Bloomberg Law®

BNA's
Banking Report™

Consumer Credit

Between a Rock and Hard Place: Debt Collection, Consumer Remediation and Tax Consequences



By John Redding, Sasha Leonhardt and Jessica Shannon

''The hardest thing to understand in the world is the income tax.'' -Albert Einstein

In recent years, debt collection has become a focal point for regulatory oversight and government enforcement actions. The Consumer Financial Protection Bureau (CFPB) considers debt collection to be a priority and scrutinizes the conduct of debt collectors for violations of the Fair Debt Collection Practices Act (FDCPA) and unfair, deceptive, or abusive acts or practices (UDAAPs) under the Dodd-Frank Act. (CFPB, Fair Debt Collection Act Practices Act Annual Report (2017)). Among the many concerns facing debt collectors is whether and how to advise consumers of the potential tax consequences of settling a debt for less than the full amount due. While such an outcome should be a boon for a consumer, settling a debt can lead to unanticipated tax consequences for struggling consumers. Notwithstanding the potential for consumer harm, courts have taken the position that incorrectly advising a consumer of potential tax consequences for settling a debt can violate the FDCPA—and courts have further held that there is no affirmative obligation for a creditor to inform a consumer of such tax consequences.

Recently, however, creditors have begun to ask whether the combination of the CFPB's increasing focus on debt collection, its broad reading of its UDAAP authority to hold creditors responsible for violations of the FDCPA for which they would otherwise be exempt, and its focus on novel calculations of borrower harm may change the way creditors address these tax consequences . . . perhaps to the detriment of the very consumers the CFPB seeks to protect. This article describes the current landscape for tax disclosure in settling a debt and considers how the CFPB and other federal

John Redding is a partner in the Los Angeles office of Buckley Sandler LLP. Sasha Leonhardt and Jessica Shannon are associates in the Washington, D.C., office of Buckley Sandler LLP. The authors represent financial institutions in responding to federal and state enforcement actions, consumer litigation and regulatory inquires. The authors may be reached at jredding@buckleysandler.com, sleonhardt@buckleysandler.com and jshannon@buckleysandler.com, respectively.

 ISSN 0891-0634

banking regulators may approach this area in the coming years.

U.S. Tax Code and Form 1099-C

The U.S. Tax Code defines taxable income as gross income minus allowable deductions. (See 26 U.S.C. § 63(a)). Because gross income is not limited to actual money received by a consumer, if a debt collector agrees to accept less than the entire outstanding amount necessary to settle a debt, in most instances the amount of debt forgiven becomes part of the debtor's taxable income.

The exceptions to this rule are few and can only be invoked in limited circumstances: cancellation of debt as a gift, bequest, devise, or inheritance; cancellation of certain student loan debt; deductible expense debt; and debt reductions under the recently-terminated Home Affordable Modification Program. (I.R.S. Pub. No. 4681, Cat. No. 51508F (Feb. 1, 2016)). In addition, debtors who are facing bankruptcy and insolvency may be able to exclude certain debt cancellations from their taxable income. Because these debt cancellations are very fact-specific, in many instances only the debtor—and not the debt collector—will have sufficient information to determine whether one of these exceptions applies.

As a general matter, a debt collector must report a forgiven debt in the amount of $600 or more as income to the debtor by filing a Form 1099-C with the IRS at the end of the tax year. (See 26 U.S.C. § 6050P(a)-(c); 26 C.F.R. § 1.6050P-1(a)(1), (b)(2)(i)). The failure to timely file a Form 1099-C by a creditor when required can result in significant monetary penalties to that creditor. However, IRS regulations provide seven exceptions for debt collectors from filing a Form 1099-C (not to be confused with the gross income exceptions above). These exceptions include debt discharged through bankruptcy, discharge of interest, discharge of other non-principal amounts owed, and the discharge of only a subset of all co-obligors of a debt. (See 26 C.F.R. § 1.6050P–1(d)). As a result, creditors must (i) determine whether the amount forgiven meets the reporting threshold, (ii) consider whether an exception to the reporting requirement applies, and (iii) timely file a Form 1099-C if required.

Fair Debt Collection Practices Act

In recent years, and much to their chagrin, a number of debt collectors have decided to disclose the potential tax consequences when providing a debtor with an offer to settle outstanding debt. These notices often inform the debtor that the debt collector may be required to report the cancellation of a debt of $600 or more to the IRS, and that the debtor should consider consulting a tax advisor. Debt collectors see this as providing a service to debtors by allowing them to consider their end-of-year tax liability when choosing whether to settle the debt and giving them notice to set aside appropriate funds to pay the IRS.

