June 24, 2013

Mr. Daniel I. Werfel
Principal Deputy Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on Guidance Concerning Information Reporting for Discharges of Indebtedness

Dear Principal Deputy Commissioner Werfel:

Enclosed are comments on guidance concerning information reporting for discharge of indebtedness. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Rudolph R. Ramelli
Chair, Section of Taxation

Enclosure

cc: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    William J. Wilkins, Chief Counsel, Internal Revenue Service
    Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of Treasury
ABA SECTION OF TAXATION
COMMENTS ON GUIDANCE CONCERNING INFORMATION REPORTING FOR DISCHARGES OF INDEBTEDNESS

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the Board of Governors or the House of Delegates of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Lee G. Zimet, Vice-Chair for the Committee on Bankruptcy and Workouts. Substantive contributions were made by following members of the Committees on Bankruptcy and Workouts, Administrative Practice, and Banking and Savings Institutions: Kent Anderson, Richard Beck, Bryan Camp, George Hani, Yoram Keinan, and Derek Krozek. The Comments were reviewed by Ken Weil, Committee Chair for the Committee on Bankruptcy and Workouts. The Comments were reviewed by Julian Kim, Council Director for the Committee on Bankruptcy and Workouts, and Frances Sheehy of the Section’s Committee on Government Submissions.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the legal issues addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 24, 2013
EXECUTIVE SUMMARY

On November 9, 2012, the Internal Revenue Service (the “Service”) issued Notice 2012-651 (the “Notice”). In the Notice, the Department of the Treasury (“Treasury”) and the Service invited public comments concerning potential amendments to existing guidance on information reporting for discharge of indebtedness.

Section 1.6050P-1(b)(2)(iv) of the Regulations generally requires that a creditor issue a Form 1099-C to a debtor reporting income from the discharge of indebtedness after a 36-month period of non-payment on a debt obligation (the “36-Month Rule”). The Notice requested comments to help Treasury and the Service determine whether the 36-Month rule should be modified or eliminated.

These Comments set forth our recommendations regarding the 36-Month Rule, as well as other rules regarding information reporting of discharge of indebtedness. We recommend that final Regulations, other future guidance, or revised information returns:

1. Retain the 36-Month Rule in some form.

2. Treat the creditor’s decision to discontinue collection activities as an identifiable event.

3. Combine (i) the existing identifiable event with respect to the defined policy of the creditor with (ii) the 36-Month Rule, so that an identifiable event would occur based upon the creditor’s defined policy or a 36-month period of non-payment, if earlier.

4. Prohibit creditors from issuing a Form 1099-C while (i) significant, bona fide collection activities are ongoing by the creditor (or an assignee or a third party collection agency), or (ii) the creditor is contemplating or negotiating a sale (or a packaging for sale) of a debt obligation to a third party.

5. Clarify that a Form 1099-C needs to be corrected if subsequent events occur that are inconsistent with the conclusion that the debt obligation was discharged in a prior calendar year (e.g., subsequent collection activities or receipt of a payment).

6. Amend section 1.6050P-1 of the Regulations to add some factual examples.

7. Modify the existing Form 1099-C and supporting instructions to better inform debtors (and their tax preparers) of potential exclusions.

1 2012-52 I.R.B. 773.
8. Combine the reporting for both sections 6050J (Form 1099-A, reporting Acquisition or Abandonment of Secured Property) and 6050P (Form 1099-C) on a single form.

9. Provide guidance regarding the constructive discharge of indebtedness.

10. Clarify the appropriate information reporting under section 6050P with respect to disregarded entities, grantor trusts, and bankruptcy estates.

11. Treat a deemed exchange of debt obligations pursuant to section 1.1001-3 of the Regulations as an identifiable event requiring a Form 1099-C.

12. Consider the interrelationship of the 24-month period with respect to waivers of default rights in the substantial modification rules (section 1.1001-3 of the Regulations) with the 36-Month Rule.

DISCUSSION

I. Introduction

This introductory section discusses cancellation of debt (“COD”) income in general and the applicable information reporting requirements under section 6050P.²

A. COD Income in General

Generally, a taxpayer realizes income from the discharge of indebtedness if the amount owed under a debt obligation is reduced or the obligation to repay is eliminated. Such income is commonly referred to as COD income. Not all debt reductions result in COD income and a variety of factors affect the amount of COD income realized. As a general rule, a taxpayer includes realized COD income in gross income, unless an exclusion provision applies.³

In certain instances, the discharge of a debt obligation results in the realization of income that is not treated as COD income. This can occur when the relationship between the debtor and creditor suggests that the discharge is unrelated to the debtor-creditor relationship. For example, the cancellation of employee debt by an employer is generally

² References to a “section” herein are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise noted.

³ I.R.C. § 61(a)(12) and Reg. § 1.61-12(a).
treated as income from the compensation of services.\(^4\) Income realized from the
discharge of a debt obligation that is recast as non-COD income is not eligible for
exclusion under section 108(a) (e.g., the insolvency and bankruptcy exceptions). Many
practitioners refer to income from the discharge of indebtedness that is recast as another
form of income as “spurious” discharge income.\(^5\)

Section 108(e)(2) provides for an exclusion from COD income to the extent that
payment of a discharged liability would have given rise to a deduction. The logic behind
this provision is to provide symmetry with the tax accounting system. Essentially, the
taxpayer is allowed to offset the COD income against the foregone deduction and is only
required to include the net amount in gross income. Under this provision, cash method
taxpayers are generally able to exclude the discharge of mortgage interest.

