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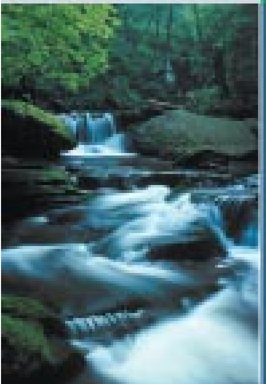
Beware of the IRS if You Settle or Default on a Debt

IRS regulations could cost you money if you settle a debt for less than the full amount owed with certain creditors or you default on a debt and the creditor writes it off.

The rule applies to banks, credit unions, savings and loan associations and all other financial institutions that have the authority to receive deposits and make loans on amounts of $600 or more.



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Debts You Settle

If a financial institution agrees to forego at least $600 of a debt you owe, the IRS will consider the amount you didn't pay as income to you. The creditor will be required to send you and the IRS a Form 1099-C or 1099-A at the end of the tax year. These forms are for the report of miscellaneous income, which means that when you file your tax return for the year in which your debt was forgiven, you must include on your return the "income" amount on the Form 1099-C or 1099-A. Most debtors receive a Form 1099-C or a 1099-A after negotiating the following kinds of settlements: a mortgage lender forgiving the balance owed after a short-sale of a home or a foreclosure sale, a car lender forgiving the balance due after a repossession sale, or a credit card issuer taking less than the full amount owed on an outstanding bill.

Debts Written Off

Increasingly, creditors issue a Form 1099-C or 1099-A after writing off a bad debt — that is, ending collection efforts (including selling the debt to a collection agency) and getting a tax break for the income lost.

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The IRS requires that financial institutions holding bad debts write them off three years after default at the latest. However, a financial institution may establish an earlier date as long as it applies that earlier date to all debtors. A bank, for example, cannot write off some debts a year after default and other debts three years after.

Creditors and collection agencies increasingly use the threat of 1099 income to try to get debtors to pay up.

Often, just before writing off a debt, a creditor will send a letter stating something like, "This is a final demand for payment. If you do not pay the full balance within 30 days, your account will be written off and the IRS will be notified. You may experience a tax liability because of your delinquency."

The following January you are likely to receive a Form 1099-C or 1099-A, and you will have to report the amount written off as income. To add insult to injury, the IRS and credit industry have taken the position that a business that holds your bad debt (such as a collection agency that buys it from a creditor) can still try to collect from you, even though the debt has been written off.

If, after listing the income on your tax return, you make any payments on the debt or the creditor sues you and seizes some of your property to satisfy the debt, you will have to file an amended tax return to get any refund due to you.

Exceptions

There are five exceptions stated in the Internal Revenue Code, three of which apply to consumers. Even if the financial institution issues a Form 1099-C or 1099-A, you do not have to report the income if:

- The cancellation or writing off of the debt is intended as a gift (this would be unusual)
- You discharge the debt in bankruptcy
- You were insolvent at the time the creditor waived or wrote off the debt

For example, let's say your credit card balance reaches $5,000 and you can't afford to pay it. After several conversations with your bank's collections department, you agree to pay $2,600 to settle the entire bill.

The January after the bank gets your check, it sends you (and the IRS) a Form 1099-C showing that you "earned" $2,400 — the

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amount your bank forgave you to settle the debt. When you file your tax return that April, you must include the $2,400 as part of your total income unless you discharge the debt in bankruptcy or can show that you were insolvent.

The Internal Revenue Code does not define what is meant by insolvent. Generally, it means that your debts exceed the value of your assets at the time the debt was settled or written off. Therefore, to figure out whether or not you are insolvent, you will have to total up your assets and your debts, including the debt that was forgiven.

Let's say your assets are worth $35,000 and your debts total $45,000. You are insolvent to the tune of $10,000. If any debts are forgiven or written off up to that amount, you will not have to count the Form 1099-C or 1099-A income as part of your income for the year. You will have to initially include the amount on your tax return, but then you can back it out. (A tax preparer can help you do this.) You will have to attach supporting documentation, such as a statement of your assets and liabilities at the time of the settlement or write off. If you simply list the income and then back it out without documentation, expect an IRS audit or adjusted bill.

Continuing, let's say your assets are still worth $35,000 and your debts still total $45,000, but your creditor forgives a $14,000 debt. This time, you will have to initially include the entire $14,000 on your tax return, but then you can back out $10,000, meaning that $4,000 will be included as part of your income. Again, you will need to attach a statement of assets and liabilities.

While most people qualify as insolvent, many people do not. You may be particularly vulnerable if you have an IRA, 401(k), 403(b), Keogh plan or other retirement plan you don't want to use to pay the debt because you need the money for retirement and would be hit with a substantial penalty for early withdrawal. In fact, one common scenario is the person whose house has depreciated in value, who walks away from it owing the bank a chunk of money (let's say $50,000) and whose only other asset is a sizeable retirement fund, such as $65,000 in a 401(k).

The last thing the person wants to do is take the 401(k) money and fork it over to the bank. But, strictly speaking, that person is not insolvent (assuming no other debts or assets) and would have to report the $50,000 as income for the year, boosting his tax liability by $15,500 (assuming a 31 percent tax bracket).

If your debts are enormous and your financial institution is willing to settle for less than you owe, it could cost you a lot in the end.

If your debts are enormous and your financial institution is willing to settle for less than you owe, it could cost you a lot in the end. Similarly, if you owe a lot and plan on walking away from your debts, your liability may shift to the IRS. Before taking a settlement or turning your back on your creditors, have a tax preparer calculate your tax liability including any likely Form 1099-C or 1099-A income.

If your tax bill will be too high and you cannot prove you are insolvent, you may file for bankruptcy and discharge the entire debt. If you decide to go that route, timing becomes an important issue.

Be sure to file for bankruptcy before April 15 of next year. Before that date, your debt more than likely qualifies as a dischargeable debt in bankruptcy. After that date, it becomes a part of your income tax liability and won't be

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dischargeable in bankruptcy for quite some time, if ever.

And bear in mind this fact: even if you don't get a Form 1099-C or 1099-A from a creditor, the creditor may very well have submitted one to the IRS. You can take the risk that the creditor did not pass the information on to the IRS and "forget" to list the income when you file your tax return. But if the IRS has the information, it will send you a tax bill, or worse, an audit notice.

You can contact the IRS at 1-800-829-1040 and request for a transcript of your current account to determine if any 1099-C's or 1099-A's have been posted to your account. This does not provide assurance though that some have been sent out to the IRS and are in the process of getting posted.

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