**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

**OFFICE OF CHIEF COUNSEL**

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INTERNAL REVENUE SERVICE NATIONAL OFFICE
SIGNIFICANT SERVICE CENTER ADVICE

MEMORANDUM FOR JILLENA WARNER
ASSOCIATE AREA COUNSEL
CC:SB:4:LOU

FROM: Heather C. Maloy
Associate Chief Counsel
(Income Tax & Accounting)

SUBJECT: Request for Significant Service Center Advice
Form 1099-C Guidance

This Significant Service Center Advice responds to your memorandum dated February 22, 2002. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Significant Service Center Advice should not be cited as precedent.

ISSUE

How should a taxpayer seek relief when he/she has reported income from the cancellation of a consumer debt and in a subsequent year makes a repayment on the debt?

CONCLUSION

A taxpayer who includes reports income from discharge of indebtedness but who later repays the debt may file a claim for refund for the year the income was reported.

FACTS

In a typical situation, a cash basis individual taxpayer defaulted on a consumer credit obligation, although the debt was not formally forgiven or compromised. The creditor, pursuant to § 1.6050P-1(b)(2)(iv) of the Income Tax Regulations, issued Form 1099-C to the taxpayer. The taxpayer included the amount in income for that year. The taxpayer paid the debt in a later year, either voluntarily or because of enforced collection action by the creditor.

LAW AND ANALYSIS:

§ 61(a)(12) provides that gross income includes income from discharge of indebtedness.

Section 6050P requires certain financial entities to report discharges of indebtedness of $600 or more during any calendar year. Under § 1.6050P-1(a) discharge of indebtedness must be reported if one of eight identifiable events occurs. The regulations make it clear that if one of the identifiable events has occurred a discharge of indebtedness is deemed to have occurred "[s]olely for purposes of the reporting requirements" whether or not an actual discharge of indebtedness has occurred.

The eight identifiable events specified in the regulations include a decision to discontinue collection activity by the creditor and the expiration of the "non-payment testing period." Under § 1.6050P-1(b)(2)(iv), there is a rebuttable presumption that an identifiable event under the regulations has occurred during a calendar year if a creditor has not received a payment on an indebtedness at any time during a testing period ending at the close of the year. The testing period is a 36-month period, increased by times during which the creditor is precluded from engaging in collection by a stay in bankruptcy or a similar bar under state or federal law.

The timing requirements discussed above are for reporting purposes only and do not automatically mean that the debtor must take the amounts reported into income in the year in question. While in most cases, the amounts are required to be taken into income under § 451 in the same year that they are required to be reported by the creditor, they do not have to be.

Generally, income from discharge of indebtedness must be taken into income when there is an "identifiable event." Cozzi v. Commissioner, 88 T.C. 435, 445 (1987). When a debt has been canceled or discharged depends on the substance of the transaction and is determined on the facts and circumstances of each case. Id.; Miller Trust v. Commissioner, 76 T.C. 191, 195 (1981); Estate of Bankhead v. Commissioner, 60 T.C. 535, 539 (1972); Randolph v. Commissioner, T.C. Memo. 2000-248.

Events that can trigger cancellation of indebtedness income can include such events as a formal settlement agreement, Exchange Security Bank v. United States, 345 F. Supp. 486 (N.D. Ala. 1972), aff'd 492 F.2d 1096 (5th Cir. 1974); Rivera v. Commissioner, T.C. Memo. 1993-609 ; the abandonment of security, Cozzi, 88 T.C. 435; Carlins v. Commissioner, T.C. Memo. 1988-79; a unilateral discharge by a creditor, Waterhouse v. Commissioner, T.C. Memo. 1994-467; and the entry of an

item on corporate books, Schneller v. Commissioner, T.C. Memo. 1996-62, aff'd without published opinion 129 F.3d 1265 (6th Cir. 1997). Taxpayers who have not reported income reported on Form 1099-C have been required to include those amounts. See, e.g., Johnson v. Commissioner, T.C. Memo. 1999-162; Stoddard v. Commissioner, T.C. Memo. 2002-31; Rinehart v. Commissioner, T.C. Memo. 2002-71.