Income from the discharge of indebtedness that is related to an item that was
deducted in a prior year can be excluded under the tax benefit rule if the debtor received
no tax benefit from the deduction.\(^6\) However, the ability to use the tax benefit rule
exclusion is extremely limited. Any deduction that creates an unexpired net operating
loss (“NOL”) will be treated as creating a tax benefit,\(^7\) and NOLs can now be carried over
for twenty years.

When the debtor transfers secured assets to a creditor, the amount of COD income
depends upon whether the debt is recourse or nonrecourse. Generally, debt is recourse if
the debtor is personally liable for its repayment, even if the debt is secured by collateral,
and debt is nonrecourse if the creditor is limited to the underlying collateral for payment
upon debtor default.

When the debtor transfers assets to a creditor in retirement of a recourse liability,
the transaction is bifurcated. The debtor is treated as selling the assets for an amount
realized equal to the fair market value of the assets. The debtor generally realizes gain or
loss on the sale. The debtor is also treated as satisfying the debt for an amount equal to
the fair market value of the assets.\(^8\) The excess of the amount of the debt obligation over
the fair market value generally is treated as COD income.

\(^4\) Reg. §§ 1.61-12(a) and 1.83-4(c).
\(^5\) In these comments, a reference to “income from the discharge of indebtedness” is a reference to income
that could be COD income, spurious discharge income, or an item of debt relief that is included in the
amount realized from the sale or disposition of property.
\(^6\) I.R.C. § 111(a) and Rev. Rul. 67-200, 1967-1 C.B. 15.
\(^7\) I.R.C. § 111(c).
\(^8\) Reg. § 1.1001-2(a)(2), -2(c) Ex. (8) and Gehl v. Commissioner, 50 F.3d 12 (8th Cir. 1995).
If, instead of transferring the assets to the holder of the debt, the collateral is sold to a purchaser (other than the creditor) and the purchaser assumes the recourse liability, the debtor has an amount realized on sale of the property equal to the amount of the debt assumed. This is the case even where the debtor does not receive a novation (i.e., is not released from liability). In such instance, the debtor does not realize any COD income.

When the debtor transfers collateral to a creditor in retirement of a nonrecourse liability, the debtor has an amount realized on sale of the property equal to the amount of the debt. In such instance, the debtor does not realize any COD income. However, if a nonrecourse debt is satisfied with cash (and the debtor retains the secured property), the difference between the principal outstanding and the cash repaid is COD income.

Section 108 provides six specific exclusions from gross income: general exclusions for bankruptcy and insolvency, as well as more targeted exclusions for farm debt, real property business debt, principal residence debt, and student loans. The exclusions of section 108 only apply with respect to COD income that is not excluded from gross income (or treated as another form of income) under another provision of the Code. The exclusions under section 108 can apply if “indebtedness of the taxpayer” is discharged (in whole or in part). For purposes of section 108, the term “indebtedness of the taxpayer” means any debt (i) for which the taxpayer is liable, or (ii) for which the taxpayer holds property subject to the debt. In the case of a partnership, section 108 (and the related attribute reduction rules described below) applies at the partner level and not at the partnership level.

The bankruptcy exception applies if the discharge occurs in a “title 11 case.” A title 11 case is a case under title 11 of the U.S. Code (i.e., the U.S. Bankruptcy Code). To qualify for the bankruptcy exception, the “taxpayer” must be under the jurisdiction of a U.S. bankruptcy court, and the discharge must be granted by the court (or be pursuant to a plan approved by the court).

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14 I.R.C. § 108(a)(1), (d)(1).
The insolvency exception applies if the “taxpayer” is “insolvent” immediately before the discharge. A taxpayer is considered insolvent if its liabilities exceed the fair market value of its assets.\(^{17}\) Unlike the bankruptcy exception, the exclusion under the insolvency exception is limited in amount. The limitation equals the amount by which the taxpayer is insolvent immediately before the discharge (i.e., the amount by which liabilities exceed the fair market value of assets).\(^{18}\)

Taxpayers that exclude COD income under the bankruptcy or insolvency exceptions are generally required to reduce their tax attributes by the amount of COD income excluded.\(^{19}\) Attributes are reduced in the following order: (i) NOLs, (ii) general business credits, (iii) minimum tax credits, (iv) capital loss carryovers, (v) asset basis, (vi) passive activity loss and credit carryovers, and (vii) foreign tax credit carryovers.\(^{20}\)

Tax attributes are generally reduced dollar-for-dollar (three-for-one for credits).\(^{21}\) Attribute reductions are made after determining the taxable income for the year of discharge.\(^{22}\) This allows taxpayers to utilize tax attributes to offset any current year income or gain before any reduction occurs. If the amount of COD income excluded exceeds the sum of the taxpayer’s applicable tax attributes, the excess is permanently excluded.\(^{23}\)

**B. Section 6050P**

Section 6050P requires certain creditors to file an information return if the creditor discharges (in whole or in part) the debt of another person.\(^{24}\) No information return is required if the discharge is for less than $600.\(^{25}\)

A creditor is required to file information returns under section 6050P only if the creditor is an “applicable entity.” An applicable entity is defined as:

