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When a Lender Must File and Send a Form 1099-C to Report Debt Forgiveness

Over the years, I have often addressed questions related to IRS Form 1099-C titled *Cancellation of Debt* for multiple lender clients. Sophisticated borrower's counsel also consider possible tax issues as they negotiate the workout of defaulted loans.

The purpose of this blog post is to discuss the basics of Form 1099-C [\[1\]](#) for lenders.

Addressing borrowers and the 1099-C, the IRS says this:

When you borrow money, you don't include the loan proceeds in gross income because you have an obligation to repay the lender later. If the lender subsequently cancels that obligation, you may be required to include the amount of the canceled debt in gross income. A commercial lender canceling a debt will issue a [Form 1099-C.pdf](#), *Cancellation of Debt* to report the cancellation.

On Form 1099-C, the lender reports the amount of the canceled debt. If the lender's acquisition of the secured property (or the debtor's abandonment of the property) and the cancellation of the debt occur in the same calendar year, the lender may issue a Form 1099-C only [as opposed to a Form 1099-A and a Form 1099-C]. . . .

In certain situations, you may exclude cancellation of debt income in whole or in part. For additional information, refer to [Publication 4681.pdf](#), *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*, [Topic No. 431](#), *Canceled Debt – Is it Taxable or Not?* and [Form 982.pdf](#), *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*.

See also [Topic Number 432 – Form 1099-A \(Acquisition or Abandonment of Secured Property\)](#) and [Form 1099-C \(Cancellation of Debt\)](#).

The second paragraph of the above quotation includes the innocuous phrase “the lender reports.” Unfortunately, that reference to what a lender must do is easier-said-than-done. First, I want to discuss two important limitations that impact when “the lender reports:” (1) only certain lenders must report using the Form 1099-C; and (2) reporting is not required when the forgiven debtor is a guarantor instead of a borrower.

Covered Lenders

The IRS provides a list of lenders that must report using a Form 1099-C. Generally speaking, covered lenders are those who are regularly engaged in the business of lending money like banks, credit unions, credit card companies and any entity whose “significant trade or business is the lending of money, . . .”

The list of covered lenders also explicitly includes “[a] federal government agency including a department, an agency, a court or court administrative office, or an instrumentality in the judicial or legislative branch of government.” The specific inclusion of government agencies has two implications that I want to discuss because they are so common – student loan debt forgiveness^[2] and debts owed to the Small Business Administration.

All the SBA loan programs that I have worked with are operated and managed through traditional lending institutions that were our clients, generally banks whose exposure to loan losses is limited by the SBA’s partial guaranty. In my experience, when SBA guaranteed loans are in default, counsel for the lender takes direction from the lender client but may participate in dealing with the SBA.^[3] If the lender forgives debt as part of the debt resolution work, the lender may report using the Form 1099-C; alternatively, at the end of the bank’s collection efforts, the SBA may become assignee of any remaining debt collection options such as claims against guarantors, unrealized collateral and remaining borrowers – in that event, the debt has not yet been forgiven and any debt forgiveness reporting will not be done by the bank.^[4]

Report Loan Forgiveness to Borrowers

Debt forgiveness reporting applies to borrowers who receive the cash and not guarantors despite their obligation to repay the debt. That is because the theory is not that escaping an obligation to pay money creates income; rather, the debt forgiveness removes the reason that the original cash receipt by the borrower [the loan] was not taxable income. As stated by the IRS above, “[w]hen you borrow money, you [the borrower] don’t include the loan proceeds in gross income because you have an obligation to repay the lender . . .” Debt forgiveness eliminates that “obligation” without actual repayment of the debt.

I am not suggesting that this distinction between borrower and guarantor should drive the loan structure. But this distinction and other considerations (like the difference between what borrowers and guarantors must show the debt on financial statements) should not to be ignored when loans are made.

When To Report Using the Form 1099-C

As mentioned above, not all forgiven debt is taxable income to the benefitted party. That fact is not an excuse for a lender’s failure to report the debt forgiveness using a Form 1099-C. This is actually very common since an [insolvent taxpayer may exclude debt forgiveness income from taxable income](#). Often, lender clients abandon debt collection efforts when the borrower is insolvent. If the abandonment involves actual debt forgiveness, a Form 1099-C may be required, but the insolvent borrower may avoid any tax liability.

