

Do Not Use Form 1099-C as a Collection Technique

Cross References

- IRC §108
- Form 1099-C, *Cancellation of Debt*
- Office of Professional Responsibility, Issue Number 2015-02, February 5, 2015

In general, gross income means all income from whatever source derived unless the Internal Revenue Code provides for a specific exemption. Included in the definition of gross income is the discharge of indebtedness [IRC §61(a)(12)]. A key principle in taxing a discharge of indebtedness centers on the concept that the taxpayer received funds in the form of some kind of loan that was not taxed because the taxpayer was obligated to repay the loan at a later date. If at a later date, the taxpayer is no longer obligated to repay the loan, the debt discharged becomes taxable, unless one of the debt forgiveness exclusions under the Internal Revenue Code applies.

What if, however, services are provided to the taxpayer in exchange for an obligation to pay? If the taxpayer does not pay for the services received, and the service provider cancels the obligation to pay, is the taxpayer obligated to pay tax on the value of the services received? This question is sort of addressed in a recent bulletin issued by the IRS Office of Professional Responsibility. The bulletin responded to the following question:

“What are the Circular 230 implications, if any, for a Tax Professional who, as an alternative to pursuing collection of an earned fee from a client, files with the IRS a Form 1099-C, *Cancellation of Debt*, reporting the amount of the client’s unpaid bill as a discharged debt?”

“My firm and I want to use Forms 1099-C, as a collection technique with delinquent/nonpaying clients. I am a tax professional subject to Circular 230. I own and operate a small firm that provides various tax representation services for compensation. My firm usually enters into a written fee agreement with a client for the services agreed upon. For most clients, the firm does not require a retainer or the payment of fees in advance. The firm generally bills clients for the services after the fact, requesting payment within 30 days. Invoices unpaid after 30 days are considered delinquent and treated as subject to collection regardless of whether the client disputes the liability.”

“We periodically write-off balance-due amounts as uncollectible based on established criteria. As to amounts treated as non-collectible, the firm would like to complete and file Forms 1099-C identifying each such client as the “debtor” and reporting the unpaid account balance as the “amount of debt discharged” in box 2 of the form. The firm would simultaneously send Copy B of the form to the

client for purposes of reporting the discharged amount on the client's income tax return(s). The goal would be to encourage the client to pay, or make him/her report additional income for our "free" services. I am unsure as to whether this business practice is consistent with my obligations under Circular 230."

The IRS response to this letter was somewhat vague. The IRS warned the letter writer that tax professionals subject to Circular 230 have a responsibility to submit forms to the IRS that are factual and correct. If a practitioner were to use Form 1099-C as a collection technique when facts and circumstances do not warrant the issuance of a Form 1099-C, the practitioner could be in violation of Circular 230. While not answering the question directly, the IRS reminded the tax professional what Form 1099-C is used for.

Whether there has been a discharge of debt that must be treated as income to a taxpayer, and the tax year in which the income is realized, are questions of fact. Whether there is a debt that can be discharged is also a question of fact, as it generally occurs when a taxpayer receives funds that are not includible in income, because the taxpayer is obligated to repay the obligation at a later date.

IRC section 6050P establishes the requirement to issue a Form 1099-C when reporting a discharge of debt. The filing requirement applies to "applicable entities" and the requirement does not apply to any discharge below \$600. An "applicable entity" is defined as an "executive, judicial, or legislative agency" of the U.S. or an "applicable financial entity," such as a bank, savings and loan association, credit union, the FDIC, or "any organization a significant trade or business of which is the lending of money."

The IRS said it is difficult to conceive of a situation in which a tax professional, principally engaged in providing tax services will be an "applicable entity" justifying the use of Form 1099-C to attribute income to an arguably scofflaw client for the nonpayment. However, every case will depend on its own particular facts and circumstances, including the existence (or not) of "debt," with the crux of the analysis turning on whether the client can be said to have received previously untaxed funds from an applicable entity for which there is an obligation for repayment.