Tax Court Rules Against Buyer of Bad Debt & IRS in 1099C Case

June 11, 2012 - Any time a creditor writes off a debt that is owed, the bank generates a form called a 1099-C which it sends to the debtor. In many cases, the amount of that write off is considered to be ordinary income for the debtor. By this I mean that if you owe 10,000 on a credit card and you refuse to pay it, when your lender writes off that debt you actually owe the IRS taxes on the $10,000 that the creditor wrote off. But in a recent case which the IRS pursued with some vigor, the tax court ruled against both the IRS and company that issued the 1099-C. There are several lessons in this story but the main one may be that anyone receiving one of these forms should probably do a little homework before they pay their taxes.

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In this particular case, David S. Stewart, et ux. v. Commissioner, the defendant in the case had an unpaid credit card debt from 1994 and was notified in 1996 by his credit card company that the debt had been written off. But the company never issued a 1099-C. Instead, they waited for more than ten years and then sold the debt to Portfolio Recover Associates (PCA) in 2007. They did this even though according to the court, the statute of limitations on the debt had expired in 2001 according to the court.

We've done a number of previous posts on statutes of limitation. These differ in each state and, depending upon state law, can be revived in many states long after they have expired. For this reason alone, if you are ever contacted about an old debt it is highly inadvisable to admit that the debt is actually yours or to make any payments on that debt. Doing so could make you responsible for the entire amount of the debt, impact your credit report, and start the statute of limitations all over again.

In this case however the defendant, David Stewart, simply wrote a letter to PCA asking them not to contact him in the future. They complied and issued the 1099-C. And when the form was issued to Mr. Stewart, a copy of it was also sent to the IRS. That form had a 2007 date on it and the amount of money shown as being written off was more than $8,500. That could easily translate into an additional $2,000 or more in taxes being owed.

When Mr. Stewart filed his taxes, he didn't include the amount shown on the 1099 in his income. The IRS notified him of his "error" and attempted to collect more money from him. He appealed claiming that the debt had been written off in 1996, not 2007, and that no further money was owed. The tax commissioner reviewing his appeal didn't see it his way and claimed that the tax was owed. Stewart decided to go to tax court to settle the matter.

The judge hearing the case decided in Mr. Stewart's favor. Although the judge was unable to determine the exact date that the discharge of the debt actually took place, he did make the determination that it was well before 2007. He also determined that the debt had been discharged well before the 36 month review period the IRS maintains for review. That would place the discharge date before December of 2004.

The beauty of this decision is that it is now case law. It means the date that appears on a 1099-C is far less important than the date that a debt actually becomes uncollectable. Of course, anyone facing a similar situation will be best served if they maintain good records, but in many cases, people will be able to reconstruct their records from other sources. And if you do receive any 1099-Cs this year, pay attention to them. Make sure you understand them and where they came from. If you think that they are incorrect, it could pay you to dispute them.

byJim Malmberg
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