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\(^{17}\) I.R.C. § 108(a)(1)(B), (d)(3).
\(^{19}\) I.R.C. § 108(b)(1).
\(^{20}\) I.R.C. § 108(b)(2).
\(^{21}\) I.R.C. § 108(b)(3).
\(^{22}\) I.R.C. § 108(b)(4)(A).
\(^{23}\) Reg § 1.108-7(a)(2).
\(^{24}\) I.R.C. § 6050P(a) and Reg. § 1.6050P-1(a)(1).
\(^{25}\) I.R.C. § 6050P(b) and Reg. § 1.6050P-1(a)(1), (2).
1. a “department, agency, court, administrative office, or instrumentality in the executive, judicial, or legislative agency”\textsuperscript{26} of the U.S. Federal\textsuperscript{27} government,
2. a bank, building and loan association, or savings institution to the extent described in sections 581 or 591(a) (and certain subsidiaries thereof),
3. a credit union (and certain subsidiaries thereof),
4. a Federal executive agency (including the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, and the National Credit Union Administration), or
5. any organization that has a significant trade or business of lending money \textit{(i.e., lends money on a regular and continuous basis during the calendar year)}.\textsuperscript{28}

A creditor that is not required by section 6050P to file information returns is permitted to comply voluntarily with the rules.\textsuperscript{29}

The reporting obligations under section 6050P apply to any discharge of a debt obligation over the $600 threshold amount, regardless of whether the debtor is subject to tax on the amount of income.\textsuperscript{30} Thus, the information return is to be filed even if, under section 108 or other provision, the COD income is excludable. This makes section 6050P unusual in the information reporting regime. Few other information reporting rules require the reporting of income that often is excluded from gross income. This aspect of section 6050P has been a source of confusion for many recipients of Form 1099-C since taxpayers may not know they are eligible for an exception.

Section 6050P is also unusual in that there is no exemption from the requirement to issue an information return for recipients that are corporations or other business entities.

The section 6050P Regulations treat a debt obligation as having been discharged if an “identifiable event” occurs. A discharge is deemed to occur upon an identifiable event regardless of whether an actual discharge occurs (at the time of the identifiable

\textsuperscript{26} 31 U.S.C. § 3701(a)(4).
\textsuperscript{27} See CCA 201122020 (May 5, 2011) (state and local government not covered by statute).
\textsuperscript{28} I.R.C. § 6050P(c)(1), (2) and Reg. §1.6050P-2(a).
\textsuperscript{29} SCA 1998-020 (June 26, 1998).
\textsuperscript{30} Reg. § 1.6050P-1(a)(3).
event or in the past). The treatment of the transaction as a deemed discharge is “solely” for the information return purposes of section 6050P.\(^{31}\)

The Regulations provide an exclusive list of eight transactions that are considered identifiable events. The instructions for Form 1099-C require a creditor to state on the form which of the eight identifiable events occurred to cause the filing (or state that an actual discharge that is not an identifiable event was the cause of the filing). The eight events are as follows:

1. a discharge under the U.S. Bankruptcy Code,
2. a cancellation or extinguishment in a federal or state receivership, foreclosure, or similar proceeding if the proceeding renders the debt unenforceable,
3. a cancellation or extinguishment (i) upon the expiration of the statute of limitations for collection (and the defense is upheld by a court), or (ii) upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding,
4. a cancellation or extinguishment arising from a creditor's election to pursue foreclosure if the foreclosure statutorily extinguishes or bars its right to pursue further collection,
5. a cancellation or extinguishment under a probate or similar proceeding if the proceeding renders the debt unenforceable,
6. a discharge pursuant to an agreement between the creditor and debtor,
7. a discharge pursuant to a decision by a creditor (or the application of a defined policy) to discontinue collection activity, and
8. a deemed discharge pursuant to the 36-Month Rule (described in more detail below).\(^{32}\)

The first seven of the eight identifiable events are generally events that would be treated as a discharge of debt for substantive tax purposes. The eighth event is the 36-Month Rule and is based upon the passage of time instead of an objective event.

Only the eight transactions described in the section 6050P regulations are treated as identifiable events for purposes of information reporting of COD income. We note that the term “identifiable event” is used for other purposes of the Code to determine the correct taxable year to take an item into account as income, gain, deduction, or loss.\(^{33}\) It

\(\text{\footnotesize \^{31} Reg. § 1.6050P-1(a)(1), -1(b)(1).}\)

\(\text{\footnotesize \^{32} Reg. §1.6050P-1(b)(2)(i)(A)-(H).}\)

\(\text{\footnotesize \^{33} E.g., see Reg. §§ 1.165-1(d) (deduction of a loss), 1.1001-1(c)(1) (significant modification of debt).}\)
appears that events that would be treated as identifiable events in other tax situations are not treated as identifiable events for section 6050P reporting purposes.

A creditor is permitted (but not required) to issue a Form 1099-C to a debtor if the debt was actually discharged (regardless of whether an identifiable event had occurred). A Form 1099-C is not required if an identifiable event occurs with respect to a discharge that was reported by a creditor in a previous calendar year.

If a creditor subsequently receives a payment on a debt obligation for which a Form 1099-C was previously issued, the creditor is not required to correct the earlier Form 1099-C or report the transaction.

