



March 2015 Tip of the Month 1099-C, Cancellation of Debt

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March's Tip of the Month focuses on the IRS tax form 1099-C, Cancellation of Debt. Around this time of year, clients begin to see these forms in their mailbox and they often come as a surprise. This tip identifies why the form is issued, some exclusions that may apply and if a client is still legally responsible for the debt.

1099-C, Cancellation of Debt

A 1099-C form reports Cancellation of Debt (COD) Income. COD Income is the cancellation of debt that must be included in a taxpayer's gross income when the client files their taxes, unless they qualify for an exclusion or exception.

A creditor is required to file the form with the IRS if it cancels \$600.00 or more in debt in a given year. A courtesy copy should be sent to the client.

Events that Trigger a 1099-C

Many events can trigger a creditor to file a 1099-C. The three most common events VLN sees are:

1. The client negotiated a settlement to pay a debt for less than the amount owed and the creditor forgave the rest.
2. The client did not pay anything on a debt for at least three years and there has been no significant collection activity for the past 12 months.
3. The client filed bankruptcy and the debt was discharged. (Not all creditors will file a 1099-C after a bankruptcy filing)

Box 6 of the 1099-C form contains a code that identifies why the form was issued.¹

Excluding Canceled Debt from Income

There are several exclusions that a client can use in order to exclude the amount of cancelled debt, and therefore not pay taxes on it. The most common two for VLN's client population are:

1. **Bankruptcy Exclusion:** Not all creditors will file a 1099-C on discharged debt but if they do, the client will need to use the bankruptcy exclusion. Debt canceled in a Chapter 7, 11 or 13 bankruptcy case is not included in income.² To show that the debt was discharged in bankruptcy and is excluded from income, attach Form 982 to the federal income tax return.

¹ Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments <http://www.irs.gov/pub/irs-pdf/p4681.pdf>

² Topic 431 - Canceled Debt – Is It Taxable or Not? <http://www.irs.gov/taxtopics/tc431.html>

2. Insolvency Exclusion: If the client was insolvent immediately before the cancellation of debt, do not include the cancelled debt in income. Insolvency means the total of all debts was more than the fair market value of all assets immediately before the cancellation.³ To show insolvency attach Form 982 to the federal income tax return.

Example: Your assets are worth \$35,000 and your debts total \$45,000, so you are insolvent to the tune of \$10,000. You receive a 1099-C form from a creditor cancelling \$5,000 of your debt. You do not have to report any of that money as income on your tax return because you are insolvent.

Creditors Can Still Collect and Sue Over Canceled Debt

If the 1099-C has been issued because there have been no payments and no collection activity for the past several years, the issuing of 1099-C alone does not bar a creditor from again trying to collect or sue on the debt. In Minnesota the six year statute of limitations⁴ will most likely dictate how the creditor will proceed.

Even if the client paid taxes on the canceled debt, the creditor can still proceed with collection efforts. Most jurisdictions, including the District of Minnesota⁵ look to IRS guidance for interpretation of the 1099-C: “The Internal Revenue Service 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.”⁶ In other jurisdictions there has been some movement in finding that a 1099-C issued by a creditor relinquishes the creditor’s right to collect on the debt, but this appears to be a minority position.⁷

Bottom Line

If a 1099-C is issued the client should not ignore it. If the client does not report it as income on their federal tax return or use an exclusion, they may face an IRS tax bill in the future.

Please note that the information provided in this tip is not a substitute for advice from a qualified accountant or tax attorney. Low-income clients in the metro area seeking assistance completing their tax filings can contact:

Prepare + Prosper (Formally AccountAbility Minnesota)

Phone: 651-262-2169

www.prepareandprosper.org

More tax services found here:

http://www.revenue.state.mn.us/individuals/individ_income/Pages/Free_Tax_Preparation_Sites.aspx

³Publication 4681 (2014), Canceled Debts, Foreclosures, Repossessions, and Abandonments
<http://www.irs.gov/publications/p4681/index.html>

⁴ Minn. Stat. [§541.05](#) (2012)

⁵ Atchison v. Hiway Fed. Credit Union, 2013 WL 1175020 (2013)

⁶ See I.R.S. Info. 2005-0207, 2005 WL 3561135 (Dec. 30, 2005) (“IRS Letter”).

⁷ Fairness Over Deference: The Shifting Landscape of Creditors Rights to Claims and Debtor Protection Regarding the Issuance of Form 1099-C, 6 ST. JOHN’S BANKR. RESEARCH LIBR. NO. 7 (2014).

<http://www.stjohns.edu/sites/default/files/documents/law/bankruptcy/bank-research2014-07-christensen.pdf>