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FEMA DEBT COLLECTION

New Orleans Bar Association CLE

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Tax Consequences of FEMA Debt Cancellation

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The Tax Problem

1. Generally, debt cancellation is income. I.R.C. § 61(a)(12). Waiver of government benefit overpayments can create debt cancellation income. *Waterhouse v. Commissioner*, T.C. Memo 1994-467.
2. FEMA maintains that a discharged FEMA overpayment is income. FEMA plans to report discharged debt by issuing a Form 1099-C to the IRS and the taxpayer. *See FEMA Debt Resolution Process: In Summary*, 76 Fed. Reg. 14,039 (Mar. 15, 2011).
3. An “overpaid” FEMA recipient will face possible taxes on any discharged FEMA debt. Also, there may be collateral tax consequences such as loss of the Earned Income Credit. Generally, taxes are non-dischargeable debts that may be collected by the IRS.

Issues and Solutions

1. **Bankruptcy.** Non-fraudulent public assistance overpayments may be discharged in bankruptcy.
2. **Statutory exclusion from income.** The Internal Revenue Code provides that debt cancellation income may be excluded from income in a bankruptcy

or if the taxpayer is insolvent at the time of the debt discharge. I.R.C. § 108 (a)(1)(A)-(B). “Insolvent” means that the taxpayer’s liabilities exceed the fair market value of his assets. However, many FEMA recipients are homeowners, and the Tax Court has held that exempt assets, such as a homestead, must be included in determining whether the taxpayer is “insolvent.” *Carlson v. Commissioner*, 116 T.C. 87 (2001).

3. **The general welfare exclusion doctrine.** The government’s forgiveness of an overpayment due to economic hardship is not income under the Service’s general welfare doctrine. *See e.g.*, Rev. Rul. 78-46, 1978-1 C.B. 22; Non-Docketed Service Advice Review, 1998 WL 1993104. FEMA may waive some overpayments based on economic hardship.
4. **Disputed debt.** If FEMA debt is compromised because of a dispute as to the debt, the settlement may not result in income to the taxpayer. *Zarin v. Commissioner*, 916 F.2d 110, 115 (3d Cir. 1990). However, to win this argument, there must be evidence of a good faith dispute of the debt. *McCormick v. Commissioner*, T.C. Memo 2009-239.
5. **Proof of the cancelled debt.** A Form 1099-C is not dispositive. If the taxpayer asserts a reasonable dispute with respect to reported income, I.R.C. § 6201 (d) may shift the burden of production to the IRS requiring it to produce reasonable and probative evidence in addition to the Form 1099-C. *McCormick v. Commissioner*, T.C. Memo 2009-239.
6. **Timing of income recognition.** If the statute of limitations has not run, debt cancellation income may not have occurred yet. *Coburn v. Commissioner*, T.C. Memo 2005-283. Duplicative FEMA overpayments may be taxable in the disaster year rather than the year FEMA cancelled the overpayment debt. *See* I.R.C. § 139. In such cases, depending on the delays, it may be too late for the IRS to assess the unpaid taxes on this income.
7. **Allocation of income among co-obligors.** Many people or households may be jointly and severally liable for a FEMA overpayment. FEMA has the right to go after any of the obligors for the entire debt. FEMA will not allocate debt among co-obligors. However, debt cancellation income should be allocated among co-obligors in an IRS tax controversy. *Brickman v. Commissioner*, T.C. Memo 1998-340 (50% liability of spouse in community property state); IRS Chief Counsel Advice 200223001 (June 9, 2000); *cf. Kahle v. Commissioner*, T.C. Memo 1997-91.
8. **Procedures to contest tax.** A taxpayer may contest a proposed tax through

the IRS examination process, an IRS appeal, and ultimately a Tax Court petition.

9. **Collection alternatives.** Low income taxpayers may qualify for the Currently Not Collectible (CNC) status. *See* Internal Revenue Manual § 5.16. CNS status does not forgive the tax debt, but the collection statute of limitations continues to run during CNC status. In addition, taxpayers may be able to obtain installment agreements or offers in compromise which will improve their financial situation or reduce their tax debt.