As noted above, a discharge in a bankruptcy proceeding is an identifiable event. However, a creditor is not required to issue a Form 1099-C with respect to the bankruptcy discharge of a consumer debt of an individual. The creditor is only required to issue a form if the creditor knows that the debt was incurred for business or investment purposes (based upon information included in the creditor’s books and records).

For purposes of determining whether a debt obligation was discharged and the amount owed to the creditor, the amount of debt includes “stated principal, fees, stated interest, penalties, administrative costs and fines.” However, a creditor is not required to report the discharge of interest. Moreover, in the case of a lending transaction (i.e., debt created by a loan of cash), only discharged amounts of stated principal are required to be reported.

C. The 36-Month Rule

Under the 36-Month Rule, a debtor is generally deemed to undergo a discharge of indebtedness (for information return purposes only) if a payment has not been made on the debt obligation over a 36-month period. As stated in the prior section, this 36-month non-payment period is one of the eight identifiable events described in the section 6050P Regulations.

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34 Reg. § 1.6050P-1(b)(3).
35 Reg. § 1.6050P-1(a)(1), (b)(1), (c)(9).
36 Reg. § 1.6050P-1(e)(9).
37 Reg. § 1.6050P-1(d)(1).
38 Reg. § 1.6050P-1(c).
39 Reg. § 1.6050P-1(d)(2).
40 Reg. § 1.6050P-1(d)(3).

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The 36-Month Rule became part of the section 6050P Regulations in response to comments made regarding a prior facts and circumstances test. Section 6050P was originally enacted in 1993. Treasury and the Service issued Temporary Regulations within months of enactment providing guidance on the applicability of section 6050P. Under the Temporary Regulations, a debt obligation was considered discharged for information reporting purposes “upon the occurrence of an identifiable event indicating that the indebtedness will never have to be paid by the debtor, taking into account all facts and circumstances,”41 including whether collection activities are taking place. This was intended by the drafters to be consistent with the cases and rulings regarding when a constructive discharge occurs. (These cases are discussed in more detail below in the recommendation section.)

Treasury and the Service received many comments (both at hearings and in writing) expressing concerns with the facts and circumstances test of the Temporary Regulations. Final Regulations were promulgated in 1996. The 1996 final Regulations replaced the facts and circumstances test with the current eight identifiable events for determining whether a discharge has occurred for information reporting purposes.

The 36-Month Rule was included in the 1996 final Regulations as one of the eight identifiable events. Since the 36-Month Rule appeared first in a final regulation (and had never appeared in proposed form), Treasury and the Service have received very few comments on the rule.

Under the 36-Month Rule, an identifiable event generally occurs (triggering an information return requirement) if the creditor has not received a payment on a debt obligation at any time during a “testing period” ending on December 31. The non-payment testing period is a 36-month period. The testing period is extended beyond 36 months to include any calendar month in which the creditor was precluded (during all or part of the calendar month) from attempting to collect the debt by a stay in bankruptcy (or similar state or local law).42

The 36-Month Rule only applies with respect to information returns required to be filed by a bank, building and loan association, savings institution, or credit union (and certain subsidiaries thereof), or a federal executive agency.43 It does not apply to governmental organizations that are not federal executive agencies and does not apply to organizations that must comply with section 6050P solely as a result of having a significant trade or business of lending money.

43 Reg. § 1.6050P-1(b)(2)(i)(H).
If a creditor has not received a payment during a testing period ending on December 31, there is a presumption that an identifiable event occurred during the calendar year. The presumption is rebuttable by the creditor. The presumption can be rebutted based upon the existence of (i) “significant, bona fide collection activities,” or (ii) facts suggesting that the debt obligation has not been discharged.44

A creditor can rebut the presumption of the 36-Month Rule if the creditor (or a third-party collection agency on behalf of such creditor) has engaged in a significant, bona fide collection activity at any time during the calendar year (in which the 36-month period expired). The Regulations are silent as to the amount of collection activity necessary to be significant and bona fide other than to state that nominal or ministerial activities (e.g., automated mailings) are not sufficient to rebut the presumption.45

A creditor can rebut the presumption of the 36-Month Rule if facts and circumstances exist that the debt obligation has not been discharged. The determination as to whether the debt has been discharged is made on January 31 of the calendar year following the expiration of the 36-month period. Examples of facts and circumstances sufficient to rebut the presumption include (i) the existence of a lien on property secured by the debt obligation (to the extent of the value of the security), and (ii) the sale (or packaging for sale) of the debt obligation by the creditor.46

The 36-Month Rule is somewhat intertwined with the seventh listed identifiable event (i.e., a decision to discontinue collection activities). An identifiable event occurs if debt is discharged pursuant to a decision by the creditor to discontinue collection activities and discharge the debt. In addition, an identifiable event occurs if the debt is discharged based upon the application of a “defined policy” of the creditor. A defined policy includes a written policy, as well as an established business practice. An example of an established business practice includes an established practice to abandon a debt (and discontinue collection activity) upon the expiration of a set non-payment period.47

D. Issues with the 36-Month Rule

In the Notice, Treasury and the Service identified what we believe are significant issues with the application of the 36-Month Rule. The Notice states that Treasury and the Service were aware that taxpayers who receive a Form 1099-C pursuant to the 36-Month Rule may be confused regarding whether to include the amount reported in gross income.

44 Reg. § 1.6050P-1(b)(2)(iv).
45 Reg. § 1.6050P-1(b)(2)(iv)(A).
46 Reg. § 1.6050P-1(b)(2)(iv)(B).
Form 1099-C does, in fact, cause confusion. Debtors who receive this form do not necessarily understand that the form may be reporting income that is properly reportable in a different taxable year. In addition, debtors do not necessarily understand that there are various exclusions from gross income that potentially could apply. Moreover, tax practitioners that prepare individual returns do not always understand the rules regarding the taxation of discharge of indebtedness. In addition, some practitioners have stated that certain tax software programs are not equipped to handle the computation of some of the available exclusions.

An even bigger source of confusion relates to an assumption by many taxpayers that the receipt of a Form 1099-C signifies that the debt has in fact been cancelled. It is possible for a taxpayer to be in a position where collection activities occur after having receiving a Form 1099-C. One court stated that “by providing for issuance of a form called ‘Cancellation Of Debt’ even when a lender may not intend to release debt, 26 C.F.R. § 1.6050P is all but certain to confuse borrowers who receive the form under those circumstances.”

In some cases, courts have prevented creditors from trying to collect on a debt after a Form 1099-C has been issued. In other cases, courts have allowed creditors to try to collect the debt after a Form 1099-C has been issued (even where a tax was paid on the COD income).

Another source of confusion has been whether the original Form 1099-C must be amended if the creditor resumes collection activities. Several courts have required that the forms be amended. One court suggested the form did not need to be amended if the original Form 1099-C included a statement that debt collection activities would continue.

51 In re Sarno, 463 B.R. 163 (Bankr. D. Mass. 2011) (Form 1099-C was corrected to show zero COD income) and In re Zilka, 407 B.R. 684 (Bankr. W.D. Pa. 2009) (Form 1099-C was issued and income tax paid).
52 In re Zilka, 407 B.R. 684; and In re Crosby, 261 B.R. 470.
We have also heard reports that creditors and collection agencies are using the threat of the issuance of a Form 1099-C as a mechanism to collect a debt. One commentator has suggested this as a mechanism to facilitate debt collection.54

II. Recommendations

We commend the Treasury and the Service for requesting comments on information reporting requirements under section 6050P. The current information reporting system is not ideal and could be improved. We respectfully make the following recommendations on how the current information reporting rules can be improved.

A. The 36-Month Rule

In the Notice, comments were requested as to whether the 36-Month Rule should be retained. We recommend that the rule be retained in some form. We note that while we do not recommend that the 36-Month Rule be eliminated, we are making recommendations for an overhaul of the rule and the related rules that treat the discontinuation of collection activities as a significant event.

We have identified three key constituencies for which the rule has an impact: (i) the Service, (ii) creditors that are subject to the 36-Month Rule, and (iii) debtors. Each of these constituents has different needs.

The 36-Month Rule is designed to capture situations where the discharge of debt would otherwise escape reporting on a Form 1099-C. The Service has an interest in ensuring that a debt obligation that will never be collected is the subject of an information return at some point. The 36-Month Rule is arbitrary but serves to avoid the possibility of a permanent deferral of the information reporting for the discharge.

Many of the creditors that are subject to the 36-Month Rule have made thousands of loans (or own thousands of debt obligations). Since they have limited resources to determine which loans have been discharged and which loans are still active, any facts and circumstances analysis requirement would be problematic. The 36-Month Rule appears to benefit creditors because it allows them to determine more easily which debt obligations are subject to information reporting in a calendar year.

Most of the problems with the 36-Month Rule are problems for the debtors receiving a Form 1099-C (and for the tax preparers that prepare their returns). We believe

that many of the existing problems under the 36-Month Rule can be alleviated by making some revisions to the rules and the administrative practices. Below we make recommendations on how the 36-Month Rule can be changed to reduce some of the existing problems for debtors.

If the 36-Month Rule were eliminated for information reporting purposes, it could result in situations where there is no established time frame for a Form 1099-C to be issued. The establishment of a certain period of time ensures an information return would be required at some point. The 36-Month Rule avoids the possibility of a permanent deferral of the information reporting for the discharge. For example, in Kleber v. Commissioner\(^5\) (described in more detail below), the Form 1099-C was issued seven years after payment and collection activities ceased. If the 36-Month Rule were eliminated, it is possible that similar delays in the issuance of a Form 1099-C could occur.

An additional consideration that the Service should take into account in addressing whether to eliminate the 36-Month Rule is that it appears that two recent Tax Court decisions have applied the 36-Month Rule as a factor in determining the taxable year in which a debtor includes COD income in gross income. We note that elimination of the 36-Month Rule for information reporting purposes could result in confusion if use of the 36-Month Rule were continued to be used by the Tax Court, notwithstanding its elimination, in determining when COD income is recognized.

In Kleber v. Commissioner,\(^6\) the Tax Court found that the non-payment testing period described in the section 6050P rules ended in 2002. As a result, the court held that there was a rebuttable presumption that the debtor had COD income in 2002, which was a year closed by the statute of limitations. The debtor had received a Form 1099-C for 2006 and the Service took the position that the COD income was taxable in 2006 (a taxable year for which an assessment was open). The Tax Court ruled that the income was not taxable in 2006 since the Service was not able to rebut the presumption that the identifiable event occurred in 2002.\(^7\)

The court in Kleber could have come to the same result (income in closed year) without referring to the 36-Month Rule and treated the COD income as having occurred in an earlier year. The creditor in this case (U.S. Department of the Navy) undertook de minimis collection actions after the last date of collection activity in 1999.

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\(^5\) T.C. Memo 2011-233.

\(^6\) Id.

\(^7\) Kleber, T.C. Memo 2011-233.
More recently, the Tax Court applied the 36-Month Rule for a second time to determine the appropriate taxable year in which COD income was recognized on facts similar to those in *Kleber*.\(^{58}\) No other case or ruling has been found that has considered the 36-Month Rule for substantive tax purposes.

Elimination of the 36-Month Rule for information reporting purposes by the Treasury and the Service could result in uncertainty if it were continued to be used by the Tax Court as a factor in determining the timing of COD income. The taxpayers in both cases were held not to have income in the year the Form 1099-C was issued. In both cases, the Tax Court found the government did not rebut the presumption that the 36-Month Rule was an identifiable event. In both cases, the Tax Court never mentioned that the presumption in the section 6050P Regulations that a debtor is “deemed” to have COD income when an identifiable event occurs is “solely for purposes of the information reporting requirements of section 6050P” and section 1.6050P of the Regulations.\(^{59}\)

If Treasury and the Service ultimately decide not to eliminate the 36-Month Rule, below are some recommendations for reducing some of the current issues with the rule.

In our view the largest source of problems and confusion with the 36-Month Rule is that the debtor can receive a Form 1099-C while attempts to collect on the debt are still being made, either by the creditor or by a third party. The problem is especially acute when there is poor communication between the creditor and a third party collection agent. We recommend that the identifiable events for the discontinuation of collection activities and the 36-Month Rule be coordinated better (as described below).

Under existing Regulations, an identifiable event occurs if there is a discharge of indebtedness pursuant to a decision by the creditor to discontinue collection activities. The discontinuation of collection activities certainly appears to be an appropriate time for a debtor to realize income from the discharge of debt. However, the requirement that there is a discharge of indebtedness in conjunction with the discontinuation of collection activities adds some ambiguity. The policy behind the rule would be better served if an identifiable event occurred when a creditor decides to discontinue collection activities.

An identifiable event also occurs if the debt is discharged pursuant to the application of a defined policy of the creditor. As a result, there are currently two different identifiable event rules with a time limit. One is based upon a set 36 months and the other is based upon internal policies of the creditor. It may be possible to simplify the rules by combining the two into a single identifiable event. In other words, an identifiable

\(^{58}\) *Stewart v. Commissioner*, T.C. Summary Opinion 2012-46.

\(^{59}\) Reg. § 1.6050P-1(a)(1); *see also* Reg. § 1.6050P-1(b)(1).
event would occur based upon the creditor’s defined policy (or a 36-month period of non-payment, if earlier).

The existence of collection activities appears to be strong evidence that the debt has not been discharged. Accordingly, we recommend that a creditor be prohibited from issuing a Form 1099-C if significant, bona fide collection activities are ongoing by the creditor or another creditor (where there are multiple creditors with respect to the debt) or a third party collection agency. Similarly, the issuance of a Form 1099-C should be prohibited if the creditor is contemplating or negotiating a sale (or packaging for sale) of a debt obligation to a third party (under the theory that the third party would not be considering the acquisition of the debt obligation unless it was at least considering potential future collection efforts).

The existence of significant, bona fide collection activities is a factor that a creditor may use to rebut the presumption under the 36-Month Rule. Presumably, the creditor has the option not to rebut the presumption.

Under the current Regulation, creditors can issue a Form 1099-C even if collection activities are ongoing.\(^\text{60}\) We believe that the rules that permit creditors to issue a Form 1099-C while collection activities are ongoing should be changed. Preventing Forms 1099-C from being issued while collection activities are ongoing (or contemplated) will go a long way in reducing some of the existing confusion.

The issues associated with collection activities are compounded when there are multiple assignees of the same debt. While situations involving multiple creditors are addressed in section 1.6050P-1(e)(2) of the Regulations, we believe that better coordination between the 36-Month Rule and the treatment of collection activities will also help situations where there are multiple creditors.

When a creditor has issued a Form 1099-C, there is currently uncertainty as to whether the form needs to be corrected if the creditor (or a third party collection agency or another creditor) resumes collection activities. Similarly, there is uncertainty as to whether the form needs to be corrected if the creditor sells or packages the debt obligation. Some court cases have required that the original Form 1099-C be corrected in such circumstances.\(^\text{61}\) Subsequent collection efforts or sales appear to be strong evidence that the debt was not discharged in the earlier year. The final Regulations should be revised to clarify that the Form 1099-C needs to be corrected if subsequent events occur.

\(^\text{60}\) Treas. Reg. §1.6050P-1(b)(2)(iv).

\(^\text{61}\) In re Zilka, 407 B.R. 684; and In re Crosby, 261 B.R. 470.
that are inconsistent with the conclusion that the debt obligation was discharged in a prior calendar year.

The existing Regulations state that a Form 1099-C does not need to be corrected if the creditor receives a payment in a subsequent calendar year.\textsuperscript{62} If the suggestions made in the prior paragraph are adopted, this rule also should be changed.

In summary, we recommend that final Regulations or other future guidance:

1. Retain the 36-Month Rule in some form.
2. Treat the creditor’s decision to discontinue collection activities as an identifiable event.
3. Combine the existing identifiable event with respect to the defined policy of the creditor with the 36-Month Rule so that an identifiable event would occur based upon the creditor’s defined policy or a 36-month period of non-payment, if earlier.
4. Prohibit creditors from issuing a Form 1099-C while (i) significant, bona fide collection activities are ongoing by the creditor (or an assignee or a third party collection agency), or (ii) the creditor is contemplating or negotiating a sale (or a packaging for sale) of a debt obligation to a third party.
5. Clarify that a Form 1099-C needs to be corrected if subsequent events occur that are inconsistent with the conclusion that the debt obligation was discharged in a prior calendar year (e.g., subsequent collection activities or receipt of a payment).

B. \textbf{Other Section 6050P Recommendations}

The Notice only requested comments on the 36-Month Rule. In the process of giving thought to how the 36-Month Rule could be improved, we noted several anomalies in other provisions of the section 6050P Regulations. Below are our recommendations for improving other portions of the existing Regulations.

\textsuperscript{62} Reg. § 1.6050P-1(e)(9).
i. Regulation Examples

Section 1.6050P-1 of the Regulations contains no examples of how the rules operate. By contrast, section 1.6050P-2, which determines whether an organization has a significant trade or business of lending money, contains five examples.

It is possible that section 1.6050P-1 does not contain examples due to its origin as a temporary regulation. Final regulations have been in place since 1996. As a result of the numerous cases and rulings, Treasury and the Service may be in a position to provide debtors and creditors with practical assistance as to how to apply section 1.6050P-1. As a result, we recommend that Treasury and the Service amend section 1.6050P-1 to add some factual examples. This will help reduce some of the existing confusion in applying the provision.

ii. Form 1099-C Changes

One source of confusion for debtors is the instructions for the Form 1099-C. Many debtors that receive the form naturally assume that the income is subject to tax and has been reported by the creditor to the Service in the proper year. While it may not be possible to reform the tax rules relating to the discharge of indebtedness, it is possible to modify the instructions to make it more likely that debtors (and their tax preparers) file their income tax returns correctly (as described in the next few paragraphs). In a later section of these comments, we recommend that Forms 1099-A and 1099-C be combined.

The second sentence of the instructions states that “if a creditor has discharged a debt you owed, you are required to include the discharged amount in your income, even if it is less than $600, on the “Other income” line of your Form 1040.” Since the Form 1099-C could be sent to a corporation or other business entity, it may make sense to change the reference to “Form 1040” to “income tax return.”

The instructions give the debtor useful information about reporting the income if the Form 1099-C was issued in the wrong year. However, the information regarding the section 108 exclusion could be improved. It may make sense to add the following after the first full paragraph of the instructions: “If the income reported on Form 1099-C is eligible for exclusion, such as for bankruptcy and insolvency, use Form 982 to report the

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exclusion and the reduction of certain tax attributes. Do not report the excluded income on the “other income” line of your return.”

iii. **Coordination Between Sections 6050J and 6050P**

Section 6050J provides rules for information returns with respect to foreclosures and abandonments of property that secure a debt obligation. These information reporting rules do not apply to consumer loans that are secured by tangible personal property (such as automobiles). Transactions subject to section 6050J are reported on Form 1099-A.

In many cases, foreclosure or abandonment transactions will be subject to reporting under both sections 6050J and 6050P. The section 6050P Regulations contain a provision for coordinating reporting where both provisions apply. If the same transaction is subject to reporting under both provisions in the same calendar year, a creditor may choose to report the amounts under both provisions on a single Form 1099-C. Use of this single filing procedure does not appear to be mandatory.

Members of the Tax Section have seen many instances where a creditor has chosen to file both Forms 1099-A and 1099–C for the same transaction for the same calendar year. On many occasions, the forms have been filed in such a way that the same income and amounts appear on both forms. This double reporting has caused difficulties for the recipient.

We recommend that the reporting for both sections 6050J and 6050P be combined on a single form on which the creditor can bifurcate the total amount of indebtedness discharged between the amount realized under section 6050J and the discharge of indebtedness under section 6050P. Such a change would reduce the risks of double reporting in real estate foreclosures and other transactions subject to both provisions.

iv. **Constructive COD income**

The Code and Regulations state that a taxpayer has realized income when indebtedness is discharged. The term “discharge” is not defined in either the Code or the Regulations. As a result of the ambiguity caused by not having a definition of an important term, many taxpayers over the years have taken the position that a discharge occurs for tax purposes only when the legal obligation to pay the debt has been formally discharged.

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64 I.R.C. § 6050J(b) and Temp. Reg. § 1.6050J-1T, Q-5-9.
65 Reg. § 1.6050P-1(e)(3).
66 I.R.C. §§ 61(a)(12) and 108(a) and Reg. § 1.61-12(a).
Notwithstanding the lack of a formal definition of the term “discharge,” the Service in private letter rulings and the courts in cases have almost uniformly adopted a concept of constructive discharge.\(^67\) As a result, a debt obligation is treated as discharged when it becomes “clear” that some of (or the entire) debt obligation will not be paid. This is determined by an assessment of all of the facts and circumstances surrounding repayment. By analogy to law related to bad debt and worthless security deductions, the cases and rulings look for “identifiable events” that establish that the debt obligation will not be repaid in full. In many cases, there will be more than one identifiable event that could be treated as the event that resulted in constructive discharge of the debt. In such case, the potential identifiable events are analyzed to determine the one that is most appropriate.\(^68\)

The concept of constructive discharge, however, does not appear in the Regulations or in any published Service guidance. The only mention of the concept in the Cumulative Bulletin or Internal Revenue Bulletin we have found is in the preamble to the temporary section 6050P Regulations.\(^69\) Revenue Ruling 71-489\(^70\) holds that a bank does not realize COD income with respect to inactive savings and checking accounts until it takes some action to assert dominion over the accounts. The concept of constructive discharge was not discussed.

Members of the Tax Section have seen many situations where knowledgeable tax practitioners believed that a taxpayer did not realize income from a discharge of indebtedness until there had been a formal discharge. The persistence of this failure to be aware of constructive discharge is perhaps attributable to the omission of the concept of constructive discharge of indebtedness income in published guidance and Regulations.

To increase awareness of the concept of constructive discharge, it may be advisable for Treasury and/or the Service to issue guidance regarding the timing of income from the discharge of indebtedness. This could be in the form of a revenue ruling with one or more fact patterns or could be in the form of Regulations, indicating situations where COD income is recognized prior to a formal discharge.

\(^{67}\) See, e.g., Friedman v. Commissioner, 216 F.3d 537, 546-49 (6th Cir. 2000) and PLR 201228023 (Apr. 11, 2012).


\(^{70}\) 1971-1 C.B. 32.
v. **Recipient of the Form 1099-C**

The members of the Tax Section have become aware of two instances where there is uncertainty as to the proper recipient of a Form 1099-C. The first relates to disregarded entities and the second relates to bankruptcy estates.

With respect to disregarded entities (wholly-owned LLCs and grantor trusts), we are generally seeing the Forms 1099-C being issued to the disregarded entities (and not to the owner of the disregarded entity). We understand that this has been a source of confusion for the owners as to how to report the income, but we do not have a specific recommendation as to how to improve the existing information reporting regime. In any case, it may be prudent for Treasury and the Service to issue guidance regarding the information returns when section 1.108-9 of the Proposed Regulations (application of section 108 exclusions to disregarded entities and grantor trusts) is finalized.

When an individual files for bankruptcy under chapters 7 or 11 of the U.S. Bankruptcy Code, the bankruptcy estate is a separate taxpayer from the individual.71 There is some uncertainty as to whether the individual or the bankruptcy estate should receive the Form 1099-C. Notwithstanding the uncertainty, the individual generally receives the Form 1099-C (on the rare occasion that one is issued since a Form 1099-C is not required for consumer debts that are discharged in bankruptcy). When the individual receives the form, there is a mismatch between the information return and the tax filing requirements as the estate is the taxpayer that reports the income and the successor to the debtor’s tax attributes.72 We recommend that the Service clarify that the bankruptcy estate should receive the Form 1099-C.

vi. **Coordination with the Substantial Modification Rules**

Section 1.1001-3 of the Regulations provides rules for determining whether a modification of the terms of a debt obligation results in a deemed exchange of an “old” debt obligation for a “new” debt obligation. Such an exchange is treated as having occurred if the modification is “substantial.”73 Where such an exchange is deemed to occur, a debtor generally realizes COD income to the extent the adjusted issue price of the old debt obligation exceeds the issue price of the new debt obligation.74

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71 I.R.C. § 1398.
72 I.R.C. §§ 108(d)(8) and 1398(g).
73 Reg. § 1.1001-3(b).
74 I.R.C. § 108(e)(10).
The section 6050P Regulations currently do not treat a deemed exchange of debt obligations pursuant to section 1.1001-3 as an identifiable event requiring a Form 1099-C. There does not appear to be a good policy reason for excluding these transactions from reporting under section 6050P. The creditor already needs to determine whether a substantial modification occurs (and if so, the issue price of the new debt obligation) for the creditor’s own income tax return.

In addition, it may be worthwhile for Treasury and the Service to consider the interrelationship of the 36-Month Rule of section 6050P with the 24-month rule that is in section 1.1001-3. Generally, a default on a debt obligation (or other failure to perform) does not result in a modification of the obligation.\(^\text{75}\) However, an agreement by the holder of a debt obligation “to stay collection or temporarily waive an acceleration clause or similar default rights (including such a waiver following the exercise of a right to demand payment in full)”\(^\text{76}\) is treated as a modification of a debt obligation in certain circumstances. The debt is treated as modified when the forbearance remains in effect for a period that exceeds two years following the debtor’s initial failure to perform. The two-year period is extended during any period (i) in which the parties are conducting good faith negotiations, or (ii) in which the debtor is under the jurisdiction of a U.S. bankruptcy court (or undergoing a similar proceeding).\(^\text{77}\) The Regulations illustrate this rule by stating that a one-year waiver of an acceleration clause is not a modification.\(^\text{78}\)

It may be worthwhile for Treasury and the Service to consider how the above-described 24-month period should interrelate with the 36-Month Rule. It is not entirely clear why the time periods for similar activities are different. As such, it may be beneficial to revise the 24-month period to 36 months to match the time period in the 36-Month Rule.

\(^\text{75}\) Reg. § 1.1001-3(c)(4)(i).
\(^\text{76}\) Reg. § 1.1001-3(c)(4)(ii).
\(^\text{77}\) Id.
\(^\text{78}\) Reg. § 1.1001-3(d) Ex. 13.