However, some debtors have argued that including information about tax liability in a debt collection letter violates the FDCPA. The FDCPA prohibits a debt collector from harassing, oppressing, or abusing any person through false, deceptive, or misleading representations or means, or by using unfair or unconscionable means in connection with the collection of a debt. (See 15 U.S.C. § § 1692d, 1692e, 1692f). Because debt collectors often use the same form letters to collect debts from a number of consumers—and because the FDCPA allows for recovery of actual damages, statutory damages, and attorneys' fees—FDCPA cases can expose debt collectors to significant class action risk.

Notwithstanding the good intentions of these debt collectors, some courts have agreed with debtors that including information about potential tax exposure without providing sufficient context can be a violation of the FDCPA. For example, in *Good v. Nationwide Credit, Inc.*, 55 F. Supp. 3d 742, 744 (E.D. Pa. 2014), a debt collector informed consumers that it was ''required to file a form 1009-C with the Internal Revenue Service for any canceled debt of $600 or more. Please consult your tax advisor concerning any tax questions.'' Even though the disclosure included the relevant statutory language, the plaintiffs argued that the mandatory 1099-C reporting exceptions may have applied to their circumstances and as such the ''declarative, unqualified statement . . . is both literally false, and misleading . . . .'' (Compl. at ¶ 24, *Good*, 55 F. Supp. 3d 742).

In addition, the plaintiffs argued that providing information about potential tax consequences was ''a collection ploy, a deception which suggests to the least sophisticated consumer that he or she could get in trouble with the IRS for refusal to pay the debt, or for obtaining any debt forgiveness of $600 or more.'' (*Id.* at ¶ 26). The defendant moved to dismiss, arguing that the statement was not inaccurate, and that providing every possible exception would actually confuse the ''least sophisticated consumer.'' (Def.'s Mot. to Dismiss at 12-13, *Good*, 55 F. Supp. 3d 742). Further, the defendant objected to the plaintiffs' claim that this was a collection ploy: ''Even the least sophisticated consumer knows – or should know – that the IRS expects proper forms to be filed. The least sophisticated consumer also could not reasonably conclude that [the debt collector] somehow influences IRS action.'' (*Id.* at 17).

The court ultimately sided with the plaintiffs and held that the language in the collection letter was deceptive and misleading because it was incomplete. (Good, 55 F. Supp. 3d at 748). Applying the least sophisticated debtor standard, the court held that the statement failed to notify debtors of exceptions that might not require the filing of a Form 1099-C or may allow the consumer to exempt the cancelled debt from taxable income. The court rejected the debt collector's argument that including all of the exceptions was the only other option; rather, the debt collector ''need only raise the debtor's awareness that potentially applicable exceptions exist'' to comply with the FDCPA. (*Id.*). The court—drawing all reasonable inferences in favor of the plaintiffs—held that the statement could be seen as a ''collection ploy'' because a consumer may believe that he or she ''must pay enough on the alleged debt so that a balance of less than $600.00 remains'' even if a reporting exception applies. (*Id.*).

In *Velez v. Enhanced Recovery Company, LLC*, No. 16-164, (E.D. Pa. May 2, 2016), a debt collector used more cautious language to describe potential tax liability, but here too the court ultimately found in favor of the debtor. In offering to settle a debt of $692.70 for $554.16, the debt collector in Velez included the following statement in its settlement offer letter: ''[A]ny indebtedness of $600.00 or more, which is discharged as a result of a settlement, may be reported to the IRS as

taxable income pursuant to the Internal Revenue Code 6050 (P) and related federal law.''

The debtor argued that the debt collector would not forgive more than $600 so there would never be any IRS reporting, and whether the debt was taxable income was not for the debt collector to decide. The debtor claimed that the ''[s]tatement needlessly injects the IRS into the collection process, creates confusion, would cause the least sophisticated consumer to believe that he might have to pay a certain amount to avoid IRS reporting, and negatively influences a consumer considering bankruptcy.''

Citing *Good*, the *Velez* court agreed with the debtors: ''The least sophisticated debtor could reasonably assume that [the debt collector] included the Statement because it was relevant, and such a debtor could believe, given the lack of specificity in the generally-stated rule that mentions one exception but not others, that the action he chooses to take with respect to the debt will trigger tax consequences or reporting requirements.'' (*Id.*).

Taking a different approach than the plaintiffs in *Good* or *Velez*, some debtors have attempted to advance the inverse argument—that the failure to proactively notify a debtor of potential tax liability is a FDCPA violation. Consistent with the above cases, however, courts have universally rejected these claims. In *Altman v. J.C. Christensen & Assoc., Inc.*, No. 13–CV–6502 (ARR-)(CLP), (E.D.N.Y June 11, 2014), aff'd, 786 F.3d 191 (2d Cir. 2015), a purported class of debtors argued that a collection letter advertising ''generous settlement terms'' and savings of thousands of dollars in exchange for settling debt promptly were ''false, deceptive, or misleading'' under the FDCPA because they failed to mention potential tax consequences of settling debt.

The court disagreed, holding that even under the FDCPA's generous ''least sophisticated consumer'' standard a debt collector was not required to identify the potential tax consequences of cancelling debt: ''[T]his goes too far in stretching the limits of reasonable interpretation under the FDCPA.''(*Id.*). The letter only addressed the indebtedness owed to the debt collector, not the possible tax implications of settling the debt, and the letter's silence on this point was not a violation of the FDCPA. Further, on appeal the Second Circuit not only affirmed the district court and agreed with the defendants, but it also held that another district court opinion supporting plaintiff's argument was ''unpersuasive.'' (*Altman v. J.C. Christensen & Assoc., Inc.*, 786 F.3d 191, 194 (2d Cir. 2015)).

Similarly, in *Landes v. Cavalry Portfolio Services, LLC*, 774 F. Supp. 2d 800 (E.D. Va. 2011), the court held that a debt collector's failure to affirmatively advise borrowers of the potential tax consequences of settling a debt for a reduced amount was not a FDCPA violation. The plaintiff debtor alleged that the debt collector's letters stating that the company wanted debtors to ''get the most out of [their] tax refund'' and ''get tax season savings'' with a discount offer were deceptive and misleading because the letters did not disclose the potential tax consequences of accepting the offer. (*Id.* at 801).

The court disagreed, finding that the references to taxes were not ''false and deceptive tax advice.'' (*Id.* at 803-04). Although the court applied the FDCPA's ''least sophisticated consumer'' standard, the court correctly held that—although lenient—this standard presumes ''a basic level of understanding and willingness to read with care.'' The court specifically held that the FDCPA does not require debt collectors to disclose potential tax consequences, and such disclosures may constitute ''improper legal practice'' that could open debt collection agencies up to criminal sanctions. (*Id.* at 804-05).

Unfair, Deceptive, and Abusive Acts and Practices

Over the past several months, the CFPB has made clear its intention to use all of the tools at its disposal to protect consumers from harmful debt collection practices. Although for decades the main tool to regulate debt collectors was the FDCPA, the CFPB has also relied heavily on its authority to prohibit UDAAPs in its debt collection enforcement actions. While the cases discussed above make it appear unlikely that a court would hold that the FDCPA requires debt collectors to provide consumers with notice of potential tax liability when settling a debt, these cases also illustrate the complicated intersection between debt collection and tax reporting.

Given the potential for consumer confusion and harm, some have begun to worry that the CFPB may turn instead to its UDAAP authority to argue that failing to disclose the potential tax liability for settling a debt runs afoul of the law. Although it is possible that the CFPB could attempt to advance this argument, we think it unlikely that such a claim would be successful if fully litigated, though creditors and debt collectors who have been in the CFPB's cross hairs are unlikely to take much comfort in that belief.

While we have identified one lower court case in which a court held that failing to inform a consumer of potential tax liability for settling a debt was a violation of the FDCPA, the Second Circuit explicitly declined to follow the holding of that case. (*Altman v. J.C. Christensen & Assoc.*, Inc., 786 F.3d 191, 194 (2d Cir. 2015)). Similarly, we have not identified any cases in which a court found the omission to be a UDAAP. Such an argument would be inconsistent with the plain statutory text, longstanding interpretive guidance, and the CFPB's own policies and settlements. However, the concern that the CFPB may employ its UDAAP authority in such situation arises from the CFPB's enforcement strategy of using a violation of another law—even a law over which the CFPB lacks enforcement authority—as a predicate for claiming that a creditor committed a UDAAP. (See, e.g., *CFPB v. Golden Valley Lending, Inc.*, No. 17-cv-3155 (N.D. Ill. April 27, 2017).

