Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Klehs	Analyst:	Jeff Garnier	Bill Number:	AB 115
Related Bills:	None	Telephone:	845-5322	Introduced Date:	01/12/2005
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Conformity/Treatment of Income from Discharge or Cancellation of Indebtedness

SUMMARY

This bill would conform California law to two federal changes made by the American Jobs Creation Act of 2004 (AJCA) relating to income from the discharge or cancellation of indebtedness.

PURPOSE OF THE BILL

The author's staff indicates that this is a spot bill that will be amended to be the "The Conformity Act of 2005."

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective and operative on January 1, 2005.

POSITION

Pending.

FEDERAL LAW

Background

Exclusion for Payments to Individuals Under National Health Service Corps Loan Repayment Program and Certain State Loan Repayment Programs

The National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") provides education loan repayments to a participant contingent on the participant providing certain services. In the case of the NHSC Loan Repayment Program, the recipient of the loan repayment is obligated to provide medical services in a geographic area identified by the Public Health Service as having a shortage of health-care professionals. Loan repayments may be as much as $35,000 per year of service plus a tax assistance payment of 39% of the repayment amount.

States may also provide for education loan repayment programs for persons who agree to provide primary health services in health professional shortage areas. Under the Public Health Service Act, such programs may receive Federal grants with respect to such repayment programs if certain requirements are satisfied.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Gerald H. Goldberg	2/16/05
_______ N	_______ OUA	___X___ PENDING		

Generally, gross income means all income from whatever source derived including income for the discharge of indebtedness. Gross income does not include discharge of indebtedness if: (1) the discharge occurs in a Title 11 bankruptcy case; (2) the discharge occurs when the taxpayer is insolvent; (3) the indebtedness discharged is qualified farm indebtedness; or (4) except in the case of a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Prior to 2004, the loan repayments provided under the NHSC Loan Repayment Program or similar state programs under the Public Health Service Act were not specifically excluded from gross income in Internal Revenue Code (IRC) Section 108; thus they are gross income to the recipient.

The AJCA amended IRC Section 108 and provided an exclusion from gross income and employment taxes for any education loan repayments provided under the NHSC Loan Repayment Program and state programs eligible for funds under the Public Health Service Act. The provision also provided that such repayments not be taken into account as wages in determining benefits under the Social Security Act.

This provision applies to amounts received by an individual in taxable years beginning after December 31, 2003.

Recognition of Cancellation of Indebtedness Income Realized on Satisfaction of Debt With Partnership Interest

A corporation that transfers shares of its stock in satisfaction of its debt must recognize cancellation of indebtedness income in the amount that would be realized if the debt were satisfied with money equal to the fair market value of the stock. Prior to enactment of this present-law provision in 1993, case law provided that a corporation did not recognize cancellation of indebtedness income when it transferred stock to a creditor in satisfaction of debt (referred to as the "stock-for-debt exception").[1]

When cancellation of indebtedness income is realized by a partnership, it generally is allocated among the partners in accordance with the partnership agreement, provided the allocations under the agreement have substantial economic effect. A partner who is allocated cancellation of indebtedness income is entitled to exclude it if the partner qualifies for one of the various exceptions to recognition of such income, including the exception for insolvent taxpayers or that for qualified real property indebtedness of taxpayers other than subchapter C corporations. The availability of each of these exceptions is determined at the partner, rather than the partnership, level.

Prior to 2004, in the case of a partnership that transfers to a creditor a capital or profits interest in the partnership in satisfaction of its debt, no Code provision expressly required the partnership to realize cancellation of indebtedness income. Thus, it was unclear whether the partnership is required to recognize cancellation of indebtedness income under either the case law that established the stock-for-debt exception or the present-law statutory repeal of the stock-for-debt exception. It also was unclear whether any requirement to recognize cancellation of indebtedness income is affected if the cancelled debt is nonrecourse indebtedness.[2]

---

[1] E.g., *Motor Mart Trust* v. *Commissioner,* 4 T.C. 931 (1945), aff'd, 156 F.2d 122 (1st Cir. 1946), acq. 1947–1 C.B. 3; *Capento Sec. Corp.* v. *Commissioner,* 47 B.T.A. 691 (1942), nonacq. 1943 C.B. 28, aff'd, 140 F.2d 382 (1st Cir. 1944); *Tower Bldg. Corp.* v. *Commissioner,* 6 T.C. 125 (1946), acq. 1947–1 C.B. 4; *Alcazar Hotel, Inc.* v. *Commissioner,* 1 T.C. 872 (1943), acq. 1943 C.B. 1.

[2] See, e.g., *Fulton Gold Corp.* v. *Commissioner,* 31 B.T.A. 519 (1934); *American Seating Co.* v. *Commissioner,* 14 B.T.A. 328, aff'd in part and rev'd in part, 50 F.2d 681 (7th Cir. 1931); *Hiatt* v. *Commissioner,* 35 B.T.A. 292 (1937); *Hotel Astoria, Inc.* v. *Commissioner,* 42 B.T.A. 759 (1940); Rev. Rul. 91–31, 1991–1 C.B. 19.

The AJCA amended IRC Section 108 and provided that when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. The AJCA applies without regard to whether the cancelled debt is recourse or nonrecourse indebtedness. Any cancellation of indebtedness income recognized under the AJCA is allocated solely among the partners who held interests in the partnership immediately prior to the satisfaction of the debt.

Under the AJCA, no inference is intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of partnership debt. This provision is effective for cancellations of indebtedness occurring on or after October 22, 2004.

State Law

California, in general, conforms to the federal rules in IRC Section 108, as it read on January 1, 2001. Essentially, state law conformed to federal law relating to exemption from income of student loan forgiveness and the exchange of debt for capital prior to the amendments made by AJCA.

THIS BILL

This bill would conform the Revenue and Taxation Code to the AJCA changes made to the IRC relating to the exemption from income of forgiveness of student loans and expressly requiring a partnership to realize cancellation of indebtedness income. The effective dates of the two federal provisions would apply for state tax purposes. This bill would not exempt education loan forgiveness from employment taxes.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Michigan and *New York* automatically conformed to the federal change because the taxable income computation for these states starts with federal "adjusted gross income."

Florida, Massachusetts, and *Minnesota* have not conformed to the federal change. In addition, *Florida* does not have a personal income tax.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Impact on California Revenue

Revenue Estimate For AB 115 Assumed Enactment After 6/30/05 ($ millions)			
	2005-06	2006-07	2007-08
Exclusion From Income For NHSC and State Loan Repayment Programs	Insignificant Loss*	Insignificant Loss*	Insignificant Loss*
Recogn. of COD Income from Satisfaction of Debt With Partnership Interest	$2	$1	$1

* A loss of less than $150,000.

State conformity revenue estimates were based on a proration of federal projections developed for the AJCA.

LEGISLATIVE STAFF CONTACT

Jeff Garnier
Franchise Tax Board
845-5322
jeff.garnier@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov