

01/15/04

**Office of Chief Counsel
Internal Revenue Service
memorandum**

CC:ITA:B04:WJoseph

date:

to: Director, Tax Forms & Publications

from: Robert M. Brown
Associate Chief Counsel (Income Tax & Accounting)

subject: Reporting Cancellation of Debt Income

The "Instructions for Debtor" on the reverse of Form 1099-C, Cancellation of Debt, state that "if you are an individual, you must include the canceled amount on the 'Other Income' line of Form 1040." The instructions further correctly note that some canceled debts are not includible in income. There are no instructions to taxpayers concerning what happens if a taxpayer has discharge of indebtedness income but later pays the underlying debt. Furthermore, there do not seem to be any instructions about this in relevant publications.

The regulations require creditors to file Form 1099-C when certain "identifiable events" occur, even though there is no formal discharge of indebtedness. For example, creditors are required to file Form 1099-C when the creditor discontinues collection activity, or upon the expiration of a "non-payment testing period." See § 301.6050P-1(b)(2)(i)(G) and (H) of the Procedure and Administration Regulations. This could cause a problem if a debtor receives Form 1099-C and reports the income in that year, but the debt has not actually been formally discharged and the debtor subsequently pays the debt.

We addressed the problem of how a subsequent payment should be handled in a Significant Service Center Advice, SCA 200235030 issued on June 3, 2002. The advice concludes that a taxpayer who includes income from discharge of indebtedness but who later pays the debt may file a claim for refund for the year the income was reported. The advice considered, but rejected, allowing taxpayers to claim a deduction or make a claim of right adjustment in the year the debt is paid rather than making a retroactive adjustment for the year the income was originally reported. A copy of the SCA, which gives further background on this issue, is attached.

Most taxpayers would benefit from being able to reverse the transaction rather than claim a potentially unusable deduction in a later year. However, taxpayers who pay the debt in a subsequent year but within the period of limitations for claiming a refund for the original year of inclusion could be disadvantaged if they are unaware of the Service's position on this issue, or if they do not become aware of it until after the

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expiration of the period of limitations. Accordingly, we recommend that language be inserted in Publication 17, Publication 525, and/or Publication 908 alerting taxpayers of their potential right to file a claim for refund. Suggested language might be "Taxpayers who report discharge of indebtedness income but subsequently pay the underlying debt may be entitled to amend their income tax returns for the year the income was reported."

If you have any questions, please call Warren Joseph at 622-7007.

Attachment