
Note

Payments on Debt After Discharge: When a Discharge Is Not Really a Discharge and the Limits of Taxpayer Recourse

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Picture yourself as one of the millions of Americans with debt in collections.¹ You worked hard to keep up with most of your bills, but one slipped away from you and is in collections. It is not a large account,² but at this point, you're doing what you can to keep the lights on, food on the table, and fuel in your car so you can go to work. You haven't made a payment on this particular account in a few years, though you have gotten calls from collectors. One day, you receive a 1099-C in the mail from your creditor, indicating that you must report the debt as income on your tax return because your creditor has apparently decided to discharge your debt.³ You pay the tax owed, thinking that is the end of it. Not long after, you receive a letter from a third-party debt buyer informing you that they now own the account and are planning on initiating legal proceedings against you on the account unless you pay today.⁴ You assume there

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1. Approximately 13.5 percent of all consumers have accounts in collection. FEDERAL RESERVE BANK OF N.Y., CONSUMER CREDIT PANEL DATA, 18 (3d Quarter 2015), <https://www.newyorkfed.org/microeconomics/data.html>. This is down only one percent from the peak of the last recession and four percent higher than pre-recession levels. *Id.*

2. The average balance in collections is \$1350. *Id.* The total amount of debt in collections is in the tens of billions of dollars. *See id.*

3. IRS, INSTRUCTIONS FOR DEBTOR FORM 1099-C (2015).

4. *See generally* FTC, REPAIRING A BROKEN SYSTEM: PROTECTING CONSUMERS IN DEBT COLLECTION LITIGATION AND ARBITRATION 5 (2010) (discussing the rapid growth in litigation as a collection strategy).

has been some mistake. The legal process begins and ends with a judgment against you for the balance that was discharged.⁵ Your wages are garnished and, over time, the judgment is satisfied in full.

You think back to the tax you previously paid on this account and ask your tax preparer if there is anything that you can do to get some of that money back. They inform you that since that was over three years ago, you cannot amend your tax return to remove the income.⁶ They also inform you that you cannot deduct the payments made via garnishment because you don't itemize your deductions,⁷ and, in any case, the payments do not exceed two percent of your adjusted gross income.⁸ They tell you there's a section that might work in a situation like this, but you don't qualify because there isn't enough money at stake. You are stuck paying tax on a discharged debt that you ultimately paid in full.

The situation outlined above arises most often at the intersection of the tax code (the Code) and the collections industry. Creditors are required to "discharge" debt for tax purposes at specific times governed by Treasury Regulation, but they are still very much interested in and able to collect on the debt.⁹ When they subsequently collect on this "discharged" debt, the economic situation of taxpayers no longer aligns with the tax position that the Internal Revenue Service (IRS) has required them to be in. The Code has mechanisms built-in to correct this misalignment, but they are not designed to remedy this situation because the dollar amounts at issue are often too low to make them useful.

5. States are increasingly recognizing that heightened pleading standards may be appropriate for debt buyers seeking judgments. Terry Carter, *The Debt Buyers*, A.B.A. J., Nov. 2015, at 58–61. Minnesota requires a copy of the contract or other document identifying the obligation to repay, a document identifying the amount owed, and a complete chain of title for the debt. MINN. STAT. § 548.101 (2015).

6. IRS, TAX TOPICS, TOPIC 308 – AMENDED RETURNS (Dec. 30, 2015).

7. *Tax Tip 2014-29: Itemizing vs. Standard Deduction: Six Tips To Help You Choose*, IRS (Mar. 10, 2014) (advising taxpayers filing as single to itemize only if those deductions exceed the standard deduction of \$6100).

8. 26 U.S.C. § 67 (2015) (providing that aggregated miscellaneous itemized deductions must exceed two percent of adjusted gross income before they are allowed).

9. See Treas. Reg. § 1.6050P-1 (2015) (describing the process for reporting debt discharges).

This Note offers a solution that would allow taxpayers to recoup the tax they were compelled to pay after they make payments on debt identified as discharged. The IRS is aware of the problem, but has limited tools available to solve the problem, as much of the harm is caused by statute.¹⁰ The solutions proposed herein do not address the use of the judicial system by creditors, as many states are acutely aware of the problem and are implementing some reforms.¹¹ Rather, this Note contends that reforms to the Code provide the only effective means to ensure that taxpayers who make payments on debt previously taxed as discharged are able to recover the tax previously paid. This ensures that their tax situation most closely aligns with their economic reality.

This Note explores the way the situations outlined above occur, the limits of the remedies available to taxpayers, and offers solutions to the problem. Part I of this Note introduces the law governing taxation of discharged debt, the circumstances leading to payments made on debt after discharge, and the work of courts to grapple with these issues. Part II examines how reporting requirements for discharged debt and limited taxpayer recourse for payments made after discharge combine to leave taxpayers paying tax and paying off debt simultaneously. Part III argues in support of proposed reforms to IRS reporting requirements and proposes legislative reforms. This Note concludes that, while proposed reforms address serious problems related to the reporting of discharged debt, they fail to provide a solution for those consumers who make payments on debt identified as discharged. Legislative reform creating a new, above-the-line deduction for payments made on debt previously discharged provides the best solution to the problem.

I. DEBT DISCHARGE, IRS REPORTING REQUIREMENTS, AND MAKING PAYMENTS AFTER DISCHARGE

The levying of tax and claiming of deductions are creatures of statute. The taxing of specific types of income at specific rates, which is the root of the problem explored in this Note, is the result of statute. The adjustments and remedies available to taxpayers likewise are enumerated by statute. Any discus-

10. See Removal of the 36-Month Non-Payment Testing Period Rule, Prop. Treas. Reg. § 1.6050P-1, 79 Fed. Reg. 61791 (Oct. 15, 2014).

11. See generally Carter, *supra* note 5 (surveying states).

sion of problems with the levying of tax requires a discussion of the relevant statutes.

This Part will introduce the sections of the Code and their attendant regulations that govern the recognition of income, the reporting of cancellation of debt classification as income, claiming deductions, and the ways a consumer can recoup tax previously paid. Section A will explore why the discharge of indebtedness must be classified as income and subsequently taxed. Section B will introduce the situations where creditors or debt buyers issue an IRS Form 1099-C and examine the consequences thereof. Section C will introduce situations in which a consumer makes payments on a debt that was previously identified as discharged, whether through judicial means or voluntarily. Finally, Section D will consider proposed regulations and pending legislation that may have an impact on this problem.

A. THE INCLUSION OF DISCHARGED DEBT IN THE CALCULATION OF GROSS INCOME

The United States tax code is based upon the implicit assumption that all accessions to wealth constitute income.¹² The Code does so “to exert in this field ‘the full measure of its taxing power.’”¹³ While *Glenshaw Glass* was decided before the Code’s current iteration, the assumption is still in force today and serves as a lens through which to view the question of what constitutes income.¹⁴ The following sections discuss the recognition of cancelled debt as income, the regulatory environment that governs its recognition and reporting, and how current trends in debt collection intersect with these requirements.

1. Section 61 Definition of Income and Inclusion of Cancellation of Indebtedness in Income

The Code provides that “gross income means all income from whatever source derived.”¹⁵ Courts have interpreted this to mean an “accession[] to wealth, clearly realized, and over which the taxpayers have complete dominion.”¹⁶ This interpretation leads to treating many events as producing income, even

12. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955) (defining income for the purposes of income taxation).

13. *Id.* (quoting *Helvering v. Clifford*, 309 U.S. 331, 332 (1940)).

14. *See Charley v. Comm’r*, 91 F.3d 72, 74 (1996) (quoting *Glenshaw Glass Co.* for a broad definition of income).

15. I.R.C. § 61(a) (2012).

16. *Glenshaw Glass Co.*, 348 U.S. at 431; *see Charley*, 91 F.3d at 74.

though they do not seem to be income in the colloquial sense of the word.¹⁷ This interpretation does, however, have a few important carve-outs.¹⁸ One of the most important for our modern economy is the classification of loan proceeds.¹⁹

When one receives an extension of credit, one has gained something. There is, however, a distinct difference between receiving an envelope of cash and a loan: an obligation to repay. The Supreme Court in *Commissioner v. Tufts* explained: “Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.”²⁰ When that obligation is extinguished, however, the taxpayer is left with the loan proceeds and any property derived from them, thereby realizing a gain with no remaining obligation to repay.²¹ With this analysis, it is clear why the Code explicitly included income from the discharge of indebtedness in gross income.²²

In the context of consumer credit card debt, the balance owed is often an amalgamation of original principal, interest both at the agreed rate and at higher penalty rates, and fees associated with delinquency.²³ This, it turns out, is of little consequence for debt’s treatment when ultimately discharged. The IRS takes the position that all interest and fees accrued pursuant to the terms of a financing agreement are treated as debt, and, in their discharge, create income for the taxpayer relieved

17. Examples include finding cash (held taxable as treasure trove income under Treas. Reg. § 1.61-14 in *Cesarini v. United States*, 296 F. Supp. 3, 7 (N.D. Ohio 1969)), or paying taxes that another owes (held as taxable income to the payee in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929)).

18. The Code provides a narrow list of explicit exceptions from inclusion in gross income, chiefly in sections 101-39E, but case law has held a few other accessions to wealth as untaxable, generally under the test announced in *Glenshaw Glass Co.*

19. As of October 2015, the Federal Reserve reported \$3.5 trillion in outstanding consumer debt. *Consumer Credit – G.19*, BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM (Oct. 2015), <http://www.federalreserve.gov/releases/g19/current>.

20. *Comm’r v. Tufts*, 461 U.S. 300, 307 (1983).

21. *Id.* at 319 (citing I.R.C. § 61(a)(12)) (“The taxation of the financing transaction then reflects the economic fate of the loan.”).

22. I.R.C. § 61(a)(12) (2012).

23. Richard C. E. Beck, *The Tax Treatment of Cancelled Interest and Penalties on Consumer Debt*, 53 N.Y.L. SCH. L. REV. 1025, 1026–27 (2008/2009) (noting that in some cases principal can be eclipsed by interest and fees).

of the obligation to repay.²⁴ Essentially, any costs or fees associated with borrowing money are subject to classification as income if they are discharged—even though nothing was gained from them.

