Q: What are the Circular 230 implications, if any, for a Tax Professional who, as an alternative to pursuing collection of an earned fee from a client, files with the IRS a Form 1099-C, *Cancellation of Debt*, reporting the amount of the client's unpaid bill as a discharged debt?

My firm and I want to use Forms 1099-C, as a collection technique with delinquent/non-paying clients. I am a tax professional subject to Circular 230. I own and operate a small firm that provides various tax representation services for compensation. My firm usually enters into a written fee agreement with a client for the services agreed upon. For most clients, the firm does not require a retainer or the payment of fees in advance. The firm generally bills clients for the services after the fact, requesting payment within 30 days. Invoices unpaid after 30 days are considered delinquent and treated as subject to collection regardless of whether the client disputes the liability.

We periodically write-off balance-due amounts as uncollectible based on established criteria. As to amounts treated as non-collectible, the firm would like to complete and file Forms 1099-C identifying each such client as the "debtor" and reporting the unpaid account balance as the "amount of debt discharged" in box 2 of the form. The firm would simultaneously send Copy B of the form to the client for purposes of reporting the discharged amount on the client's income tax return(s). The goal would be to encourage the client to pay, or make him/her report additional income for our "free" services. I am unsure as to whether this business practice is consistent with my obligations under Circular 230.

A: The provisions of law in the Internal Revenue Code (Title 26) relating to discharge of indebtedness and reporting discharges on federal tax or information returns are separate and distinct from the provisions governing practice before the IRS (31 U.S.C. § 330; 31 C.F.R. Subtitle A, Part 10).

A tax professional who prepares and submits any form to the IRS, including tax returns and information returns, whether for his or her own business purposes or on behalf of a client, should know the purpose of the form, the situations in which the form must or should be used, and the rules and instructions as to the time and manner for filing the form. A tax professional also should know the related state and federal laws, including applicable internal revenue provisions. If a tax professional repeatedly uses Forms 1099-C, as a business strategy to collect unpaid fees, when the tax professional knows, or should know, that the facts and circumstances do not provide a basis for doing so, the conduct calls into question the tax professional's fitness to practice before the IRS. A pattern of issuing Form 1099-C with a reckless disregard as to the existence of a debt (because, for example, the former client does not have a fixed contractual liability to **repay** a sum previously received), or the absence of an "identifiable event"[1] triggering a

[1] Regulations under section 6050P enumerate certain "identifiable events" that are deemed a discharge of indebtedness, and require a Form 1099-C from an "applicable entity" (described below). These events include an applicable entity's discharge of indebtedness in accordance with a "decision" or "defined policy" (a written policy or established business practice) of the entity to "discontinue collection activity," such as after the end of a period of nonpayment. *See* 26 C.F.R. § 1.6050P-1(a)(1) and (b)(2)(i)(G), (iii).

reporting requirement, is inconsistent with the standards of competency and professionalism embodied in the rules of practice.

A number of provisions concern responsibilities in connection with client communications. Section 330(b)(4) (Title 31), for example, allows for discipline, after notice and proceeding, for a representative who, with intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented. Several provisions of Circular 230 also are relevant, and should be kept in mind. Section 10.22(a) of Circular 230 requires a tax professional to exercise due diligence in (1) preparing and filing returns, documents, and other papers relating to IRS matters, (2) determining the correctness of oral or written representations made by the tax professional to the IRS, and (3) determining the correctness of oral or written representations made to clients. Section 10.35 requires tax professionals to "possess the necessary competence to engage in practice" before the IRS. To be competent, a tax professional must have the "appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged." Section 10.51(a)(4) identifies as "incompetence and disreputable conduct," the giving of false or misleading information "to the Department of the Treasury or any officer or employee thereof."

We are not opining that the facts as described herein constitute a violation of the law or regulations governing practice before the IRS. Such a determination is always a matter of facts and circumstances, including the presence or absence of conduct that was willful, grossly incompetent or a reckless disregard of the rules and regulations. Additionally, nothing in our answer should be construed as suggesting a violation of the Internal Revenue Code, or any liability for a penalty under the Code. Practitioners must use an appropriate level of care and thought in submitting forms or other documents to the IRS or to a client, compatible with the letter and spirit of the regulations governing practice.

While not directly within OPR's purview, the analysis of substantive law would be highly relevant to this fact pattern. As a matter of tax law, a discharge of indebtedness is generally gross income of the debtor, pursuant to section 61(a)(12) of the Internal Revenue Code (and Treasury Regulation section 1.61-12(a)). Certain discharges of indebtedness are excluded from gross income (see Code section 108). Whether there has been a discharge of debt that must be treated as income to a taxpayer, and the tax year in which the income is realized, are questions of fact. *See Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987). Whether there is a debt that can be discharged is also a question of fact, as it "**generally occurs when a taxpayer receives funds that are not includible in income, because the taxpayer is obligated to repay the obligation at a later date**." *Merten's Law of Federal Income Taxation*, Vol. 2, § 11:6 (Jan. 2014) (Emphasis added).

Code section 6050P, which establishes the requirement to file an information return reporting a discharge of debt (Form 1099-C), is directed only at "applicable entities" and excludes from such reporting any discharge below $600. An "applicable entity" is

defined as an “executive, judicial, or legislative agency” of the United States or an “applicable financial entity,” such as a bank, savings and loan association, credit union, the FDIC, or “any organization a significant trade or business of which is the lending of money” (§ 6050P(c)).

It is difficult to conceive of a situation in which a tax professional, principally engaged in providing tax services will be an “applicable entity” justifying the use of Form 1099-C to attribute income to an arguably scofflaw client for the nonpayment. However, every case will depend on its own particular facts and circumstances, including the existence (or not) of “debt,” with the crux of the analysis turning on whether the client can be said to have received previously untaxed funds from an applicable entity for which there is an obligation for repayment.