

Cancellation of Debt and Form 1099-C Reporting Requirements

By Jessica Mac Naughton, Senior Manager

January 2011

The current economic downturn has led to an increase in the number of charge-offs, foreclosures, and cancellations of debt. After a debt has been cancelled, a financial institution must determine whether Form 1099-C, Cancellation of Debt, should be filed. This is not always an easy question to answer. This article will explore the reporting requirements of Form 1099-C, including when to file, what to report, how much to report, and the effect on the debtor.

When to File

A financial institution must file Form 1099-C when a debt of \$600 or more has been cancelled. For purposes of the \$600 filing threshold, it is not necessary to aggregate debts. In other words, multiple cancellations of the same debtor do not have to be combined for reporting purposes (unless the separate cancellations are under a plan to avoid the Form 1099-C filing requirements). The Form 1099-C must be filed by January 31 of the year following the cancellation of debt and is filed regardless of whether the debtor needs to include the cancellation of debt as taxable income.

It is important to note that cancellation of debt is not necessarily the same thing as a charge-off. A charge-off is an accounting entry and a cancellation of debt is a legal decision. Cancellation of debt needs an "identifiable event" to occur before a Form 1099-C is required. The easiest way to define an identifiable event is when the financial institution is no longer attempting to collect the debt. The following are eight specific identifiable events listed in the regulations, as follows:

- Discharge in bankruptcy when indebtedness was for business or investment purposes. Personal bankruptcy is not a reportable event.
- Cancellation or extinguishment of indebtedness rendering a debt unenforceable under a receivership, foreclosure, or similar proceeding.
- Cancellation or extinguishment by the statute of limitations or by a judicial decree.
- Cancellation or extinguishment of indebtedness pursuant to a creditor's election of foreclosure remedies.
- Cancellation or extinguishment of indebtedness pursuant to a probate or similar proceeding (i.e., the estate is insolvent).
- Discharge of indebtedness pursuant to an agreement between an applicable financial entity and a debtor, i.e., a "loan workout."
- Discharge of indebtedness pursuant to a creditor's decision or defined policy not to continue collection activity.
- Expiration of the "nonpayment" or testing period of at least a 36-month period ending on December 31 (plus any time when the creditor was precluded from collection activity by a stay in

bankruptcy or similar bar under state or local law) where no payments have been received and the creditor has not undertaken significant, bona fide collection activity in the prior 12-month period ending on December 31. Significant, bona fide collection activity does not include nominal or ministerial collection action, such as an automated mailing.

For example, a loan has had no payments in 2008, 2009, or 2010; also in 2010, the bank did not attempt to collect the debt. In 2010, the debt is deemed constructively forgiven and reporting is required.

What to Report

After it has been determined when to file, the next step is to determine what information needs to be reported. For 2010, the Form 1099-C requires the following information:

- Debtor's name, address, and federal identification number – The debtor is the person(s) that is (are) personally liable for the debt (all parties that are liable for the debt need to have a Form 1099-C issued to them; however, there is no requirement to issue a Form 1099-C to guarantors).
- Date of the cancellation.
- Amount of debt cancelled (see discussion below).
- Amount of interest included in the cancellation amount.
- Description of the debt.
- Notification if the debtor was personally liable for the debt.
- Notification if the debtor was in bankruptcy.
- Fair market value of the property.

How Much to Report

A debt is any amount owed to a financial institution, including principal, stated interest, fees, penalties, administrative costs, and fines. The amount of debt cancelled may be all or only part of the total amount owed. For a lending transaction, a financial institution is only required to report the stated principal that has been cancelled; however, if a bank chooses to report interest as part of the cancelled debt (in box 2), the interest must be shown separately (in box 3).

Note that the amount reported is reduced by the fair market value of property received by the financial institution. The fair market value is the bid price at the date of foreclosure, unless the debtor can provide clear and convincing proof that the fair market value is different. If the cancellation of debt occurs due to a deed in lieu of foreclosure, the fair market value is the lesser of appraised value or the amount of the debt.

Consider the following example: John Doe has an outstanding balance of \$500,000 on his mortgage. The appraised value of his

home is \$350,000, and he has \$25,000 of accrued interest on his loan. John agrees to deed his home to the bank in lieu of foreclosure. His bank will issue him a Form 1099-C for \$175,000 as shown below:

8585 <input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED		OMB No. 1545-1424	
CREDITOR'S name, street address, city, state, ZIP code, and telephone no. ABC BANK 123 MAIN ST ANYTOWN, WI		1 Date canceled 12/1/2010	2010 Cancellation of Debt
CREDITOR'S federal identification number 39-0000000		2 Amount of debt cancelled \$ 175,000	
DEBTOR'S identification number 123-45-6789		3 Interest included in box 2 \$ 25,000	
DEBTOR'S name JOHN DOE		4 Debt description MORTGAGE	
Street address (including apt. no.) 456 MAIN ST		5 Was borrower personally liable for repayment of the debt? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
City, state, and ZIP code ANYTOWN, WI		6 Check for bankruptcy <input type="checkbox"/>	
Account number (see instructions)		7 Fair market value of property \$ 350,000	
Form 1099-C		Department of the Treasury - Internal Revenue Service	
Do Not Cut or Separate Forms on This Page		Do Not Cut or Separate Forms on This Page	

Summary

The current economic downturn has led to a significant increase in the number of debt cancellations. This makes it even more important to understand the information reporting requirements for cancellation of debt: when to file, what to report, how much to report, and the effect on the debtor. The information provided above is intended to be a high-level overview of these requirements. Should you require additional assistance, please consult your Wipfli tax advisor.

About the Author

A certified public accountant, Jessica Mac Naughton provides tax compliance, planning, and research services to clients. She understands tax laws, and her clients rely on her to apply them to their situation and to their advantage. Jessica assists with IRS and Wisconsin Department of Revenue franchise and sales and use tax audits. Her expertise also includes consolidated and multistate tax returns.

About Wipfli LLP

The mission of Wipfli's Financial Institutions Practice is to educate, advise, and assist financial institutions in successfully navigating the complex environment they face. Our clients range from small community financial institutions to multi-billion dollar organizations. The practice consists of certified internal auditors, certified compliance specialists, former financial institution personnel, former regulators, and licensed certified public accountants regionally recognized for their knowledge and expertise. Whether your needs include regulatory compliance, profit improvement, risk management, strategic planning/board development, information technology, audit, or tax, let our experts assist you. For more information, visit www.wipfli.com.

Effect on the Debtor

Even though the financial institution is required to issue a Form 1099-C, this does not mean that the debtor is required to include the cancellation of debt as taxable income. The following are specific exceptions within the Internal Revenue Code that allow a debtor to exclude debt relief from taxable income:

- Insolvency
- Bankruptcy
- Qualified principal residence exclusion
- Student loans
- Qualified farm debt
- Qualified real property business debt

The debtor could also have a gain or loss resulting from the foreclosure transaction. The foreclosure is considered a deemed sale of the debtor's property. The transaction would result in a gain or loss if the deemed sales price is more or less than the income tax basis in the property.