Under the Dodd-Frank Act (and the interpretive guidance adopted by the FTC and CFPB), an act or practice is unfair when it causes or is likely to cause substantial injury, which is not reasonably avoidable by consumers, and is not outweighed by the benefit to consumers or competition. (FTC Policy Statement on Unfairness (1980)). On balance, forgiving a consumer's debt or offering to settle a debt for only a fraction of the amount owed is unlikely to be seen as causing ''substantial injury'' to consumers. Although there may be a one-time increase in reportable income and taxes for the consumer, this is only a potential outcome as there are ways for consumers to offset the increase in gross income.

Further, consumers can easily avoid this increase in gross income by declining the offer to settle the debt,

and even a consumer who settles the debt and accepts the increase in gross income and taxes can mitigate any immediate payment shock by planning ahead and/or entering into a tax payment plan with the IRS. Finally, the CFPB cannot credibly argue that consumers generally do not on balance benefit from debt forgiveness. The increased tax liability that any consumer may face is only a fraction of the amount forgiven, and the CFPB itself has consistently advocated debt forgiveness in its recent settlements and reports. (See *Synchrony Bank, f/k/a GE Capital Retail Bank*, No. 2014-CFPB-0007 (2014).

An act or practice is ''deceptive'' when it contains a ''representation, omission or practice likely to mislead a consumer acting reasonably in the circumstances, to the consumer's detriment, and the misleading act is material.'' (FTC Policy Statement on Deception (1983)). The CFPB has alleged in prior enforcement actions that a creditor's failure to disclose certain information can be deceptive or misleading.(See *CFPB v. CashCall, Inc.*, No. CV157522JFWRAOX, (C.D. Cal. Aug. 31, 2016); *CFPB v. Prime Marketing Holding, LLC*, No. 16-cv-7111 (C.D. Cal. Sept. 22, 2016). In such cases, the CFPB's deception claims have been based on either a theory that the omission coupled with another representation misled the consumer, or that the failure to disclose is a violation under another statute or regulation.

However, it seems unlikely a court would hold that not disclosing a consumer's potential tax liability would ''mislead'' a consumer, as the consumer still receives all of the pertinent information about settling the debt and can use that information to evaluate the tax consequences of doing so. As discussed above and consistent with the CFPB's own policies, forgiving a consumer's debt is not a ''detriment'' to a consumer—while some consumers may have increased taxes, even these consumers have more debt forgiven than the increase in their tax payment. In many instances the amount of debt forgiven is relatively small so the increased tax liability is unlikely to be considered ''material''—and even if it were significant (such as forgiving a significant portion of a consumer's mortgage debt) the debt forgiveness is neither likely to mislead nor be a detriment to the consumer. Indeed, applying a very similar standard for deception, the FDCPA cases cited above also make clear that not disclosing a consumer's potential tax liability for settling debt is not deceptive.

Finally, while UDAAP law also prohibits ''abusive'' acts or practices, it is difficult to see how failing to disclose a speculative tax liability for settling a debt for less than is owed would be abusive. Under the Dodd-Frank Act, an act or practice is abusive when it ''materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or takes unreasonable advantage of – (A) a consumer's lack of understanding of the material risks, costs, or conditions of the product or service; (B) a consumer's inability to protect his or her interests in selecting or using a consumer financial product or service; or (C) a consumer's reasonable reliance on a covered person to act in his or her interests.'' (12 U.S.C. § 5531(d)). Forgiving a consumer's unpaid, delinquent debt is unlikely to fall into any of these categories: the consumer owes money and understands that they are agreeing to pay less to settle the debt; the consumer is not at a disadvantage and can always decline the offer to settle the debt; and there is no fiduciary or other relationship that would could reasonably lead a debtor to rely upon a debt collector to protect the debtor's interests.

Conclusion

In most instances, settling a debt for less than is owed is a net benefit to a debtor, as it immediately improves the consumer's financial outlook by reducing the overall amount of outstanding debt. However, this immediate improvement to the consumer's balance sheet may also cause an immediate increase in the consumer's tax liability. Although some debt collectors may feel obligated to inform the consumer of this risk, courts have consistently and clearly held that the FDPCA does not require such notice. And while the CFPB has used its UDAAP authority to pursue debt collectors, it seems unlikely that the CFPB could prevail in litigation if it sought to require debt collectors to inform consumers of the potential tax consequences of forgiving debt.