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CONSUMER CREDIT

Neither Forgiven Nor Forgotten: Taxation and UDAAP Concerns With Collecting Charged Off Debt

BY JOHN REDDING, SASHA LEONHARDT, AND JESSICA SHANNON

When debtors are unable to pay their debts, creditors are left with a choice: (i) allow the consumer to pay a lesser amount, if possible, to settle the obligation and recover some funds; or (ii) charge off the debt and cease all collection efforts. Regardless of the path chosen, each has potential implications for both the creditor and debtor.

As discussed in our November 2, 2017 article in BNA's Banking Report, when creditors settle the debt by allowing a debtor to pay less than the amount due, this may result in unanticipated consequences for debtors, largely centered around potential tax liabilities for the forgiven amounts. If, however, the creditor determines that the debt is simply uncollectable and "charges off"—or internally declares uncollectable—the remaining amount of the debt, other potential issues may arise if the creditor later decides to resume collection efforts. While a debtor may believe that the creditor cannot take further actions to collect charged off debt after sending a Form 1099-C related to that debt, this is not always the case, and the resulting confusion can create challenges for both debtors and creditors. Such post-charge off collection activities may raise legal issues under federal consumer protection laws, and creditors should proceed with caution.

John Redding is a partner in the Los Angeles and San Francisco, CA offices of Buckley Sandler LLP. Sasha Leonhardt is a counsel and Jessica Shannon is an associate in the Washington, DC office of Buckley Sandler LLP. The authors represent financial institutions in responding to federal and state government enforcement actions, consumer litigation, and regulatory inquiries. The authors may be reached at jredding@buckleysandler.com, sleonhardt@buckleysandler.com, and jshannon@buckleysandler.com, respectively.

Tax Treatment of Charged Off Debt

Generally, when a creditor "discharges" a consumer's debt of $600 or more, the creditor must inform the IRS of the discharge. 26 U.S.C. § 6050P(a). A discharge occurs, for purposes of determining whether reporting to the IRS is required, when there is an "identifiable event," and the IRS has set forth a number of specific identifiable events that will trigger a discharge. These events include a discharge of debt through bankruptcy, a cancellation of debt by a court, the expiration of the statute of limitations to collect a debt, a foreclosure action that "statutorily extinguishes" the right to collect a deficiency amount, a probate proceeding that eliminates a debt, an agreement between a debtor and credi-

tor to extinguish a debt, or ''a discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt.'' 26 C.F.R. § 1.6050P-1(b)(2)(i).

Consistent with the last item above, financial institutions are required to continually evaluate their portfolios for risk, and an important part of that process is determining when a particular consumer debt is unlikely to be repaid. If an institution determines that it is unlikely to collect a debt, that debt is deemed ''charged off.'' In addition, a financial institution may be required by external guidance to classify certain debts as charged off; for example, a 2000 Office of the Comptroller of the Currency (''OCC'') policy document advises OCC-supervised institutions to charge off closed-end loans that are 120 days past due, and to charge off open-end credit at 180 days past due. Critically, the decision to charge off debt is a ''unilateral action of a bank's [or financial institution's] accounting department. . . on its books'' and is not subject to review or discussion with the debtor. *In re Diaconx Corp.*, 69 B.R. 333, 341 (Bankr. E.D. Pa. 1987).

Once a debt is charged off, federal regulations require the creditor to ''file an information return on Form 1099-C'' with the IRS. 26 C.F.R. § 1.6050P-1(a)(1). In addition, the creditor must also provide the debtor with a copy of the 1099-C for his or her records. *Id.* § 1.6050P-1(f)(2). Failure to comply with these reporting requirements can result in significant penalties for the creditor that can reach as high as $3 million. *See* 26 U.S.C. § § 6721–24.

Filing a 1099-C has tax implications for both a creditor and a debtor. Because a 1099-C form treats charged off debt as ''income'' since it improves a debtor's overall financial picture, the receipt of a 1099-C may increase a debtor's tax liability. Similarly, because a charge off acknowledges the low likelihood of recovering the initial money lent to the debtor, a creditor may be able to deduct the unpaid amount of the debt as a loss. *See* 26 U.S.C. § 166.

Collection of Charged Off Debt: FDCPA and FCRA

After a creditor charges off a debt pursuant to either an internal or regulator-mandated policy, there may be circumstances in which a creditor later decides to renew collection actions on the debt. For example, a consumer who was at one point unable to make payments may have obtained a better job, received additional funds, or paid off other indebtedness and is now able to make payments on the previously discharged debt. Even though the creditor charged off the debt on its own books, the funds that were initially loaned to the debtor nevertheless remain unpaid and are a loss to the creditor, and the creditor may want to be made whole for this debt.

After receiving a 1099-C and potentially paying taxes on this charged off debt as income, however, a debtor may believe that he or she is no longer liable for the debt. In response to such collection activities, some debtors have argued that attempting to collect debt after receiving a 1099-C violates the Fair Debt Collection Practices Act (''FDCPA''). In other instances, a creditor has issued a 1099-C and subsequently reported the debt to a consumer reporting agency, and in response debtors have claimed that this is inaccurate credit reporting under the Fair Credit Reporting Act (''FCRA''). *E.g. Ware v. Bank of America Corp.*, 9 F. Supp. 3d. 1329 (N.D. Ga. 2014). In both instances, a threshold question is whether a creditor's decision to charge off a debt and issue a 1099-C actually extinguishes the debt.

Throughout the United States, courts are divided on this issue—and therefore are divided as to whether collection actions or credit reporting of discharged debts constitute violations of the FDCPA or FCRA. *See In re Rodriguez*, 555 B.R. 871 (Bankr. S.D. Fla. 2016). A significant majority of courts take the position that a creditor's decision to classify a debt as ''charged off'' and issue a 1099-C—standing alone—does not prevent a creditor from taking subsequent collection actions. For example, in *In re Diaconx Corp.*, 69 B.R. 333 (Bankr. E.D. Pa. 1983), a creditor charged off a portion of a debtor's obligation, and the debtor argued that the charged off debt was unrecoverable in bankruptcy. The bankruptcy court disagreed, holding that without some agreement between ''the parties in the nature of an accord and satisfaction or a novation,'' the original obligation and security agreement remained in effect. Two decades after *Diaconx*—and after several other courts upheld this position—the IRS Office of the Chief Counsel endorsed this view in a 2005 letter: ''The Internal Revenue Service 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.'' In the years since the IRS letter, courts and financial regulators have continued to reaffirm that issuing a Form 1099-C does not discharge a debt, and therefore collection actions can continue. *See, e.g., Ware v. Bank of America Corp.*, 9 F. Supp. 3d at 1341 (collecting cases); OCC Bulletin 2014-37, Consumer Debt Sales, Aug. 4, 2014.

Notwithstanding the position of most courts, the IRS, and the OCC, a minority of courts have nevertheless taken the position that charging off debt and issuing a 1099-C bars future collection activity. Most prominently, in 2013, the United States Bankruptcy Court for the Eastern District of Tennessee held that—once a creditor issued a 1099-C and a debtor incurred tax liability—the creditor could no longer take collection actions. *In re Reed*, 492 B.R. 261 (Bankr. E.D. Tenn. 2013). In *Reed*, the creditor issued a 1099-C for a mortgage debt and the debtors filed the 1099-C as part of their taxes. Although acknowledging the long line of cases and the IRS guidance above, the *Reed* court held that the case law was not persuasive, the IRS guidance was not binding, and thus the creditor could not resume collection activities. The *Reed* court emphasized that it would be inequitable to allow a creditor to collect on such debt because the debtor had paid taxes on the charged off amount. Although the creditor argued that a 1099-C can be reissued to address this equity argument, the *Reed* court held that the initial issuance of the 1099-C is itself an admission of discharge and such admission is not reversible.

Collection of Charged Off Debt: UDAAP Risk

Even if a court were to follow the majority rule that a creditor's decision to issue a 1099-C because of a charge off does not extinguish the debt, there remains

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the possibility that taking collection actions after a charge off could be viewed as an unfair, deceptive, or abusive act or practice under the Dodd-Frank Act, or an unfair or deceptive practice under the FTC Act or state law (collectively referred to as a ''UDAAP'' for purposes of this article). UDAAP laws are more flexible than the FDCPA or FCRA, and behavior that is not technically a violation of one of these two statutes may nevertheless be considered unfair or deceptive by a court or regulator. While many expect the Bureau of Consumer Financial Protection (the ''Bureau'') to take a less stringent approach to UDAAP enforcement under the current administration, other federal regulators and state attorneys general have parallel UDAAP enforcement powers that they can use. Even in the absence of a federal or state governmental enforcement action, state laws may allow consumers to file private actions against creditors. And because creditors often use similar forms and follow standard policies and procedures, an individual consumer action can quickly become a class action exposing a creditor to significant legal and reputational risk.

In determining whether an action or practice is unfair, regulators generally consider whether there is a substantial consumer injury, whether there is a violation of established public policy, and whether a practice is ''unethical or unscrupulous.'' FTC Policy Statement on Unfairness (1980). Of these three criteria, the most important factor is frequently consumer injury. In jurisdictions where filing a 1099-C is purely informational and a charged off debt remains outstanding, it is unlikely that a court would find that collection activities after filing a 1099-C create substantial consumer injury. However, in the minority of jurisdictions where courts have held that filing a 1099-C effectively discharges the debt, a debtor may argue that ongoing collection actions are unfair because the creditor is seeking repayment of an amount that was charged off. It is unclear how such an argument would fare in an unfairness analysis; we note that while a debtor may argue that he or she was harmed by having to pay taxes on the discharged debt, these prior tax payments can be resolved by filing an amended 1099-C and seeking an appropriate tax refund from the IRS.

An action is generally considered deceptive under federal UDAAP law if it is likely to mislead a consumer acting reasonably in the circumstances, and if the deception was ''material.'' *See* FTC Policy Statement on Deception (1983). As a threshold matter, we think it unlikely that a court would hold that issuing a 1099-C is itself deceptive. 1099-C forms are created by the IRS, and IRS regulations govern when a 1099-C should be issued for charged off debt; so long as a creditor complies with the IRS's requirements the creditor can argue that it was taking actions explicitly required by federal law, and such actions should not be deemed deceptive. Communications associated with the post-1099-C collection of debt may also be relevant to a deception analysis, however, as deception claims often turn on the actual content of the communication with the consumer—accordingly, it is difficult to consider the effect of such communications in the abstract. Overall, however, creditors likely face more risk from anti-deception laws in collecting debts where courts have held that a 1099-C discharges the debt.

Collecting with Caution: Best Practices in Collecting Charged Off Debt

Recognizing some of the risks in this area of law, creditors may want to consider the following precautionary steps when handling charged off debt:

- Complete Form 1099-C accurately and provide appropriate copies to both the IRS and the debtor.
- Understand the law in the jurisdiction where one is taking collection actions, and consider carefully how to proceed in jurisdictions where courts have held that issuing a 1099-C discharges a consumer's debt.
- Ensure that all communications with debtors are accurate and precise.
- Identify accounts that pose a greater risk of consumer harm from further collection activity and determine whether additional activity is appropriate and warranted. In particular, the 2014 OCC bulletin notes that accounts of minors, servicemembers, individuals in disaster areas, or nearing the statute of limitations should be treated with care.
- Ensure that all credit reporting of charged off debt conforms with the FCRA, Regulation V, and Consumer Data Industry Association guidelines.
- If a debtor makes payments after a charge off, take appropriate actions under FCRA and IRS regulations, including filing an amended 1099-C if necessary.

Collecting debts from consumers who are delinquent can be challenging, and the rules, inconsistent case law, and potential legal exposure surrounding charged off debts may create further risks for financial institutions. By understanding the legal landscape and creating an appropriate debt-collection plan, creditors can take steps to reduce their risks when collecting on charged off debts.

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