Under the facts presented, the debt survived as a legally enforceable obligation. Under the case law, this would not be enough to stop the triggering of income for the debtor because, under Cozzi, the debt is viewed as having been discharged the "moment it becomes clear" that it will never have to be paid. 88 T.C. at 445. However, if the particular facts and circumstances presented demonstrate that it was not clear in the year for which the Form 1099-C was issued that the amounts would never be repaid, then the taxpayer did not realize cancellation of indebtedness income in that year and is entitled to a refund. Those facts and circumstances could include (but are not limited to) the creditor issuing a Form 1099-C despite the fact that the debtor made payments within the testing period. Payment of the entire liability in a later year would support a conclusion that the original amount reported should not have been included in income. The proper amount that should have been included if the taxpayer later partially paid the liability would depend on the particular facts in question. Accordingly, the taxpayer may file an amended return if the period of limitations for filing a claim for refund is open.

We considered whether § 1341 could apply instead of requiring that a claim for refund be filed for the year of inclusion. Section 1341, which was enacted in response to United States v. Lewis, 340 U.S. 590 (1951), pertains to the computation of tax for the year in which a taxpayer repays amounts received under a claim of right. Taxpayers who qualify under § 1341 are permitted to pay the lesser of the tax for the year of repayment, computed with the allowable repayment deduction, or the tax for the year of repayment, computed without the repayment deduction, minus the decrease in tax for the prior taxable year that would result solely from the exclusion of the item from gross income for the prior taxable year. The effect of the provision is to give the taxpayer the equivalent of a refund (without interest) for the year of inclusion if the taxpayer is advantaged thereby. Section 1341 applies only if the amount of any allowable deduction exceeds $3,000.

We do not believe that § 1341 applies to this situation. Because § 1341 applies only to situations in which it appears that the taxpayer has an "unrestricted right" to the income, we do not believe that it applies when a taxpayer fails to pay a debt and it becomes apparent that the debt will never be paid. In such a situation, the taxpayer does not have a right to the income and, in fact, still legally owes the debt to the creditor, notwithstanding the issuance of Form 1099-C. Second, a condition to application of § 1341 is that the taxpayer would otherwise be entitled to a deduction for the repayment. Deductions for repayments of amounts included in

income under a claim of right must be deductible under some other section of the Code. See Rev. Rul. 69-115, 1969-1 C.B. 50 (repayment of excess salary); Rev. Rul. 65-254, 1965-2 C.B. 50 (repayment of embezzled amounts); and Rev. Rul. 82-74, 1982-1 C.B. 110 (deduction permitted on repayment of insurance proceeds). Because payments of personal loans are generally not deductible under any provision of the Code, a taxpayer who takes an amount into income because of a cancellation of indebtedness and who later paid that amount cannot deduct the payment.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

We are concerned about your point that the remedy of allowing/encouraging a claim for refund would not apply if a taxpayer paid the debt after the expiration of the period of limitations for claiming a refund for the original year of inclusion. Because we do not believe that § 1341 applies, we considered allowing a deduction in the year of debt payment, but not allowing taxpayers to recompute their liabilities under § 1341. There may be a "reverse tax benefit rule," in which a cash basis taxpayer who properly took an amount into income based on a transaction, rather than a payment, would be entitled to a deduction upon reversal of the transaction, i.e., payment of the prior amount included in income. If that were the case, the statute of limitations would not constitute a bar to the deduction. In Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983), the Supreme Court rejected the argument that the tax benefit rule only applied to "recoveries." "On the contrary, it is to approximate the results produced by a tax system based on transactional rather than annual accounting." Id. at 383. This rationale, if extended, could support a deduction in the year of payment.

Allowing a deduction in the year of payment to the extent of the payment might be an attractive solution to this problem. We note, however, that discharge of indebtedness income is one of the few, if any, items of income that are taxable to cash basis taxpayers without actual receipt of either cash or property. [redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call 202-622-4920 if you have any further questions.