in collecting any additional amounts after it has filed a Form 1099-C, the debtor should be sure to amend his previous tax returns to reflect this change in position. By doing so, the debtor should be entitled to a refund for that period (though if the debtor is in bankruptcy, any refund will likely be included as property of the estate and will be used to satisfy the creditors’ claims).

If the debtor is receiving it in a minority jurisdiction more reliance can be placed in the Form 1099-C filing that the debt has been cancelled. The developing theme of the minority decisions has demonstrated that receiving the filing and acting on it as if the debt has been canceled can be read as a true cancellation of debt.\textsuperscript{74} A debtor is less likely to be subjected to initial double payment (via taxes on COD income and debt repayment), when receiving the Form 1099-C filing in a minority jurisdiction.\textsuperscript{75}

In a neutral jurisdiction the best course of action would depend on the position of the debtor. If a double payment is absolutely not an option, then the debtor should not rely on the discharge until it has been confirmed. If the debtor could stomach a double payment (and eventual recover of some funds), then reliance on the filing would be a palatable option.

Regardless of the jurisdictional stance, there is a silver lining for debtors Importantly, if the creditor is successful in collecting any additional amounts after it has filed a Form 1099-C, the debtor should be sure to amend his previous tax returns to reflect this change in position. By doing so, the debtor should be entitled to a refund for that period (though if the debtor is in bankruptcy, any refund will likely be included as property of the estate and will be used to satisfy


\textsuperscript{75} See generally id.
the creditors’ claims). This is admittedly less than optimal for a debtor who is strapped for funds, but serves as a future respite to alleviate some of the earlier inequity.

**Conclusion:**

Overall, the issues surrounding Form 1099-C filings are complex. Determining whether there has been a discharge of indebtedness after a Form 1099-C filing has been made is not an easy task. The decisions handed down across different courts have split the issue into two distinct camps. The majority focused their holdings on a strict reading of the regulations while granting deference to the IRS and guidance letters provided on the issue. The minority of courts focused more on principals of fairness and equity, and afforded the IRS a lower standard of deference due to contradictions discovered between the guidance letters and the regulations. Currently creditors seeking payment after filing a Form 1099-C have the majority of the case law at their disposal. This advantage is apparent in the numerous affirmative options creditors have when determining whether to file a Form 1099-C, seek debt payment, or pursue both. Depending on the jurisdiction where the action is taking place a debtor can stave off such initial double payments if they react appropriately. The issue is far from settled. It will be interesting to see if a minority approach continues to develop, using themes of equity and fairness, to counter the entrenched majority position.

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