In 2013, the most recent year for which data is available, individual taxpayers realized over ten billion dollars of cancellation of debt income. This is net of any applicable exclusions which are discussed in Subsection A.2 *infra*.²⁵ This is down from previous years, but still represents over 770,000 taxpayers realizing income from this code provision.²⁶ The most interesting fact about the dataset is the breakdown along income lines. While one might expect that those with cancellation of debt income are either destitute or very wealthy, the data indicate that over 460,000 taxpayers with between \$20,000 and \$200,000 of adjusted gross income have cancellation of debt income.²⁷ The amount of cancellation of debt income attributable to this group of “middle-class” taxpayers exceeds 4.5 billion dollars.²⁸ Whatever the underlying source of this income, for those so impacted, it represents an often surprising tax bill at the end of the year.

While the IRS may take away in the form of taxing cancellation of debt income, the Code provides several avenues for excluding cancellation of debt income; chief among these are exclusions for debt discharged by bankruptcy or where a taxpayer is insolvent (where their debts exceed their assets).²⁹ The most useful provision is § 108, which allows qualifying taxpayers to exclude discharged debt from income.³⁰ While § 108 is potentially very powerful, it is operative only when a taxpayer or their tax preparer has knowledge of the section and applies it in a particular case. That said, a large number of taxpayers use this exclusion in any given year. In 2013, over 453,000 taxpayers

24. See *Bross v. Comm’r*, T.C. Summ. Op. 2012-122 (2012); *Payne v. Comm’r*, T.C. Memo 2008-66, *aff’d*, 357 F.App’x. 734 (8th Cir. 2009).

25. IRS, INDIVIDUAL INCOME TAX RETURNS 2013, at 43–56 tbl.1.4, <https://www.irs.gov/pub/irs-soi/13inalcr.pdf>.

26. *Id.*

27. *Id.* Adjusted Gross Income is defined as gross income less specifically enumerated, “above-the-line” deductions. I.R.C. § 62 (2012). Generally, these are the deductions listed on IRS Form 1040 and used in the computation of Adjusted Gross Income thereon. IRS, FORM 1040 (2015).

28. IRS, *supra* note 25.

29. See I.R.C. § 108 (2012).

30. *Id.*

excluded a total of over \$39 billion.³¹ This represents cancellation of debt income that is never subject to tax.

No matter the nature of the underlying identifiable event, tax is imposed. There are, however, methods to exclude some of the debt identified as income from gross income.³² The most useful ground for excluding cancelled debt from income is the insolvency exemption, as it asks the simple question of whether debt exceeds assets post-discharge. What on the surface is a simple question becomes complicated by two factors: first, one must have knowledge of the exclusion to be able to use it, and second, courts have made it more difficult to qualify as insolvent in recent years.³³ The final result of this is that many individuals that may have been able to exclude income are now unable to do so.

IRS statistics show that individual taxpayers exclude a significant amount of income under § 108.³⁴ The same statistics show that a very large number of taxpayers with rather low incomes are reporting and paying tax on income attributable to cancellation of debt.³⁵ Unfortunately, that data does not show precisely who is reporting this income, why they are unable to exclude it, and what their demographic characteristics are. What can be determined is that a sizeable number of individuals are receiving 1099-Cs related to non-bankruptcy discharges of indebtedness.³⁶ Many taxpayers exclude large amounts of it, but many do not for whatever reason, and many pay tax.

The conclusion that can be drawn from the available data is that many low-income taxpayers are realizing income from

31. IRS, INDIVIDUAL INCOME TAX RETURNS LINE ITEM ESTIMATES, 68–69 (2013).

32. See generally I.R.C. § 108 (discussing the exclusion of cancellation of debt income from gross income).

33. See Matt Christy, *Measuring Assets and Liabilities Under the I.R.C. § 108 Insolvency Exclusion*, 19 BANKR. DEV. J. 429, 495–96 (2003) (concluding that recent decisions have made the insolvency exception less useful than perhaps initially intended by broadening the definition of what qualifies as an asset); Craig J. Langstraat & William G. Prascher, *Cancellation of Debt Income Exclusions for Individuals: Good and Bad News*, 85 PRAC. TAX STRATEGIES 15, 18 (2010) (discussing the increasing difficulty of claiming the insolvency exemption).

34. The Line Item estimates suggest that over \$39 billion were excluded. IRS, *supra* note 31.

35. IRS, *supra* note 25.

36. No 1099-C must be issued in the case of consumer bankruptcy unless the creditor knows that the debt was incurred for business or investment purposes. Treas. Reg. § 1.6050P-1(d) (2016).

the discharge of indebtedness. These same taxpayers are unlikely to be able to afford professional tax preparation and are unlikely to possess the knowledge as to how best avoid paying tax on this income themselves.³⁷

While nearly 40 billion dollars is a lot of money, that was money that would rightly have been taxed but for the exclusion. The money left over, the more than 10 billion dollars, is taxed because it was not excluded, either because none of the exclusions apply or because the taxpayer was not aware of their existence. If a taxpayer or their tax preparer knows the Code, and the tax payer otherwise qualifies, the IRS is not interested in adding insult to injury and taxing what was supposed to be an opportunity to get debt under control.

2. Statutory and Administrative Framework Governing the Reporting of Cancellation of Debt Income

The IRS can only tax what it knows about. In the case of discharged debt, the IRS requires reporting to the IRS and to the individual taxpayer.³⁸ This information reporting requirement accomplishes the goal of making sure all parties have the information they need to impose tax and report income. The regulations provide a more detailed description of the required information, including the name of the taxpayer, date of the identifiable event, the amount discharged, and whether it was because of bankruptcy, among other requirements of Form 1099-C.³⁹ The regulations further provide that the discharge must be reported even if the debt discharged is not actually taxable by operation of § 108 as discussed above.⁴⁰

This reporting is triggered any time a discharge of indebtedness occurs, but, “a discharge of indebtedness is deemed to have occurred, . . . if and only if there has occurred an identifiable event.”⁴¹ Identifiable events include discharge in bankruptcy, discharge because of foreclosure, an agreement to settle

37. IRS, IRS CERTIFIED VOLUNTEERS PROVIDING FREE TAX PREPARATION, Pub. 3676-B (2015). This document describes what many volunteer organizations are able to do, but more importantly identifies several categories of complexity where the IRS recommends seeking professional tax preparation advice. *Id.*

38. Treas. Reg. § 6050P (2015) (providing for the reporting of cancellation of debt income).

39. Treas. Reg. § 1.6050P-1(a)(1) (as amended in 1996).

40. *Id.* (a)(3).

41. *Id.* (a)(1).

the obligation for less than the full balance owed, the running of the statute of limitations on an action to collect, the creditor's decision to no longer pursue collection pursuant to a defined policy, and the expiration of the non-payment testing period.⁴² While most of the above are situations where the underlying obligation to repay is extinguished, the regulations do not explicitly require that any discharge of the legal obligation to repay occur to trigger the reporting requirements.⁴³ In the situations where a legal discharge has not occurred but a taxpayer is informed that they must report cancellation of debt income, questions often arise for taxpayer as to the meaning of a Form 1099-C and what their current situation is.

These questions are furthered by the very text of the Form 1099-C. The form indicates, in no uncertain terms, that it reports the cancellation of debt and has spaces for listing the amount and description of the debt discharged.⁴⁴ When asked by a member of the credit and collections industry what the effect of a 1099-C was without a legal discharge the IRS answered, "[t]he Internal Revenue Service does not view a Form 1099-C as an admission by the creditor that it has discharged the debt and can no longer pursue collection."⁴⁵ The IRS remains steadfast in its position that the required reporting is simply to make sure that tax is levied appropriately, rather than tracking legal discharges of indebtedness.

The cause of much of this confusion is one particular identifiable event, which does not coincide with a legal discharge of the obligation to repay. The expiration of the thirty-six month, non-payment testing period creates a "rebuttable presumption that an identifiable event [otherwise requiring reporting] has occurred."⁴⁶ This presumption is rebuttable by making a good-faith effort at collecting an outstanding debt within the last twelve months.⁴⁷ While this may seem like a perfectly reasonable presumption, the fact remains that the underlying obligation is not actually discharged. Debtors are not able to rebut

42. *Id.* (b)(2). Note, the statute of limitations event only occurs if the question is actually litigated, otherwise the statute of limitations expiration would normally fall into the broad classification of the creditor's decision to no longer pursue collection activity. *Id.* (b)(2)(ii) (as amended in 1996).

43. *Id.* (a)(1).

44. IRS FORM 1099-C, Instructions to Debtor (2015).

45. IRS, Info. Ltr., 2005-0207 (Dec. 30, 2005).

46. Treas. Reg. § 1.6050P-1(b)(2)(iv) (as amended 1996).

47. *Id.*

this presumption; it is for the creditor alone to rebut. It is completely permissible to attempt collection at a later date, even a date far removed from the original delinquency that started the testing period.

When the effect of a Form 1099-C is litigated, trial and bankruptcy courts have generally come to three separate conclusions. First, some courts explicitly follow the IRS information letter⁴⁸ and hold as a matter of law that no discharge has occurred.⁴⁹ Second, many courts, taking notice of the IRS position, are inclined to engage in an “inquiry into the facts and circumstances” surrounding the issuance of the form to determine whether there was intent to discharge the debt or not at the time of issuance.⁵⁰ Finally, some courts explicitly do not follow the IRS information letter and hold that the issuance of a Form 1099-C operates to discharge the underlying obligation to repay, whether or not there was intent to discharge the debt.⁵¹

3. Reporting Requirements and the Debt Collection Industry

The changing landscape of debt collection necessitates the complicated treatment of Form 1099-C and the variety of circumstances requiring its issue. Today, creditors routinely outsource collection activities and just as often package and sell debts to third-party debt buyers.⁵² The debt-buying industry

48. See *id.*; *supra* note 25.

49. See *In re Zilka*, 407 B.R. 684, 689 (W.D. Pa. 2009) (finding that a 1099-C does not, as a matter of law, discharge the associated indebtedness); *Debt Buyers' Ass'n v. Snow*, 481 F. Supp. 2d 1, 13 (D.D.C. 2006) (finding that issuance of a Form 1099-C does preclude subsequent attempts at collection); *Owens v. Comm'r*, 67 F. App'x 253, 3 (5th Cir. 2003) (finding that filing a Form 1099-C does not itself discharge an obligation).

