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Legal Alert

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QUESTION: **WILL I JEOPARDIZE MY RIGHT TO COLLECT IF I FILE A 1099 FORM ON THE DEBTOR?**

ANSWER: **BE CAREFUL TO COMMUNICATE THAT YOU STILL INTEND TO COLLECT THE DEBT, EVEN THOUGH YOU HAVE FILED THE 1099 WITH THE I.R.S.**

Creditors sometimes say that they will threaten to file 1099 forms if debtors don't pay. What they mean is that they will file Form 1099-C with the Internal Revenue Service ("IRS") indicating that the debtors should pay income tax on the unpaid debts. Threatening to turn someone into the IRS in order to make them pay your debt could be viewed as extortion, however. The creditor either has justification for the IRS filing, or it does not. "Threatening" is not one of the reasons recognized by the IRS to require a filing.

You also need to be cautious in your Form 1099-C filings with the IRS not to create any defenses for your debtors. Careless 1099 filings may be construed as intentional discharges of indebtedness, letting the debtors avoid repayments.

What is a form 1099-C?

A Form 1099-C is commonly labeled a "Cancellation of Debt." Internal Revenue Code, 26 U.S.C. § 6050P requires the filing of the Form 1099-C when one of eight "identifiable events" triggers the reporting obligation by the creditor. The identifiable events include the filing of bankruptcy by the debtor, the expiration of the statute of limitations, the conclusion by the creditor that the debt is uncollectable, or the creditor's decision "to discontinue collection activity." I.R.C. § 1.6070P-1(b)(2)(i). Form 1099-C basically tells the Internal Revenue Service that the creditor doesn't think it can collect the debt. Under certain circumstances, the IRS will tax the gain received by the debtor by failing to repay the loan.

Who would have the nerve to raise this defense?

Avery T. Cashion, III signed a promissory note in the amount of $2,000,000.00 payable to the Bank of Asheville ("Bank") in August 2006. Mr. Cashion defaulted on the debt and in September 2010 the Bank sued for full payment plus interest. The Bank must have had other bad debts because it closed and the Federal Deposit Insurance Corporation ("FDIC") was named the receiver and liquidating agent. The FDIC continued with the lawsuit to collect the debt from Mr. Cashion. Among his defenses, Mr. Cashion said that the Bank had sent him a "Cancellation of Debt" Form 1099-C and that meant that he didn't need to pay anymore.

In *FDIC v. Cashion,* 720 F.3d 169 (4th Cir. 2013), the Fourth Circuit Court of Appeals told Mr. Cashion that he was wrong:

> Cashion's claim of cancellation or assignment of the Note is based solely on the 1099-C Form. He never proffered a reason for cancellation or any evidence beside the 1099-C Form he received to prove cancellation. Cashion admitted he had not paid the Note. Only Cashion's bald speculation ties his receipt of the 1099-C Form to a specific reason as to why the Bank would have issued it.

As the court noted, a creditor might be legally required to file a Form 1099-C where no actual discharge of indebtedness has occurred or is even contemplated.

The court looked at the IRS regulations and decided that creditors have to file 1099-C forms to comply with IRS tax reporting requirements. The IRS issued Information Letters saying 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." According to the IRS, filing a Form 1099-C satisfies the reporting requirements of the Internal Revenue Code, but does not "prohibit collection activity after a creditor reports by filing a Form 1099-C."

Although the district court in the *Cashion* case held that "a Form 1099-C does not itself operate to legally discharge a debtor's liability," other courts have thought that the notices at least create issues of fact. *Amtrust Bank v. Fossett*, 224 P.3d 935 (Ariz. App. 2009).

In the *Cashion* case, the fourth circuit said that the *Amtrust Bank v. Fossett* case represented a small minority of lower court opinions. That minority view makes the filing of a Form 1099-C prima facie evidence of intent to discharge indebtedness. If the form has been filed with the IRS, the creditor must show evidence that the debt had not been cancelled. The creditor would need to show that the form was required by another "identifiable event" under the IRS regulations, rather than actual discharge of indebtedness.

The fourth circuit approach seems to make sense. After all, if the creditor had chosen to actually discharge the indebtedness, why is it suing to collect?

How do you keep debtors from raising Form 1099-C filings as defenses?

In the *Cashion* case, the court agreed with the FDIC and entered judgment in the amount of $2,111,427.12, together with accruing interest against Mr. Cashion. A creditor does not let the debtor off the hook automatically when it sends the Form 1099-C as required by the IRS. The *Fossett* case suggests that lenders can avoid the defense by sending notices to borrowers that they intend "to continue debt collection activities."

Let me know if you have questions about overcoming creative defenses raised by your debtors.