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Key Points for Bankers Concerning Federal Income Tax Filing Requirements When Discharging a Debt

I. What Constitutes a Debt for Form 1099-C Purposes

The Treasury Regulations issued by the Internal Revenue Service broadly define the term “debt” to mean any amount owed to the applicable entity (often a borrower), including stated principal, fees, stated interest, penalties, administrative costs, and fines. Importantly, the amount of the debt that is discharged can represent either the entire debt itself, or only a portion of the total amount owed to the applicable entity. However, when reporting a discharged debt for Form 1099-C purposes, only the portion of the discharged debt that represents the stated principal needs to be reported. But the institution is at liberty to report the full indebtedness forgiven, if it so chooses.

II. Is My Business an Applicable Entity for Form 1099-C Purposes

The Internal Revenue Code broadly defines the term “applicable entity” to mean certain governmental agencies and certain applicable financial entities. The Code generally defines the term “applicable financial entity” to include any regulated incorporated bank or trust company, chartered savings institutions, credit union, as well as any regulated subsidiary of such entity, or any other organization (whether regulated or non-regulated) that engages in the lending of money as a significant trade or business. Therefore, if you are a business that is licensed to engage in and actually do engage in the business of lending money, you generally will be required to file a Form 1099-C when you discharge a debt of \$600 or more pursuant to an identifiable event.

III. When Does an Identifiable Event Occur for Form 1099-C Purposes

Before a Form 1099-C must be filed, the applicable entity must have discharged a debt of \$600 or more pursuant to an identifiable event. The Treasury Regulations issued by the Internal Revenue Service define eight situations which will constitute an identifiable event, all of which are listed in the Form 1099-C instructions. For banks and other applicable financial entities, a common identifiable event occurs where a debt is discharged pursuant to the terms of an agreement to discharge the debt for less than full consideration. However, in situations where there is a good-faith dispute as to whether or not the debtor actually owes the full value or some portion of the debt, Courts may apply what is known as the contested liability doctrine to hold that there is no cancellation of debt for the amount of the debt that was in dispute. Under the contested liability doctrine, Courts consider the settlement of a good-faith dispute to mean that the terms of the settlement represents full consideration in exchange for the discharge of the disputed amount of the original debt. However, to support the application of the contested liability doctrine, a debtor cannot simply make an unsupported claim that all or a portion of the debt is in dispute. The dispute must be bona fide and the debtor must be able to provide actual evidence of the dispute. Below are two examples which illustrate when the discharge of debt for less than full consideration would likely constitute an identifiable event, and how the contested liability doctrine can impact the amount of cancellation of debt income to be reported.

Example 1: Borrower executed a \$100,000 promissory note in favor of Bank A to purchase White Acre, which had a FMV of \$100,000 at the time the promissory note was executed. Two-years later when the promissory note still has a value of \$100,000 and the FMV of White Acre has decreased to \$70,000, Borrower defaults on the terms of the promissory note. In consideration for discharging Borrower from the terms of the promissory note, Bank A takes title to White Acre and receives \$10,000 from the Borrower. Because Bank A received less than full consideration in exchange for discharging the promissory note in full, Bank A must generally file a Form 1099-C reporting the actual \$20,000 debt that was discharged (\$100,000 Promissory Note – (\$70,000 FMV of White Acre + \$10,000)).

Example 2: Same basic facts as in Example 1, but in this instance, Borrower raises a good faith dispute about whether it owes the full \$100,000. To settle this dispute, Bank A enters into an agreement with Borrower to take White Acre and receive \$10,000. In this situation, the Courts would likely apply the contested liability doctrine and rule that the consideration received by Bank A was in full satisfaction of the \$100,000 promissory note and thus no Form 1099-C will need to be filed.

If you have any questions about this article or the Form 1099-C requirements for your institution, contact Austin Byars, with the Tax Group of Frost Brown Todd's Louisville offices, at (502) 779-8176 or abyars@fbtlaw.com.

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