FINANCIAL newsletter

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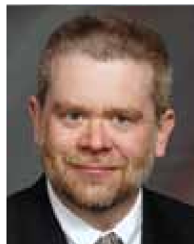
A LENDER'S DUTY TO REPORT CANCELLATION OF INDEBTEDNESS INCOME



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A question often arising during or after workout negotiations between a lender and a borrower is when must the lender file a form 1099 and report debt forgiveness as income to the borrower. As a general matter, when all or part of a borrower's debt is forgiven by a lender, the amount of debt forgiven constitutes income to the debtor under the Internal Revenue Code. In turn, lenders generally have a duty to file an informational return—a 1099-C—reporting the amount of debt forgiven.

When Must Cancelled Debt Be Reported

When an "applicable entity" subject to the IRS's reporting requirements discharges $600 or more of indebtedness owed by a borrower, that entity must file a 1099-C with the IRS. Applicable entities include any financial institution or credit union, and any organization which has a significant trade or business of lending money.

The IRS regulations list a number of "identifiable events" which trigger a lender's obligation to report cancellation of indebtedness income. They include the discharge of indebtedness pursuant to the bankruptcy code; a borrower's statute of limitation defense to an action on the indebtedness being upheld in a judicial proceeding; the "extinguishment of an indebtedness pursuant to an election of foreclosure remedies….that statutorily extinguishes or bars the creditor's right to pursue collection;" the "discharge of indebtedness pursuant to an agreement;" and the "discharge of indebtedness pursuant to a decision by the creditor, or the application

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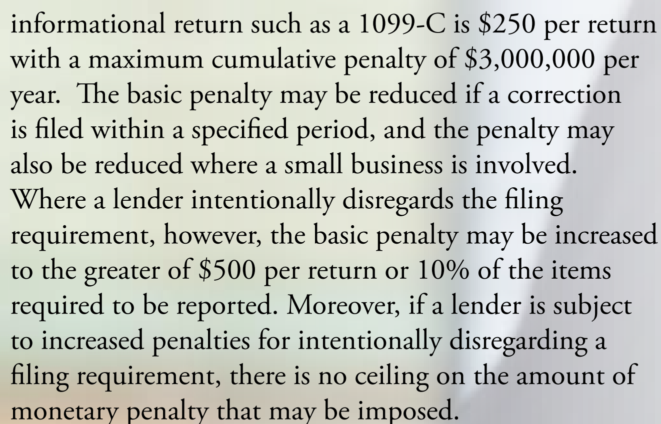
of a defined policy of the creditor, to discontinue collection activity." So long as the amount of debt discharged is at least $600 and an exception does not apply, the lender must file a 1099-C to report the discharge. This is true even if the discharge might not constitute taxable income to the debtor.

The IRS regulations provide several exceptions to the reporting requirement. Generally, if a lender releases a co-borrower, guarantor, or surety, the lender need not report the release as a discharge of indebtedness. Of particular importance in the context of negotiating workout agreements, "the discharge of an amount of indebtedness that is interest" need not be reported. Similarly, in lending transactions, "the discharge of an amount other than stated principal is not required to be reported." Questions can arise in the case of credit card debt when applying the interest and non-principal exceptions, where it can be difficult to sort out just what portion of the debt is principal or compounded interest.

Penalties for Failing to File a 1099-C

A lender who fails to report discharged debt by filing the required 1099-C may be subject to monetary penalties. The basic penalty for a late or incorrectly filed



informational return such as a 1099-C is $250 per return with a maximum cumulative penalty of $3,000,000 per year. The basic penalty may be reduced if a correction is filed within a specified period, and the penalty may also be reduced where a small business is involved. Where a lender intentionally disregards the filing requirement, however, the basic penalty may be increased to the greater of $500 per return or 10% of the items required to be reported. Moreover, if a lender is subject to increased penalties for intentionally disregarding a filing requirement, there is no ceiling on the amount of monetary penalty that may be imposed.

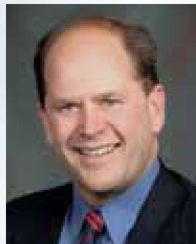
Addressing a Lender's Duty to Report During Workout Negotiations.

Sometimes during workout negotiations a borrower might request that a lender refrain from making any filing with the IRS. Given the mandatory filing requirement and the potential for significant monetary penalties, lenders should not agree to such demands. As an alternative, the lender and borrower could agree to characterize as much of the reduction as possible as a discharge of interest or other non-principal amounts. Late fees, interest, and collection costs may be discharged without filing a 1099-C in most cases. If some principal reduction is necessary to reach a settlement, a lender and borrower should agree during the negotiation on the amount of principal reduction so the borrower will not be surprised later over the potential tax implications of the lender's reporting.

Even if the borrower does not insist on non-reporting or does not raise the issue during settlement negotiations, it may be prudent to discuss the duty to report discharge of indebtedness as a result of a settlement agreement. If nothing is said regarding tax filings, a borrower may later attempt to use the fact that a 1099-C was filed to attempt to avoid the agreement or assert some claim against the lender. For example, in a recent case from the 6th Circuit Court of Appeals, a borrower sued a lender for breach of a settlement agreement after the lender reported over $150,000 in discharged debt which increased the debtor's tax liability by nearly $70,000. While the court ultimately concluded the lender did not breach the settlement agreement, litigation might have been avoided had the agreement addressed the issue. A cautious lender could insert a provision in the final agreement indicating the lender will be filing any IRS forms such as a 1099-C which are mandated by law. By raising the issue and addressing it in the agreement, the lender can avoid subsequent disputes with borrowers who are surprised about the tax implications of their agreement.