Generally speaking, a Form 1099-C must be issued in the year when the debt discharging event occurs.^[5] So, if there is debt forgiveness at the end of a stream of periodic payments, then a Form 1099-C is appropriate when receipt of the last payment causes forgiveness of the remaining debt. The test is whether there has been an “identifiable event” resulting in the debt discharge. IRS regulations 1.6050P-1(b)(2)(i)(F) and (G) demonstrate that identifiable events can be: a completed agreement between the lender and borrower that results in release of the debt for less than payment in full; or implementation by the lender of a written or unwritten policy to “discontinue collection activity and discharge the debt.”

A Form 1099-C is not required if the discharged debt is less than \$600.

Lenders should remember that merely classifying a loan for regulatory purposes, internally transferring management of a loan to a particular group of employees, or removing a debt from your current assets (perhaps via a bad debt charge off) is not necessarily an “identifiable event” that triggers the need to file a Form 1099-C because those are internal business activities or accounting policies and do not impact the borrower’s legal obligation to pay the debt.

There are special rules exempting from reporting requirements debt discharges that occur through a bankruptcy court discharge or state court litigation. Additional rules exempt from reporting situations when some but not all borrowers of the same indebtedness are released.

Reporting the Forgiven Debt

The only forgiven debt that must be reported on Form 1099-C is the debt principal then owed. This is consistent with the IRS explanation to borrowers quoted above where the IRS says “[w]hen you borrow money, you don’t include the loan proceeds in gross income because you have an obligation to repay . . .” The actual money received by the borrower that was not included in income and no longer must be repaid is the remaining principal balance.

Obviously, this presents a planning opportunity for lender’s and borrower’s respective counsel when they negotiate partial payments of the total debt and forgiveness of the remaining amount owed; partial payments credited to debt principal will reduce the reported debt forgiven when the last agreed partial payment is received by the lender. Of course, this planning opportunity also impacts the lender because the accounting impacts are different depending on whether the forgiven debt is accrued interest and late fees (that may or may not have been recorded as accrued income) or loan principal.

Finally, I want to address one common situation. Suppose a borrower who owes \$10,000 in debt principal transfers to the bank

collateral with an estimated value of \$4,000 and makes a cash payment of \$1,000 all in exchange for a complete release that is not dependent on the ultimate sale proceeds generated by the collateral. The “identifiable event” has occurred when the borrower transfers the collateral and cash. So, how much does the lender report as discharged debt — \$9,000 or \$5,000 or wait until the collateral is sold and then determine the unrecovered principal debt using the net collateral proceeds? The IRS regulations are unclear in this situation. My advice, however, is to issue a Form 1099-C for \$5,000 because that is the lender’s best estimate. This seems best because the lender has the risk/benefit of the collateral’s unknown value and control over the collateral sale.

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[1] Related to Form 1099-C is Form 1099-A. The 1099-A is used by a secured lender when the lender reports the principal amount of the debt owed and the fair market value of the secured property as of (i) abandonment of the property by the borrower in favor of the secured lender, or (ii) acquisition of the lien property by the lender from the borrower. The borrower / debtor uses the amount shown on the form as “realized” to determine a gain or loss on the disposition of the property and report the gain or loss on titled Capital Gains and Losses or Form 8949 titled *Sales and Other Dispositions of Capital Assets* if the property isn’t used for business, or on Form 4797 titled *Sales of Business Property* if the property is used for business. Lenders are not required to report using both a Form 1099-A and Form 1099-C related to one transaction that simultaneously involves both collateral transfer and debt forgiveness.

[2] An in-depth discussion of the rules involving forgiveness of student loan debt is beyond the scope of this post. The general rule is that a 1099-C will be sent but certain specific federal student loan forgiveness programs exempt the forgiven debt from the borrower’s taxable income. See the specific rules of the federal

government's Public Service Loan Forgiveness, teacher loan forgiveness, law school loan repayment assistance, and National Health Service Corps Loan Repayment programs.

[3] This lender / SBA collection work relationship may include preparation for SBA approval a litigation plan and budget and a collection opportunities analysis that justifies any settlement which the lender may ask the SBA to approve.

[4] IRS rules explicitly state that the covered lender who must report debt forgiveness is the holder of the loan when the debt is forgiven whether the original lender or an assignee.

[5] See Internal Revenue Code section 6050P at 26 U.S.C. and regulations thereunder.

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