50. See *FDIC v. Cashion*, 720 F.3d 169, 180 (4th Cir. 2013) (finding that additional evidence beyond the bare form was required to determine if debt was actually discharged); *Atchison v. Hiway Fed. Credit Union*, Civ. No. 12-2143 (DWF/FLN), 2013 WL 1175020 (D. Minn. 2013) (holding that additional discovery on the intent underlying the issuance of a Form 1099-C was required before it was possible to determine if there was a discharge by its issuance).

51. See *In re Reed*, 492 B.R. 261, 271-72 (E.D. Tenn. 2013) (finding the IRS Opinion Letter not entitled to *Chevron* deference, and finding it not persuasive under *Skidmore*); *Franklin Credit Mgmt. Corp. v. Nicholas*, 812 A.2d 51, 61 (Conn. App. Ct. 2002) (taking judicial notice that a 1099-C is prima facie evidence of the discharge of debt); *In re Crosby*, 261 B.R. 470, 477 (D. Kan. 2001) (finding it inequitable to allow collection while a 1099-C reports the debt has been discharged).

52. FTC, THE STRUCTURE AND PRACTICES OF THE DEBT BUYING INDUSTRY, 11-12 (Jan. 2013).

packages and sells tens of billions of dollars of consumer debt every year.⁵³ Approximately thirty percent of all debts sold by original creditors are more than three years old.⁵⁴ Of debts purchased from other debt buyers, the FTC estimates that approximately fifty-nine percent were more than three years old.⁵⁵ While age alone does not trigger the reporting requirement discussed above, as age increases the likelihood of triggering an identifiable event—particularly the non-payment testing period—necessarily increases.

In situations where a Form 1099-C has been previously issued, but collection activities resume, it is possible to issue an amended form to recognize that some of the underlying debt was actually collected.⁵⁶ Creditors, however, are not required to do so.⁵⁷ Nor are they likely to, given that it may be interpreted as a “deceptive practice” under the terms of the Fair Debt Collection Practices Act, opening them up to liability.⁵⁸

B. CREDITORS, DEBT BUYERS, AND DISCHARGING DEBT IN THE COURSE OF THEIR TRADES

Setting aside the complicated treatment of the discharge of indebtedness and the reporting requirements surrounding it, it is worth asking why creditors choose to discharge debt or otherwise cause the occurrence of an identifiable event, triggering the reporting requirements. Generally, when a consumer has failed to make payment on an account for 180 days, a creditor

53. The FTC reports that over the course of its three-year study, the total value of consumer debt purchased by study participants was \$143 billion. *Id.* at 8. In 2008, the study participants purchased 78.2 percent of the \$55.5 billion of credit card debt bought directly from credit card issuers. *Id.* The total value of the industry necessarily exceeds \$143 billion during the three-year period. *Id.*

54. *Id.* at 43.

55. *Id.*

56. The IRS specifically allows for issuing amended or corrected 1099-C forms. IRS, GENERAL INSTRUCTIONS FOR CERTAIN INFORMATION RETURNS (2016).

57. *Id.*

58. Some debt buyers have expressed concerns that issuing a 1099-C form in the first instance may open them up to liability under the Fair Debt Collection Practices Act (FDCPA) as this could be viewed as a deceptive practice. *Debt Buyers' Ass'n v. Snow*, 481 F. Supp. 2d 1, 6 (D.D.C. 2006). While this case held that it was not, the case did not address the issuance of subsequent forms. The FDCPA exists to prevent abuse of consumers at the hands of debt collectors. 15 U.S.C. § 1692 (2012). One of the key proscriptions is against the use of deceptive practices, a broadly construed term. *Id.* § 1692e.

is required to charge-off the account.⁵⁹ This is done to ensure that bank assets and capital reserves are accurately tracked.⁶⁰ If a bank was not required to charge-off accounts, it would be able to maintain a large stock of hopelessly delinquent accounts as assets, leading to it reporting a much healthier financial situation than they actually have.⁶¹ Once charge-off has occurred, the collection process generally begins, including assignment of collection responsibilities or sale to third parties.⁶² Beyond being required to do so, creditors charge off debts because they are then able to deduct the value of charged-off debts as a business expense.⁶³ This provides an incentive to identify those debts that are unlikely to be paid in a timely manner and deduct them sooner rather than later.⁶⁴ The general rule of aligning accounting and tax positions with economic realities does much to explain why discharge occurs.

Asking why a creditor or debt buyer would willingly discharge an obligation to repay is a more difficult question to answer. Creditors generally will not discharge debts unless they have a reason to do so (the world would be a much kinder place if creditors willingly did so).⁶⁵ Reasons for actually discharging debt often track the identifiable events listed by the IRS in Section 1.6050P-1.⁶⁶ If a creditor cannot legally collect the debt because it is time-barred, agrees to settle the account for less than full consideration, or determines that they will no longer attempt to collect, they will discharge the debt, either by operation of law or agreement.⁶⁷ As noted above, the occurrence of an

59. After 180 days of non-payment, the debt is classified as in default for bank capital requirement testing. 12 C.F.R. § 324.101 (2014). At this point, realizing the loss and deducting it as a bad debt yields a good result for the bank. I.R.C. § 166 (2015).

60. The Office of the Comptroller of the Currency and its capital requirement regulations are key drivers here. *See generally* 12 C.F.R. pt. 324 (2014).

61. These regulations also require that any assets be risk-weighted so that risky assets (which bad debt is) are valued appropriately and not carried at their nominal value. *See generally id.* § 324.30 (2015).

62. *See generally* FTC, *supra* note 52, at 11–12.

63. *See* I.R.C. § 166 (2012).

64. Money today is worth more than money tomorrow. *See Time Value of Money – TVM*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/timevalueofmoney.asp> (last visited Nov. 2, 2016).

65. Steve Bucci, *When Must Debt Collectors Give Up?*, BANKRATE.COM (Aug. 6, 2015), <http://www.bankrate.com/finance/debt/when-must-debt-collectors-give-up.aspx>.

66. Treas. Reg. § 1.6050P-1(b)(2) (as amended in 1996).

67. *See id.* (b)(2)(iii) (describing situations in which debt must be recog-

identifiable event does not itself operate to legally discharge the debt; there must be some intent to do so on the part of the creditor for this to happen.

C. AMENDING TAX RETURNS AND CLAIMING DEDUCTIONS

Occasionally taxpayers find that they need to adjust their tax position in the current or prior years. In the context of this Note, this happens when debt is taxed as discharged but subsequent payments are made. Taxpayers have effectively two ways to adjust their tax positions for a current year or prior years.⁶⁸ The first is amending tax returns. An amendment is applicable only to prior-year tax returns and is limited to the last three taxable years.⁶⁹ The second are deductions. These reduce the amount of income subject to tax, leading to a decreased amount of tax imposed on a taxpayer.⁷⁰ Some of these deductions are available only in a single, particular year.⁷¹ Others can be carried forward or backward to decrease income in prior or subsequent years.⁷² Each of these tools are addressed in in turn.

1. Amending Tax Returns

The first avenue available to a taxpayer to claim a deduction, credit, or refund otherwise available to them is through amending their tax return. This allows a taxpayer to change their prior-year tax returns to claim a refund owed to them on account of changed circumstances or an error discovered since filing.⁷³ The IRS does not encourage amendments for mathematical errors or simple omissions of forms that don't materially impact a tax return.⁷⁴ The IRS does encourage an amendment anytime a taxpayer needs to make a change that would entitle them to a refund.⁷⁵

nized as discharged).

68. This Section omits a discussion of tax credits, which are often employed to directly decrease tax liability, rather than adjusting what is eventually subject to taxation.

69. See IRS, *supra* note 6.

70. See IRS, FORM 1040 (2015).

71. A classic example of a deduction allowable in the year in which it occurs is the deduction for casualty or theft losses. I.R.C. § 165(c)(3) (2012).

72. The Code explicitly provides that capital losses incurred by individual taxpayers may be carried forward and deducted from income in future years. *Id.* § 1212(b).

73. IRS, *supra* note 6.

74. *Id.*

75. *Id.*

Congress has, however, limited such claims for refund to at most three years from when the return was filed for individual taxpayers.⁷⁶ For business taxpayers claiming deductions related to bad debts, the limit extends back seven years.⁷⁷ Further complicating matters is the inability to electronically file an amended return, necessitating preparation of a paper form and physically mailing it in with supporting documentation.⁷⁸ If a taxpayer fails to claim a refund within the three-year period, any subsequent claim for a refund is to “be considered erroneous and a credit of any such portion shall be considered void.”⁷⁹

2. Claiming Deductions

The Code provides for a whole host of deductions, often in very detailed fashion.⁸⁰ The major distinction between deductions is whether they are allowed above the line or below the line. This distinction effectively determines whether deductions are available for all taxpayers or only those that choose to itemize their deductions.⁸¹ Only approximately thirty percent of all taxpayers elect to itemize their deductions.⁸² The other seventy percent of taxpayers are best served by taking the standard deduction allowed by the IRS.⁸³ If a deduction is to have broad applicability and impact, it generally must be an above-the-line deduction.⁸⁴ The following Subsections explore the differences between the two broad classifications and reasons why one may be preferred to another.

a. Above-the-Line Deductions

Above-the-line deductions are those deductions specifically enumerated in 26 U.S.C. § 62 and are used in calculating a taxpayer’s adjusted gross income.⁸⁵ These deductions include

76. I.R.C. § 6511(a).

77. *Id.* § 6511(d)(1).

78. IRS, *supra* note 6.

79. I.R.C. § 6514(a).

80. *See id.* § 162 and accompanying regulations (governing the taking of business deductions, providing an example of just how detailed these provisions can be).

81. *See id.* § 63; *see also* IRS, *infra* note 93 and accompanying text.

82. IRS, *supra* note 31, at 16.

83. *Id.*

84. *See* Allan J. Samansky, *Nonstandard Thoughts About the Standard Deduction*, 1991 UTAH L. REV. 531, 543–44 (1991).

85. I.R.C. § 62 (2012). Adjusted Gross Income (AGI) is calculated by subtracting above-the-line deductions from gross income. *Id.* An above-the-line

student loan interest deductions⁸⁶ and retirement savings deductions.⁸⁷ But, this list also includes deductions the average taxpayer is unlikely to ever encounter, such as reforestation expenses and early withdrawal penalties for savings accounts or certificates of deposit.⁸⁸ Some of these deductions are widely taken. For example, in 2013, the student loan interest deduction was taken by over 11 million taxpayers, with a total value of over \$11 billion.⁸⁹ But, just because something is an above-the-line deduction does not mean that it has wide applicability or is widely employed. As an example, the deduction for early withdrawal penalties was taken by approximately 690,000 taxpayers in 2013, for a total value of \$221 million.⁹⁰

Whether or not an above-the-line deduction is taken by a large number of taxpayers, by its very nature it represents a special, statutory carve out. Above-the-line deductions exist because Congress determined that some particular cost incurred by taxpayers was of the character that it should be explicitly deductible, no matter how large or small the deduction is for a taxpayer.

b. Below-the-Line Deductions

In contrast are below-the-line deductions, which are deducted from *adjusted* gross income to calculate a taxpayer's taxable income.⁹¹ These deductions are expressly not available to a taxpayer unless the taxpayer elects to itemize their deductions.⁹² The election to itemize is entirely up to the taxpayer, but the IRS strongly encourages itemizing only when the sum total of all itemized deductions exceeds the standard deduction.⁹³ Still, for the thirty percent of taxpayers who choose to itemize, these deductions represented more than \$1.1 trillion in 2013.⁹⁴ Some of the most popular itemized deductions are state

deduction directly decreases the amount of income subject to tax.

86. *Id.* § 62(a)(17).

87. *Id.* § 62(a)(7).

88. *Id.* § 62(a)(11)(9).

89. IRS, *supra* note 31, at 14–15.

90. *Id.*

91. I.R.C. § 63 (2012).

92. *Id.* § 63(b) (providing that no deduction other than the standard deduction is allowed unless the taxpayer elects to itemize).

93. IRS, *supra* note 7 (advising taxpayers to itemize only if those deductions exceed the standard single taxpayer deduction of \$6100).

94. IRS, *supra* note 31, at 33.

and local income taxes paid, representing more than \$320 billion, and home mortgage interest, representing \$290 billion.⁹⁵

The statutory scheme governing itemized deductions is, in a way, similar to that governing the whole scheme of deductions. The difference is that, instead of dividing between above-the-line and below-the-line deductions, the distinction is between miscellaneous and non-miscellaneous itemized deductions.⁹⁶ Non-miscellaneous deductions are expressly provided for by statute.⁹⁷ Those deductions not specifically enumerated in § 67 of the Code are the miscellaneous itemized deductions. Miscellaneous itemized deductions are limited in that only the amount of total miscellaneous itemized deductions that exceeds two percent of a taxpayer's adjusted gross income may be taken.⁹⁸ Included in the miscellaneous itemized deductions are repayments of income, including cancellation of debt income.⁹⁹

From time to time, Congress decides that a below-the-line deduction should be granted above-the-line status. This most recently happened with attorney fees in discrimination cases.¹⁰⁰ Prior to this action, attorney fees in discrimination cases were only deductible as miscellaneous itemized deductions, leading in some cases, to serious tax consequences.¹⁰¹ Congress decided that outcomes like that were unjust, and acted to create a specific, above-the-line deduction for attorney fees in some discrimination cases.¹⁰² The result of this was to ensure that those¹⁰³

95. *Id.*

96. This sorting is implicit in listing which itemized deductions are subject to a higher level of scrutiny as miscellaneous itemized deductions and those that are not. I.R.C. § 67 (2012).

97. *Id.* § 67(b).

98. *Id.* § 67(a); IRS, FORM 1040, SCHEDULE A (2015).

99. IRS, PUBLICATION 529, MISCELLANEOUS DEDUCTIONS 3–6 (2014).

100. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418 (2004).

101. Steve Johnson, *Major Changes to Taxation of Tort Damages*, NEV. LAW. Apr. 2005, at 12 (providing the example of a taxpayer who ended up owing more in taxes than the amount recovered net of attorney fees).

102. H.R. REP. NO. 108-755, at 131–33 (2004) (Conf. Rep.). The provisions originated in a Senate amendment; the conference report addresses the Senate amendment directly. *Id.*

103. In FY 2014, the EEOC reported that 88,778 charges of discrimination were filed with them. *Charge Statistics FY 1997 Through FY 2014*, EEOC, <https://www.eeoc.gov/eeoc/statistics/enforcement/charges.cfm>. The filing of a charge of discrimination is required before a case can be filed, and serves as a ceiling for the number of federal discrimination suits filed. *Filing a Charge of Discrimination*, EEOC, <https://www.eeoc.gov/employees/charge.cfm> (last visited Nov. 2, 2016).

recovering otherwise-taxable damages¹⁰⁴ would be able to deduct their attorney fees without having to worry about their character as miscellaneous itemized deductions. Reclassifying deductions is something that can, and does, happen.

C. MAKING PAYMENTS AFTER DISCHARGE

Admittedly, there are no issues if debt is reported as discharged, tax is paid, and nothing further happens. There are only problems when there are payments made after issuance of a Form 1099-C and subsequent payment of tax. There are two broad situations where an individual may make payments on debt: either they make payments because they are forced to by the terms of a settlement agreement or judicial order or they make payments on a voluntary basis because they perceive a benefit in doing so. These situations will be addressed in turn.

1. Mandatory Payments

In Minnesota, like many states, there exists a robust set of post-judgment remedies available to creditors. Chief in their arsenal is the ability to garnish wages or bank accounts until a judgment is satisfied.¹⁰⁵ All that is required to use this remedy is knowledge of an employer or bank account and a judgment entered against the consumer.¹⁰⁶ Once these are in hand, service of notice of intent to garnish on the consumer must be given, accompanied by a form with which to claim exemption from garnishment, as well as a garnishment summons on the employer or financial institution.¹⁰⁷ Collection of amounts so garnished is effected by service of a writ of execution.¹⁰⁸

There are limits to this procedure designed to ensure that garnishment does not leave a consumer destitute. First, if a consumer receives, or in the last six months has received, government assistance, the consumer cannot be garnished.¹⁰⁹ Second, only twenty-five percent of disposable earnings may be garnished.¹¹⁰ Even with these limits, the number of consumers

104. See I.R.C. § 104 (2012) (allowing for exclusion from income only those damages arising from a physical injury).

105. See MINN. STAT. § 571.72, .92, .91 (2014).

106. *Id.* § 571.72.

107. *Id.*

108. *Id.*

109. *Id.* § 571.912.

110. *Id.* § 571.922. In the case of child support collection actions, the amounts are higher. *Id.*

with active garnishments in 2013 exceeded seven percent.¹¹¹ Of that seven percent, 2.9 percent was attributable to consumer and student debts, an amount ADP, a major payroll services company, estimates to represent more than four million Americans.¹¹²

Minnesota also offers creditors the ability to place a judgment lien on any real property owned by a consumer in a county where the judgment is docketed.¹¹³ Such a lien continues for ten years or until the judgment is satisfied.¹¹⁴ This operates like any other lien on property, clouding the title, and decreasing its marketability.¹¹⁵ The ten-year limit derives from Minnesota's statute of limitations on enforcement of judgments.¹¹⁶ Ten years, however, is not the end of a judgment, as they may be renewed under a claim of failure to pay a judgment.¹¹⁷ This effectively allows a judgment, garnishment actions, and liens on property to have perpetual life until the obligated party dies, declares bankruptcy, or otherwise satisfies the judgment.¹¹⁸

2 Voluntary Payments

There are a few circumstances where a consumer would choose to make payments on debt previously discharged where no continuing obligation to repay exists. In the world of credit reporting, a closed and paid account can be reported in two ways, either as "paid in full," or as "settled for less than full balance."¹¹⁹ Experian, one of the three major credit bureaus indicates that settlement is less desirable because "[a]ny time you

111. ADP RESEARCH INST., GARNISHMENT: THE UNTOLD STORY, 8 (2014).

112. *Id.*; Chris Arnold, *Your Money: Millions of Americans' Wages Seized over Credit Card and Medical Debt*, NAT'L PUB. RADIO (Sept. 15, 2014), <http://www.npr.org/2014/09/15/347957729/when-consumer-debts-go-unpaid-paychecks-can-take-a-big-hit>.

113. MINN. STAT. § 548.09.

114. *Id.*

115. *See Cloud on Title*, INVESTOPEDIA, http://www.investopedia.com/terms/c/cloud_on_title.asp (last visited Nov. 2, 2016).

116. MINN. STAT. § 541.04 (providing that actions on judgments must be commenced within ten years of entry).

117. *Dahlin v. Kroening*, 784 N.W.2d 406, 413 (Minn. Ct. App. 2010).

118. *See* Greg Fitzgerald, *There Are Only 3 Ways To Get Rid of a Judgment*, FITZGERALD & CAMPBELL CAL. CONSUMER DEBT PROTECTION L. BLOG (Jan. 15, 2014), <https://debtorprotectors.com/lawyer/2014/01/15/Judgments/there-are-only-3-ways-to-get-rid-of-a-judgment-bl11194.htm>.

119. "Paid in Full" vs. "Settled for Less than Owed," EXPERIAN (June 20, 2013), <http://www.experian.com/blogs/ask-experian/3013/06/20/paid-in-full-charged-off-account-is-better-than-settled-for-less-than-owed>.

fail to repay the full amount you owe it will be considered negative.”¹²⁰ Payments made in addition to those required by a settlement agreement can move the report to paid in full status, helping to increase chances of securing credit in the future.¹²¹

An analogous situation is the repayment of debt after discharge in bankruptcy because of a moral obligation to do so. Courts have recognized that “some people might consider full debt re-payment a moral obligation, even though the legal remedy for the debt has been extinguished.”¹²² While hard numbers are hard to find, this is a common enough occurrence to warrant provisions in the bankruptcy code to provide a method of reaffirming debts, making them legally binding again in spite of the bankruptcy discharge,¹²³ and allowing for the voluntary repayment of debt, even though no legal obligation exists after discharge.¹²⁴

D. PENDING ACTIONS TO REMOVE THE NON-PAYMENT TESTING PERIOD

Recognizing the confusion the non-payment testing period identifiable event can cause, both Congress and the IRS have proposed eliminating it. The IRS first solicited comments on a tentative proposal to eliminate the testing period in December of 2012.¹²⁵ They subsequently issued a Notice of Proposed Rulemaking on October 15, 2014.¹²⁶ Comments were received, but, to date, no further action has been taken on the proposed rule.¹²⁷ Congress has also taken up the issue. In the Senate, Bill 2333 was introduced on November, 30, 2015 and was subse-

120. *Id.*

121. See Sintilia Miecevole, *The Effects of Bad Credit*, EXPERIENCE, https://www.experience.com/alumnus/article?channel_id=managingyourmoney&source_page=additional_articles&article_id=article_1131053248326 (last visited Nov. 2, 2016).

122. *McMahon v. LVNV Funding, LLC*, 744 F.3d 1010, 1020 (7th Cir. 2014).

123. See 11 U.S.C. § 524(c) (2012) (providing the requirements of an agreement to reaffirm debt and allowing for enforcement thereof).

124. *Id.* § 524(f).

125. I.R.S. Notice. 2012-65, 2012-52 I.R.B. 773 (Dec. 27, 2012).

126. Removal of the 36-Month Non-Payment Testing Period Rule, Notice of Proposed Rulemaking, 79 Fed. Reg. 61791 (Oct. 15, 2014) (to be codified at Treas. Reg. pt. 1).

127. *Removal of the 36-Month Non-Payment Testing Period Rule Docket Folder Summary*, REGULATIONS.GOV, <http://www.regulations.gov/docket?D=IRS-2014-0034> (last visited Nov. 2, 2016).

quently referred to the Finance Committee.¹²⁸ In the House of Representatives, Bill 4128 was introduced on November 30, 2015 and was subsequently referred to the Ways and Means and Financial Services Committees.¹²⁹ No further action on either bill has occurred.

II. PROBLEMS ARISE WHEN PAYMENTS ARE MADE AFTER DEBT IS REPORTED AS DISCHARGED

In the case of our hypothetical taxpayer from the Introduction of this Note, he or she had no problem until he or she were subsequently compelled to make payments after a creditor reported the indebtedness to the IRS as discharged. In this Part, this Note discusses the ways in which the problem arises and the lack of effective solutions. This Part will explore how the reporting requirements, legal and moral obligations to repay, and rules governing the taking of deductions lead to a situation where a taxpayer is forced to make payments on debt previously discharged, but is unable to recoup the tax previously paid. Section A explores how the problem arises and Sections B and C discuss the insufficient remedies available to taxpayers and why currently proposed solutions fail to adequately address the problem. This Part concludes with the proposition that there is more that can and should be done to address this problem.

A. DISCHARGE OF INDEBTEDNESS, IDENTIFIABLE EVENTS, AND MAKING PAYMENTS LEADS TO AN OBLIGATION TO PAY BOTH TAX AND DEBT

When identifiable events combine with uncertain legal status and payments, either forced or voluntary, taxpayers find that they have very limited resources to square their economic position with their tax position. While on their own each of these events are unobjectionable, in combination, they create a veritable black hole for taxpayers unfortunate enough to find themselves at their intersection. Here, they are just as our hypothetical taxpayer described in the introduction—without recourse and without money in their pocket. In what follows, this Section explores how the Code sections discussed above inter-

128. S. 2333, 114th Cong. § 305 (2015). The bill would bar the use of an expiration of a testing period for determining whether a discharge of indebtedness has occurred. *See id.*; S. 2333, 114th Cong. § 305 (2015).

129. H.R. 4128, 114th Cong. § 305 (2015). The text is identical to that of the Senate bill. *Id.*

sect to create the problem.

1. Occurrence of an Identifiable Event

The ultimate cause of the problem this Note explores is the inconsistent status of debt recognized as cancelled and classified as income. This is traceable primarily to the IRS reporting requirements discussed above.¹³⁰ Most identifiable events, such as the running of a statute of limitation, or a creditor's choice to pursue foreclosure remedies, coincide with the extinguishment of the obligation to repay. The text of the regulation is replete with allusions to a debt being rendered "unenforceable," or a "cancellation or extinguishment" of a debt.¹³¹ These stand in opposition to those events that discuss only a discharge of indebtedness, namely bankruptcy, an agreement with the creditor to settle the debt, or the expiration of the non-payment testing period. The regulations in these instances only refer to the "discharge of indebtedness."¹³² The difference in language suggests a difference in the underlying character of debt.

Such a difference is borne out in the context of debt discharged pursuant to the bankruptcy code, where the text of the statute states that the effect of a discharge "operates as an injunction against the commencement or continuation of an action, the employment of process, or any act . . . to collect, recover, or offset any discharged debt as a personal liability of the debtor"¹³³ Courts have further held that the discharge of indebtedness in bankruptcy never extinguishes the underlying obligation to repay; it simply makes that obligation unenforceable against the individual.¹³⁴ This distinction between extinguishment of an obligation and a mere discharge sets the stage for future disagreement about what precisely remains after a debt is labeled as discharged.

The dichotomy between tax status and legal status is further supported by situations where a creditor decides to discontinue further collection efforts or otherwise settle the debt for less than full consideration. Both of these events trigger the reporting requirements, but it is clear that the underlying debt

130. See Treas. Reg. § 1.6050P-1 (2015).

131. *Id.*

132. *Id.*

133. 11 U.S.C. § 524(a)(2) (2012).

134. See *Johnson v. Home State Bank*, 501 U.S. 78, 84 (1991) (finding that discharge of liability, while extinguishing personal liability, does not constitute complete termination of the claim).

may still be enforceable.¹³⁵ In the case of discontinuation of collection efforts, one could conceive of a situation where a creditor applies their policy and formally discontinues collection efforts, but upon learning new information, begins collection efforts anew. Where a creditor decides to settle a debt for less than the amount owed, there is no requirement that the underlying obligation being settled be discharged before payment in full.¹³⁶ If a consumer fails to comply with the settlement agreement, there is no reason why the entirety of the underlying obligation could not be enforced pursuant to the terms of the settlement agreement.¹³⁷ The IRS's position on the issue is, in a way, consistent with the above textual distinctions, but emphasizes that the issuance of a Form 1099-C is used solely for informational reporting reasons, especially in the context of the expiry of the non-payment testing period.¹³⁸ Indeed, the lack of public information about the aggregate amount of debt identified as discharged and sorted by identifiable event further suggests that the IRS simply does not care why the information is being reported.¹³⁹ They prefer to focus on identifiable events, and define them broadly, rather than focus on the legal status of debt triggering the identifiable event.

2. Making Payments After Discharge: The Black Hole

In spite of the differences between the tax and legal statuses of debt, no problem arises if no payments are made after the issue of a 1099-C. Unfortunately, due to the varying legal status of the debts subject to the reporting requirement, receiving a 1099-C and paying tax is no guarantee that the creditor

135. Treas. Reg. § 1.6050P-1(b)(2)(E)–(F) (2015).

136. Settlement agreements are simply contracts, and performance thereunder can be structured and enforced under the body of contract law. *See* Trapp v. Roden, 41 N.E.3d 1, 8–9 (Mass. 2015) (citing Sparrow v. Demonico, 960 N.E.2d 296, 301 (Mass. 2012)); Georgos v. Jackson, 790 N.E.2d 448, 453 (Ind. 2003) (citing Indiana State Highway Comm'n v. Curtis, 704 N.E.2d 1015, 1018 (Ind. 1998)).

137. This is a surprisingly common practice in the debt collection world. *See, e.g.*, Confession of Judgment of Marty Miller & Bindery Plus, Inc., A+ Bindery, Inc. v. Miller, No. 62-CV-09-11636, 2010 WL 2552817 (Minn. D. Ct. Ramsey Cty. 2010).

138. I.R.S. Info. Ltr. 2005-0207 (Oct. 7, 2005); *see supra* notes 49–51 and accompanying text.

139. This data is likely available to select individuals working internally in the IRS through its “Information Returns Master File.” Given the sensitive nature contained in unredacted tax returns, it is not surprising that access to this database is limited.

will not come knocking later, looking for money they had previously said was discharged. This Subsection explores the differing treatment of a 1099-C around the country, why subsequent collection attempts are likely with the thirty-six month testing period, and the role of voluntary payments.

a. Split in Lower Courts as to Effect of Form 1099-C

There is disagreement in trial courts across the country as to the meaning and effect of a 1099-C. Some courts are inclined to find it as prima facie evidence of the discharge of indebtedness, some are inclined to see it as one part of a larger facts and circumstances inquiry into the intent of the issuing organization, and a small number see it as simply complying with IRS regulations.¹⁴⁰ This disagreement stems in large part from the distinction discussed above between the character of the identifiable event triggering the issue of a 1099-C and the actual legal status of the debt. The differing positions reflect a deeper attempt to reconcile the universal treatment of legally distinct circumstances, with an eye towards treating all debts taxed as discharged the same, or at least offering the possibility of a path beyond the IRS's rigid position of the meaning and effect of a 1099-C form.

