CHARGE OFF

A Charge-off is 1) an accounting entry for your creditor and 2) a report that is sent to the credit bureaus and becomes incorporated into your credit score.

Charge-off as an accounting entry:
A creditor or lender manages your debt as a business asset. When you fall behind in your payments, the loan ceases to be an asset for the creditor. It suddenly is costing the lender money, and the lender is not making money from your account. The debt soon becomes more of a liability to the lender. The law (and the IRS) requires your lender to remove your loan from the lender's asset list after a specific period of time. For regular credit card debt, the time period is 180 days. For student loans, the time period is often about 270 days. The original creditor is required by law to properly report an account as a charge-off when the payment has not been made for a certain period of time. The original creditor then charges-off part of the loan or the entire balance of the loan, pursuant to the law.

A charge-off is not the same as "forgiven" debt, unless you also receive a 1099-C for the total debt. This is very important concept to understand. A charge-off is simply an accounting entry on your credit. The 1099-C is forgiveness of the debt. Only the 1099-C makes the debt go away, at least until the IRS vultures come swooping in for a piece. The charge-off does not make the creditors go away. The credit card can no longer be used after the account is charged-off. The benefit is that the original creditor is usually no longer charging interest and late fees once the debt is charged-off.

Remember, though, the original creditor can still try to collect the charged-off debt if a 1099-C has not been issued. Or, the origin al creditor may sell the debt to a third-party or hire a third-party to collect on its behalf if the 1099-C was not issued.

Charge-off as a report to credit:
A charge-off is reported to the credit bureaus by your lender. It becomes a part of your credit score and will likely damage the credit score. You may see a lower score immediately after an account is reported as charged-off, depending on which credit reporting agency is providing the credit score. Approximately 30% of your score is based on payment history. Late payments lower it. Though the charge-off negatively impacts your score, your late payments cause the initial damage to your credit. Furthermore, the charge-off may remain on your credit report for up to 7 years under the Fair Credit Reporting Act.

Do I still have to pay the debt?
As stated before: yes, you still must pay the debt after the account is charged-off. A charge-off is not a release from the debt. The only exception to paying the creditor after the charge-off is if you receive a 1099-C tax form from the original creditor for the full value of the debt. The bank can either attempt to collect the debt on its own, hire a collection agency to collect the debt on the bank's behalf, or sell the debt once it has been charged-off. You should still try to pay or settle the debt, even though it has been charged-off. There may be two reasons why you should settle the debt after this occurs. First, paying the debt changes the status of the account from "charge-off" to "charge-off, paid," thus increasing your credit score. The second reason to pay is that the collections process will stop once you have settled the debt.

PRACTICE TIP: If you settle the debt instead of paying the debt in full, the forgiven portion of the debt may be considered taxable income on which you may have to pay taxes. Note that there are some exemptions to the requirement to pay taxes on forgiven debt that are later discussed in this book. You will likely receive a 1099-C for the forgiven portion of the settled debt. Do not forget to report the 1099-C on your income tax return.