Knowing when a lender is obligated to report a discharged of indebtedness should allow the lender to proactively address the issue during workout negotiations and avoid agreeing to a request that might expose the lender to IRS penalties.

Effective Risk Management of Participation Loans – FDIC Issues New Purchased Loan Financial Institution Letter Advisory



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In November, 2015, the FDIC rescinded and replaced its 2012 Financial Institution Letter on effective risk management practices for purchased loans and purchased loan participations, with new requirements and guidelines for financial institutions - FIL-49-2015 (the "November 2015 FIL"). In doing so, the FDIC recognized that some "banks' over-reliance on lead institutions" for purchased loans and purchased participations (collectively "Purchased Loans") caused "significant credit losses,. . . particularly for loans to out-of-territory borrowers and obligors involved in industries unfamiliar to the bank." The FDIC further observed that "it is evident that financial institutions have not thoroughly analyzed the potential risks arising from third-party arrangements." This article provides a short summary of the pertinent provisions.

Independent Credit and Collateral Analysis

The FDIC's November 2015 FIL greatly expands the requirements and obligations for financial institutions in Purchased Loans, and unequivocally "expects institutions" to meet strong underwriting requirements when purchasing Purchased Loans. The November 2015 FIL reiterates that financial institutions

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should perform "the same degree of independent credit and collateral analysis as if they were the originator." The FDIC goes further, however, stating that it is "necessary for the institution to ensure it has the requisite knowledge and expertise specific to the type of loans or participations purchased and that it obtains all appropriate information from the seller" in making its independent determination. In expanding the financial institution's obligations (as compared to the 2012 Advisory), the FDIC mandates that "this assessment and determination not be contracted out to a third party".

Board Approval/Reporting

The November 2015 FIL includes a specific provision regarding board interaction for Purchased Loans. It directs that the financial institution's management "ensure that reports to the board provide a sufficient account of activity, performance and risk of purchased loans and participations." Additionally, the FDIC provides that management should "ensure that prior approvals from the board, or an appropriate committee, are obtained as necessary, including prior to entering into any material third-party arrangements."

Due Diligence of Third Parties

The November 2015 FIL further expands financial institution's management requirements for Purchased Loans before and during its term. The November 2015 FIL details that management should "perform due diligence prior to entering into a third-party relationship as well as periodically during the course of the relationship." Due diligence is to include financial analysis of the third party, and a review of the third party's business reputation, experience and compliance with other federal and state laws, rules and regulations. Again, the FDIC reminds financial institutions that "the responsibility to perform due diligence cannot be outsourced."

Loan Purchase and Participation Agreements

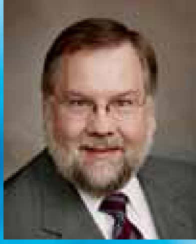
The November 2015 FIL also delineates and describes what should be included in a written loan sale or participation agreement, stressing that the purchasing financial institution should understand all of its obligations under the agreement; to include that it may be required to make additional obligations. The FDIC directs that financial institutions also understand the limitations contained within the sales or participation agreement, such as the financial institution's limitations in participating or having input in loan modifications or defaulted credits (when comparing to credits originated by the institution itself), selling or transferring its loan interest, declining to make additional advances, and/or declining to purchase additional loans if the originator's credit standards are relaxed. In that context, the FDIC encourages financial institutions to "seek appropriate legal counsel to review purchase and participation agreements prior to finalization to determine the institution's rights, obligations and limitations."

Others

Finally, the November 2015 FIL also includes new guidelines for other areas, to include profit analysis, the ability to transfer/sell/assign an interest, special due diligence and monitoring of Purchased Loans out of territory or unfamiliar markets, financial reporting, audit and Bank Security Act/Anti-Money Laundering.

Conclusion

The November 2015 FIL contains significant changes for financial institutions regarding Purchased Loans. It is imperative to review the new requirements, analyze your current practices and adapt as necessary.



New LLC Statute – a FREE webinar

Tuesday March 15

11:00 a.m.

By Wade Wacholz
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Topics to be discussed:

- Understand the basics of Minnesota's New LLC Law – what's new, what's different?
- What types of governance can LLCs have and how does that affect the lending relationship?
- What documents do you need to see when you have an LLC borrower?
- How do you confirm an LLC borrower's authority?
- When do the changes take effect?

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Gislason & Hunter LLC is proud to announce that Dick Nelson and Joel Cich have joined Gislason & Hunter LLP as Of Counsel Attorneys focusing on Real Estate Issues with Title Resources, LLC.

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Gislason & Hunter represents numerous financial institutions and has a thorough familiarity with financial economic conditions, as well as an ever-evolving regulatory environment. We have extensive experience in the following banking areas:

- Management & shareholder issues
- Transfer of bank assets
- Bank litigation
- Business planning
- Real estate
- Property foreclosures and repossessions
- Loan and workout agreements
- Collateralizing and securing all forms of loans
- Loan and credit agreements
- Subordination and participation agreements

This publication is not intended to be responsive to any individual situation or concerns as the contents of this newsletter is intended for general informational purposes only. Readers are urged not to act upon the information contained in this publication without first consulting competent legal advice regarding implications of a particular factual situation. Questions and additional information can be submitted to your Gislason & Hunter Attorney.

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