This split also has other unintended consequences. The jurisdiction where one is located will determine whether or not a creditor issuing a 1099-C forfeits all remedies when they comply with the reporting requirement.¹⁴¹ Creditors may be inclined to aggressively collect outstanding debts in these jurisdictions, or they may simply slowly decrease the amount of credit they choose to extend in these jurisdictions. If creditors know that complying with IRS regulations will decrease their chances of collecting on outstanding debts, they may simply determine that it is not worth the time and expense of doing business in that jurisdiction.

b. The 36-Month Testing Period Is Far Shorter than Most Statutes of Limitation, and Often Leads to Subsequent Collection Attempts

The 36-month testing period was presumably set to align with the general fact that, as a debt gets older and contact with a debtor has been lost, the chances of ever collecting on the

140. See *supra* notes 49–51 and accompanying text.

141. *Id.*

debt decrease.¹⁴² Unfortunately, with the growth of the debt-buying industry and sophisticated research tools, old debts are not necessarily as unlikely to be collected as they may have been in the past.¹⁴³ The growth of the debt-buying industry means that aging debt has a high chance of being packaged and sold to another debt collection firm that is more willing to take a risk and attempt collection.¹⁴⁴ The increasing sophistication of the debt collection industry does mean that applicable statutes of limitation have become much more important. Attempts to collect are routinely made on debt that is approaching the statute of limitation, and in some cases, after the expiration of the statute of limitations.¹⁴⁵

This would not be a problem of any great magnitude if most statutes of limitation were similar in length to the 36-month period, but the vast majority of states have statutes that are longer than this, and in some cases significantly so.¹⁴⁶ This has the effect of keeping debt alive far past the expiry of the testing period, leading to imposition of tax on discharged indebtedness even though an intention, or at the least a possibility, to collect later or in the future exists. Splitting the tax status of debt from the legal status of debt creates this odd circumstance, a circumstance which may lead to making payments on debt that was previously taxed as discharged.

As discussed above, the legal system is increasingly being used by creditors to enforce their claims and secure repayment.¹⁴⁷ As sources show, judgment can be entered with minimal documentation.¹⁴⁸ Indeed, the cases where the meaning of a Form 1099-C has been actively litigated have been in the context of attempts to collect on debt, or otherwise assert a claim, *after* a tax discharge.¹⁴⁹ While courts are not unified in their treatment of Form 1099-C, many are inclined to agree with the IRS interpretation, or at least demand further proof of an actu-

142. *How Your Accounts Receivables Lose Value over Time*, PROFESSIONAL RECOVERY PERSONNEL, INC., <http://www.prorecovery.com/how-your-accounts-receivables-lose-value-over-time> (last visited Nov. 2, 2016).

143. FTC, *supra* note 52, at 29, 43–44.

144. FTC, *supra* note 52, at 34–36.

145. Encore Capital Grp., Inc., CFPB No. 2015-CFPB-0022, 17 (Sept. 9, 2015).

146. *See, e.g.*, MINN. STAT. § 541.053 (2015) (specifying that debt actions shall be commenced within six years).

147. FTC, *supra* note 52, at 5–6.

148. *See Carter, supra* note 5, at 55.

149. *See supra* notes 49–51 and accompanying text.

al intention to extinguish the underlying obligation to repay. There is no indication that a creditor or debt buyer would be inclined to agree that a previously issued Form 1099-C evinces an actual discharge. Indeed, there are accounts of debt buyers attempting to collect on debts that they knew were time-barred and otherwise extinguished.¹⁵⁰

Getting a judgment against a debtor is just the first step towards leveraging the full spectrum of creditor's remedies. As discussed above, many states have robust schemes available to a judgment creditor to secure payment. The use of these techniques to force payment is growing and leaves a debtor with limited recourse.¹⁵¹ Though a debtor may protest the propriety of the judgment against them, the time to litigate those issues has since passed, and their only defense is claiming that the funds they have are exempt.¹⁵² While they may be able to negotiate the issuance of an amended Form 1099-C to reflect partial payments, it is highly unlikely that a judgment creditor who had no part in issuing the original Form 1099-C would be inclined to issue an amended Form 1099-C, undoing a discharge they have no knowledge of. Even if a debtor pays the judgment voluntarily (either to avoid the perceived impact of garnishment or to avoid a lien on their property) they are just voluntarily complying with their legal obligation. They have still been compelled to make payments—payments on debt previously taxed as discharged.

c. Voluntary Repayment

Even with the robust tools available to creditors, debtors sometimes voluntarily make payments on debt, even though they may have no legal obligation to make payments. These situations stand in distinction to those where an obligation to repay remains, as there is no requirement to make payments. As discussed above, there are a variety of reasons why a debtor may decide to make payments on debt where there is no obliga-

150. Encore Capital Grp., Inc., CFPB No. 2015-CFPB-0022, 22–23, 28 (Sept. 9, 2015).

151. See Arnold, *supra* note 112 (finding that, for example, more than half of U.S. states have garnishment laws permitting creditors to take a quarter of debtors' after-tax wages).

152. In many states this defense will not help the debtor: creditors can seize money directly from the debtor's bank account. See Chris Arnold, *With Debt Collection, Your Bank Account Could Be at Risk*, NAT'L PUB. RADIO (Sept. 16, 2014), <http://www.npr.org/2014/09/16/348709389/with-debt-collection-your-bank-account-could-be-at-risk>.

tion to repay. One of the best examples arises in the context of a bankruptcy proceeding and making payments out of a feeling of moral obligation. Debtors do not have any reason to make payments, but still decide that they should make some partial payments to maintaining business relationships, or to feel better about getting the fresh start the law provided to them. While bankruptcy gives the best examples of making payments after a clear extinguishment of the obligation to repay, such situations are not limited to that context. Even though taxpayers are making payments they have no obligation to make out of their own self-interest, they are still in the same position as those debtors that are forced to make payments.

In the cases where an individual has settled an account for less than full consideration, that notation of settlement will stay on the individual's credit report for seven years.¹⁵³ While it may not operate as a complete bar to accessing credit in the future, it is a less desirable notation than "paid in full." Moving an account from a settled status to paid in full can show creditors that a prospective debtor takes seriously the obligation to repay. Payment in full shows a debtor will strive to make the creditor whole again, even though no obligation to do so exists.¹⁵⁴ Admittedly, once an account has been charged off, the distinction between paid in full and settled for less is a fine one, but it is important enough that people consider paying after settlement. However, these voluntary payers have even more limited recourse: they cannot claim that they have been forced to put themselves into a complex and disadvantageous tax position. Indeed, they are deriving tangible benefits by making payments.

That the Code and circumstances can create difficult situations for taxpayers is not unique to this situation.¹⁵⁵ Differenti-

153. See Daniel Sayre, *How Long Do Settled Accounts Stay on a Credit Report*, EXPERIAN (Aug. 11, 2016), <http://www.experian.com/blogs/ask-experian/how-long-do-settled-accounts-remain-on-a-credit-report>.

154. *But cf.* Erica Sandberg, *Should I Pay in Full, Even After a Debt Settlement?*, FOX BUS. (April 24, 2014), <http://www.foxbusiness.com/features/2014/04/23/should-pay-in-full-even-after-debt-settlement.html> (arguing that there are better methods to improve one's credit report after a debt settlement than offering collection agencies free money).

155. One such example is the recognition of income under the claim of right doctrine. See generally *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932) (recognizing the claim of right doctrine in the context of company profits, the receipt of which were contingent on the outcome of a pending lawsuit). This doctrine requires that one recognize as income things that it appears one has

ating this situation from the others is that a person falls prey to this simply because they were doing what many perceive as the right thing. Solutions exist for large numbers of analogous situations (for example, the Code carves out particular remedies¹⁵⁶), but not in this situation. It is unclear why this particular situation deserves special, punitive treatment, especially given the availability of remedies that are unfortunately beyond the reach of these taxpayers.

B. CURRENTLY AVAILABLE SOLUTIONS ARE INSUFFICIENT TO ADDRESS THE PROBLEM

In a perfect world, making payments after a tax discharge of debt would never create the problem outlined above. Parties would have multiple ways of ensuring their tax position closely tracked their economic situation. Unfortunately, the methods available to taxpayers today are limited in their scope of applicability. This Section explores the practical limits of the currently available strategies of amending previous tax returns and deducting payments as a miscellaneous itemized deduction, which have created a situation where tax is paid, the debt is paid, and debtors are left with no options for recovering the value of their tax payment.

1. Amending Prior-Year Returns Is Not Normally Available

While ordinarily a useful tool for fixing errors, amending one's tax return is ill-suited for the complexities of this situation. The most important problem is that of timeframe. From the initial filing of the tax return reporting the discharge, the three-year period begins running. As the FTC's research has shown, three-year-old debt is not, in the grand scheme of

an "unrestricted right" to. I.R.C. § 1341(a)(1) (2012). This recognition is required even though the actual receipt or final dollar amount of the income might be indeterminate. The rationale behind this doctrine is that income should be realized when one accrues a right to receive it, not on the date of actual possession.

156. Although the claim of right doctrine may cause some taxpayers pain, the IRS recognizes that such a forward-looking doctrine may result in the imposition of tax today while the actual amount received tomorrow may be different. Section 1341 provides a complex way of determining the manner in which one can account for differences in expected and actual income attributed to the claim of right doctrine. *Id.* § 1341(b). There are limitations to this particular remedy, namely that the dollar amount must exceed \$3000 before these remedies become available. *Id.* § 1341(a)(3).

things, very old.¹⁵⁷ Debt that must be reported as discharged for tax purposes likely still has several years of life under the applicable statute of limitation.¹⁵⁸ Mixing this with the possibility of a protracted collection period and the ability to renew judgments in hopes of eventually collecting, it is likely that payments will be made outside the range of time where amending tax returns is permissible.

Even assuming that the payments are made within the three-year period for amending tax returns, amending one's tax return demands a certain measure of sophistication. The IRS does not make a habit of mailing letters indicating that individuals may be entitled to refunds. Rather, the converse is true. The IRS sends letters indicating that, by their math, additional tax is owed and an amended form is required to be filed so that one can pay the additional tax they are obligated to pay.¹⁵⁹ What this means is that an individual taxpayer must be aware of their rights to amend and must know that as they pay off previously discharged debt, they are, in effect, decreasing the amount of debt previously discharged. They must also know that this necessarily decreases their tax liability in the previous years, and that they are entitled to amend their tax returns to take advantage of this change. As mentioned above, Congress and the courts have expressed some concern about the level of sophistication among those subject to collection attempts.¹⁶⁰ It seems unlikely that a "least sophisticated consumer" would be expected to know the procedures and timelines for amending a prior year tax return.¹⁶¹

Amending a tax return may be a useful strategy for those that know about it and are within the applicable time limits for it. But, because of its complexities, it is not a one-size-fits-all solution. Further, the strategy as applied to the realities of the debt collection industry does not offer a solution that accords with the changing landscape of the industry. However, all is

157. FTC, *supra* note 52, at 42–43.

158. Lucy Lazarony, *Statute of Limitations on Debts by State*, BANKRATE.COM, <http://www.bankrate.com/finance/credit-cards/state-statutes-of-limitations-for-old-debts-1.aspx> (last visited Nov. 2, 2016).

159. *Understanding Your CP3219A Notice*, IRS, <https://www.irs.gov/individuals/understanding-your-cp3219a-notice> (last visited Nov. 2, 2016).

160. FTC, *supra* note 52, at 38 (explaining that, for example, some consumers do not receive a validation notice or cannot understand its contents).

161. The least sophisticated consumer standard governs most debt collection practices and communications. See *Grden v. Leikin Ingber & Winters PC*, 643 F.3d 169, 172 (6th Cir. 2011).

not lost. There are other strategies, albeit of similarly narrow application, that may afford relief to some taxpayers.

2. Currently Available Deductions Do Not Offer an Effective Solution

Of the two general classes of deductions, miscellaneous itemized deductions exist as a general catchall classification for itemized deductions that are otherwise not specifically identified in 26 U.S.C. § 67.¹⁶² They exist as a subset of the overall class of itemized deductions. As a result, they are only available to taxpayers who choose to itemize their deductions.¹⁶³ Such a limitation means that this particular strategy has two important problems: first, many taxpayers who have income from the discharge of indebtedness will be disadvantaged by choosing to itemize. Second, even if they choose to do so, miscellaneous itemized deductions must exceed two percent of a taxpayer's adjusted gross income (AGI) before they may be taken.¹⁶⁴ If the deduction does not exceed that percentage, it simply disappears.

As discussed above, the Code allows for an individual to elect to itemize their deductions or take the standard deduction.¹⁶⁵ This voluntary choice is based implicitly on a calculation every taxpayer does, wherein they total their expected itemized deductions and determine if that exceeds the standard deduction to which they are otherwise entitled. The result is that for the vast majority of low to upper-middle income taxpayers, it is far more tax advantageous to take the standard deduction than to itemize. Further, it would likely take large payments on previously discharged debt to tip the balance and suddenly shift the calculation to justify itemizing.

Even if the math comes out to favor itemizing, the two percent AGI floor remains an important hurdle that must be cleared. No matter how large a block of miscellaneous itemized deductions a taxpayer has, an amount equal to two percent of one's AGI is simply wiped out and cannot be taken.¹⁶⁶ For a taxpayer with \$40,000 of AGI, this represents a sum of \$800. This can be a significant hurdle to clear, and a sizeable per-

162. I.R.C. § 67(b) (2015).

163. IRS, *supra* note 31, at 16.

164. I.R.C. § 67(a).

165. I.R.C. § 63 (2012).

166. *Id.*

centage of the median amount in collections.¹⁶⁷ The effect is that, even if against all odds a taxpayer can justify itemizing their deductions, they are still precluded from deducting a significant portion of any payments made after discharge. This avenue leaves them effectively right where they started.

Taxpayers looking to partially recoup their prior tax payments have limited recourse. The nature of the debt collection industry suggests that they will likely be outside the three-year period where returns can be amended, they are unlikely to itemize their deductions, and even then, the magnitude of payments made are likely to be wiped out by the two percent AGI floor. The Code and the legal system puts taxpayers in a place where they owe tax on debt they have to pay back, but gives them very limited tools to recoup the tax paid. Recognizing this, there are a few things that may be done to solve this problem—some of which are better than others.

C. PROPOSED SOLUTIONS FAIL TO ADEQUATELY ADDRESS THE PROBLEM

Both the IRS and Congress have recognized the inequity that the thirty-six month non-payment testing period can cause. The IRS has proposed a regulation to remove the non-payment testing period from the list of identifiable events,¹⁶⁸ but has not yet finalized it.¹⁶⁹ Both houses of Congress have bills pending that would preclude the use of an expired testing period as grounds for reporting cancellation of debt income.¹⁷⁰ While these proposals are laudable, they only solve part of the problem. The following sections discuss the pending proposals, and discusses why, while they may be essential steps towards resolving the problem, they fail to adequately address the problem.

1. Removing the Non-Payment Testing Period Is Essential

The main causal factor of being unable to recoup tax paid on debt identified as discharged but subsequently repaid is the

167. The median amount in collections is \$1350. See FED. RESERVE BANK OF N.Y., *supra* note 1.

168. I.R.S. Reg-136676-13, I.R.B. 2014-45 (Nov. 3, 2014), http://www.irs.gov/irb/2014-45_IRB/ar12.html.

169. REGULATIONS.GOV, *supra* note 127.

170. The bills would bar the use of an expiration of a testing period for determining whether a discharge of indebtedness has occurred. See *supra* notes 128–29 and accompanying text.

possibility that debt can be taxed as discharged without any actual extinguishment of the obligation to repay. The pending proposals are all intended to remove the obligation to report debt as discharged at the expiry of the testing period. These proposals have the effect of eliminating the main causal force leading to payments after discharge. This will eventually solve the problem in the same way that cutting off the supply of anything eventually makes it disappear. Importantly, this change better aligns the tax code with the economic realities of all impacted parties without significantly decreasing the tax collections of the United States. Neither creditors nor debtors would need to maintain effectively two sets of books to track their accounting position and their tax position. Debt remains legally enforceable and undischarged for tax purposes until it is actually rendered legally uncollectable. There is no intentionally disparate treatment, and gains and losses for tax purposes are only recognized when they are actually realized by the taxpayer. Further, this change is unlikely to significantly alter the amount of tax collected by the IRS because it does not make the discharge of debt untaxable. It just demands that the debt actually be discharged before tax is imposed on it.¹⁷¹ The proposed changes do admittedly postpone the date on which tax is levied, likely to the date that an action becomes time-barred, which impacts the value of the tax to be collected.¹⁷² However, given the relatively small portion of revenue it represents (in the context of the entire federal budget), the impact is very small.

2. The Proposed Changes Fail To Offer Taxpayers a Remedy to Their Situation

The proposed changes are laudable, but they do not go far enough in solving the varied problems associated with making payments on debt after it is reported as discharged for tax purposes. Taxpayers have limited tools to recoup taxes previously paid on debt they choose to make payments on today. This proposal does not give them a useful solution to their particular dilemma. While the number of taxpayers that have been forced to pay tax on non-discharged debt would not continue to grow,

171. See Treas. Reg. § 1.6050P-1 (2015) (considering other categories that generally require either a change in legal status of the debt or a promise to no longer collect on the obligation).

172. Money in hand today is worth marginally more than money tomorrow. See *Time Value of Money*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/timevalueofmoney.asp> (last visited Nov. 2, 2016).

many taxpayers will likely be affected for several years into the future given the protracted collection process. Further, this change does not account for those individuals that choose to make payments after discharge, even though they might not be obligated to do so. Admittedly, they are small in number, but, in resolving the problem as Congress and the IRS are proposing, the tacit message is that these payments after discharge are not distinctive or laudable, and are best characterized as essentially a gift to the creditor. This proposal makes progress towards solving the problem, but it does not go far enough. There are different and more effective avenues to solving the problem.

III. CHANGING THE REGULATORY ENVIRONMENT IS ESSENTIAL, BUT THE PROBLEM IS ONLY TRULY RESOLVED WITH A CHANGED APPROACH TO DEDUCTIBILITY

This Note proposes a solution that allows for deductibility above the line for all payments made on debt previously discharged where tax was paid. This solution preserves the statutory and regulatory environment currently in place, but removes the sting from the situation. This solution is preferable from a pure implementation perspective, but it is admittedly still subject to general criticisms of deductions. Namely, will people actually take it, and should there be a mechanism to ensure that the actual tax impact is neutral, lest a discharge at a low tax bracket benefit one who is subsequently in a higher bracket? These are real issues and concerns with this solution, but they can be overcome through careful planning and in combination with the changes currently under consideration by Congress and the IRS.

A. CONGRESS SHOULD ALLOW AN ABOVE-THE-LINE DEDUCTION FOR ANY PAYMENTS MADE ON DEBT THAT WAS PREVIOUSLY DISCHARGED AND SUBJECT TO TAX

The substance of this solution is to add a new provision to the laundry list of deductions that currently may be taken in the calculation of adjusted gross income.¹⁷³ This creates a specific, above-the-line deduction that may be taken by any tax-

173. I.R.C. § 62 (2012). Revising the text of the provision could be as simple as adding "(22) payments on debt previously identified as discharged pursuant to Treas. Reg. § 6050P-1 and subject to taxation."

payer who has made payments on debt identified as discharged and on which tax was previously paid. A new above-the-line deduction will ensure that payments are deductible, no matter the sophistication or income status of a taxpayer. Further, it will increase the equity of the tax system, encourage voluntary payments on previously discharged debt, and give taxpayers a way to lessen the sting of paying tax on discharged debt, all while not disturbing the debt collection industry or the general rule that discharged debt constitutes income. The following sections discuss (1) why this particular form of deduction is preferable; (2) how the equity of the tax system is increased; (3) how such a provision encourages making payments; and (4) why a simple solution like this is preferable.

1. An Above-the-Line Deduction Allows All Taxpayers, Regardless of Income or Time-Frame Factors to Take Advantage of the Deduction

The beauty of an above-the-line deduction is that it may freely be taken by anyone regardless of his or her income level. There is no calculation to determine if it is better to itemize or not; one simply deducts the expense. This also removes any concerns about the mechanics of miscellaneous itemized deductions. The benefits of allowing an above-the-line deduction are readily apparent when one looks to the disparities associated with the sort of taxpayer who takes the student loan interest deduction versus who takes the mortgage interest deduction. The data available suggests that the group of taxpayers that benefit from the home mortgage interest deduction skews higher than average.¹⁷⁴ In comparison, the group that takes the student loan interest deduction tends to skew lower.¹⁷⁵ While there may be many factors contributing to this division,¹⁷⁶ one of them is undoubtedly the fact that one must be in a position where itemizing deductions makes good sense financially before it pays to take the deduction. Allowing an above-the-line deduction ensures that the taxpayers most likely to be in this situa-

174. See Will Fischer & Chye-Ching Huang, *Mortgage Interest Deduction Is Ripe for Reform*, CTR. ON BUDGET & POL'Y PRIORITIES (June 25, 2013), <http://www.cbpp.org/research/mortgage-interest-deduction-is-ripe-for-reform>.

175. I.R.S., *supra* note 25.

176. Recent grads likely make less money, they often don't own homes yet, and the deduction phases out at an upper-middle class level. See I.R.C. § 221(b)(2) (2012).

tion are able to square their tax situation with their overall economic situation.

2. This Solution Maximizes the Equity of the Tax System

The addition of this above-the-line deduction will also increase the equity of the tax system. Setting aside the various voices and perspectives calling for whole-sale, radical change for the tax code, adding this particular provision is one small step towards greater equity.¹⁷⁷ No longer will it be possible that one can find themselves in a position where they make payments on previously taxed debt and are unable to adjust their tax position to reflect those payments. Indeed, the recourse is as freely available as deductions for legal expenses related to discrimination suits, or retirement plan contributions. The Code does not generally aim to leave people in bad positions by operation of its various provisions, but all too often it does. This particular solution at the least solves one of those situations that can occasionally arise.

3. This Solution Encourages Payment on Previously Discharged Debt, Where Such Payment Is Feasible

Compared to amending prior-year tax returns, an above-the-line deduction encourages payments simply because it takes a present-year view of a taxpayer's actions. Payments today are fairly and freely deductible from one's gross income for the present year. For those contemplating making voluntary payments today, the prospect of deducting their payments can make such payments much more appealing than paying and getting nothing more than the benefits of increased access to credit and fulfilling a felt moral obligation, discussed above.¹⁷⁸

As applied to our hypothetical individual at the beginning of this Note, picture them getting back on their feet, having some liquid cash, and they decide to pay in full a few accounts they previously settled for less than full consideration. They do the math and decide that the payments they make today are basically an opportunity to pay off their debt in full, and taking a tax deduction, all while deriving personal benefits from doing so. Admittedly, the prospects of a small tax deduction might not be the most compelling reason to make voluntary payments, it certainly makes it more appealing, and that may be enough to

177. See Samansky, *supra* note 84, at 544–45.

178. See *supra* Part I.C.2.

encourage additional persons to make payments they otherwise might not be interested in making. The ancillary benefit to this may be that, by doing the debt collection work for creditors, an individual may be doing a small part toward decreasing the overall cost of credit in this country.¹⁷⁹

4. This Solution Simplifies the Process for All Parties Involved

The above-discussed benefits, laudable as they are, pale in comparison to the real, tangible good this solution does in simplifying a confusing and problematic tax situation for people that fall into it. The appeal of this solution is that it does little to shake up the overall landscape of creditors' remedies and the tax processes associated with them.¹⁸⁰ It is narrowly tailored and focused on fixing one specific problem arising from the application of the already existent Code to a set of facts. For those that fall into the cracks, solutions that require multiple steps or are highly complex have little appeal. They want a quick, simple solution to the problem. This solution provides it.

B. PROBLEMS WITH A NEW ABOVE-THE-LINE DEDUCTION

Adding an entirely new above-the-line deduction to the tax code is not without disadvantages or additional complexity. The chief arguments against such a revision to the tax code are akin to those leveled at any changes to the Code. Threats of misuse, difficulty substantiating the deduction, and complaints of even further increased complexity are all checked by existing provisions in the tax code, or otherwise pose minimal risks of serious harm. In this Section, this Note discusses counterarguments likely to be raised, namely the risk of fraud and increased tax code complexity, and presents a simple solution to these threats.

1. Increased Risk of Fraud

Tax evasion and tax fraud are perennial problems with any sort of taxation. In the United States, hundreds of millions of dollars are lost every year to tax fraud.¹⁸¹ This Note's proposed

179. The role of third-party debt collection in the economy is often grossly underestimated by unacquainted parties. See ACA INT'L, *THE IMPACT OF THIRD-PARTY DEBT COLLECTION ON THE U.S. NATIONAL AND STATE ECONOMIES IN 2013*, at 1 (July 2014).

180. See *supra* note 173 and accompanying text.

181. See Matt Hunter, *Tax-Refund Fraud To Hit \$21 Billion, and There's Little the I.R.S. Can Do*, CNBC (Feb. 11, 2015), <http://www.cnbc.com/2015/02/>

solution does admittedly provide another opportunity for graft, namely falsely claiming that payments have been made on previously discharged debt. This opportunity for fraud is, however, checked by the very reporting requirements that give rise to the problem in the first place.¹⁸² The only way to substantiate a claim of prior taxation is by having filed a return previously based on the receipt of a Form 1099-C. The only reason that such a form is issued is to communicate to a debtor that the IRS has been informed of a discharge of indebtedness, and is expecting its inclusion on the present year's tax return. This means that only a narrow and readily identifiable group of people even qualify to take the deduction, a narrow group against which those claiming the deduction can be checked. Requiring substantiation, as discussed below, forces taxpayers taking this deduction to prove that they did in fact pay, thus decreasing the risk of fraud.

Another fraud-related concern is that individuals or groups of individuals could conspire to structure transactions in such a way so as to realize a tax obligation today and tax deduction in the future. A transaction so structured is not beyond comprehension, but in other areas where structured transactions are possible, the Code works to prohibit its exploitation.¹⁸³ In the context of § 1231 recharacterization, ordinary gains are recategorized as capital gains subject to the proviso that if ordinary losses have occurred in prior years, the amount of gain that may be recharacterized is limited to the extent that present gains exceed losses taken as ordinary losses in the last five years. This provision has the effect of preventing a taxpayer from structuring business transactions to realize losses this year and gains next year while receiving favorable tax treatment in both years. In the case of this proposed solution, a taxpayer has already paid all tax owed in year one. The IRS has received a windfall of tax, and may be obligated to receive diminished tax collections in subsequent years. Such an occurrence operates, in effect, as an interest-free loan to the govern-

11/tax-refund-fraud-to-hit-21-billion-and-theres-little-the-irs-can-do.html.

182. See Treas. Reg. § 1.6050P-1 (2015). Admittedly the reporting requirements generally only apply to institutions that one would normally classify as a bank or other financial institution. It is possible that individuals could report discharges of debt in furtherance of a conspiracy to defraud the government. *Id.*

183. See I.R.C. § 1231 (2012).

ment, slowly paid back in the form of diminished tax receipts over subsequent years.

2. Increased Tax Code Complexity

There is something to be said for a simple tax code. Every election cycle, one can hear calls for radical changes to be made to the tax code.¹⁸⁴ This solution does add another element of complexity to the already complex tax code. However, it is not a provision of general applicability that would impact all taxpayers. The vast majority of taxpayers in a given year would have no reason to even be aware of the existence of this provision. Indeed, casually looking over the data for the number of taxpayers taking particular deductions, it is evident that many of the more obscure deductions are taken by a very small number of taxpayers, and often for a relatively small amount of money.¹⁸⁵ An additional above-the-line deduction simply adds another provision to that list of relatively obscure deductions. It does not create a wholesale shift in the collection of tax.

3. Problems Substantiating the Payments Made

Looking to the mechanics of making the deduction work, there would likely need to be some sort of reporting requirement on the part of creditors to ensure that the claimed payments have actually been made.¹⁸⁶ This would impose an additional reporting requirement on creditors that receive payments after discharge. At first glance, this seems unreasonable, but there are two things tempering its impact. First, much of the sum total of payments received after discharge are going to be attributed to active collection efforts by a creditor. They will know precisely what they have received and the sum total of their reporting could be electronic reporting of amounts collected on previously discharged accounts. Second, it could be possible to shift the reporting burden to the actual taxpayer taking the deduction. This would take the form of producing a

184. See generally *Comparing the 2016 Presidential Tax Reform Proposals*, TAXFOUNDATION.ORG, <http://taxfoundation.org/comparing-2016-presidential-tax-reform-proposals> (last visited Nov. 2, 2016).

185. IRS, *supra* note 32, at 14 (2013).

186. This could be effected simply by requiring that creditors issue a Form 1098-C to track payments made to them for debts already reported as discharged by a Form 1099-C. Unfortunately, the same problems with debt buyers arise, as they do not have actual knowledge whether any of the debt they are collecting was previously discharged or not.

receipt from the creditor for the amount claimed in a given year.¹⁸⁷ Similar situations of self-tracked future deductions can be found in the capital loss carry-forward provisions in the tax code.¹⁸⁸ There, one is permitted to carry forward capital losses for several years. One must keep track of this information on one's own, and maintain records to substantiate such a claim for deduction. While a reporting requirement is indeed "one more thing," the alternative is an increased threat of fraud, and this is a comparatively simple method of preventing it.

CONCLUSION

Recognizing the discharge of indebtedness as income to the debtor is a bedrock principle of the United States tax code. By following existing law, creditors occasionally are forced to report debt as discharged even though they have every intent to continue collecting. This disparate treatment leads to taxpayers paying tax on discharged debt and subsequently paying off the debt in the future. Taxpayers have a limited ability to recoup tax previously paid on debt identified as discharged if they repay at a later date.

Adding an above-the-line deduction to the Code allows a debtor to repay debt recognized by the IRS as discharged and recoup the tax previously paid without needlessly complicating the tax code or opening the door to a heightened threat of fraud. To the extent that fraud is a threat, requiring substantiation of payments and reporting by creditors mitigates the risk.

187. The importance of getting a receipt from a debt collector cannot be understated. *See* FTC, *supra* note 52, at 30; Encore Capital Grp., Inc., CFPB No. 2015-CFPB-0022, 11–12 (Sept. 9, 2015).

188. *See* I.R.C. § 1212.