Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Niello/Garcia, et al.	Analyst:	Scott McFarlane	Bill Number:	AB 1918
Related Bills:	See Prior Analysis	Telephone:	845-6075	Amended Date:	June 25, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Mortgage Forgiveness Debt Relief

_X_ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced February 8, 2008.

_X_ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended ____________________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________________.

_X_ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED February 8, 2008, STILL APPLIES.

_X_ OTHER – See comments below.

SUMMARY

This bill would generally conform California law to the recently enacted Federal Mortgage Forgiveness Debt Relief Act of 2007, which generally provides for an exclusion from gross income for qualified debt forgiveness on a principal residence up to a maximum amount.

SUMMARY OF AMENDMENTS

The June 25, 2008, amendments do the following:

- Provide that no interest or penalties shall be assessed on cancellation of debt (COD) income that results from the discharge of qualified residence indebtedness during the 2007 taxable year;
- Reduce the maximum exclusion amount from $2 million to $1 million;
- Reduce the exclusion period by one year (discharges during 2009 would no longer be excludable); and
- Add additional coauthors.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	6/23/08
____ N	____ OUA	_X_ PENDING		

As a result of the amendments, the ECONOMIC IMPACT, FEDERAL/STATE LAW, and THIS BILL sections have been revised. In addition, the EFFECTIVE/OPERATIVE DATE section is provided below to clarify the operative date of this bill.

Except for the discussion in this analysis, the remainder of the department's analysis of the bill as introduced February 8, 2008, still applies.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2007, and would apply to discharges of indebtedness that occur on or after January 1, 2007.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal Law

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness (Internal Revenue Code (IRC) sections 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities immediately after the discharge (IRC section 1017).

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. For example, assume a taxpayer who is not in bankruptcy and is solvent owns a principal residence subject to a $200,000 mortgage debt. If the creditor forecloses and the home is sold for $180,000 in satisfaction of the debt, the debtor has $20,000 of income from the discharge of indebtedness.

THE MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007 (P.L. 110-142), *enacted December 20, 2007*

The Mortgage Forgiveness Debt Relief Act of 2007 (the Act) excludes from the gross income of a taxpayer any discharge of indebtedness income by reason of a discharge of qualified principal residence indebtedness occurring on or after January 1, 2007, and before January 1, 2010. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of IRC section 163(h)(3)(B)), up to $2,000,000. Acquisition indebtedness with respect to a principal residence generally means indebtedness incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and secured by the residence. It also includes refinancing of such debt to the extent the amount of the refinancing does not exceed the amount of the indebtedness being refinanced.[1]

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt that is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 debt is discharged, then only $100,000 of the amount discharged may be excluded from gross income under this provision.

The individual's adjusted basis in their principal residence is reduced by the amount excluded from income under the Act. Under the Act, the exclusion does not apply to a taxpayer in a Title 11 case; instead, the Title 11 exclusion applies. In the case of an insolvent taxpayer not in a Title 11 case, the exclusion under the Act applies unless the taxpayer elects to have the insolvency exclusion apply.

STATE LAW

Currently, California does not conform to the Mortgage Forgiveness Debt Relief Act of 2007.

The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. An adjustment relating to the income from the discharge of qualified principal residence indebtedness is required under current law. A taxpayer excluding income from the discharge of qualified principal residence indebtedness on the federal individual income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal exclusion.

[1] The term "principal residence" has the same meaning as when used in IRC section 121. (IRC section 121 provides a $250,000 exclusion ($500,000 for married taxpayers filing a joint return) on the gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more. Refer to federal Treasury Regulation section 1.121-1 for the facts and circumstances used to determine "principal residence.")

The following discussion provides a background of state law and the application of the June 25, 2008 amendments (pertaining to penalty and interest waiver) to state law.

Estimated Tax

Individuals are generally required to pay their estimated California income tax in four installments spread over the taxable year. For example, 2007 calendar-year taxpayers were required to pay 25% of their estimated tax by April 15, 2007; the next 25% by June 15, 2007; the next 25% by September 15, 2007, with the final 25% due by January 15, 2008. Any withholding is treated as a payment of estimated tax, and the total withholding for the year is generally considered as having been paid in four equal installments.

There are special rules for farmers and fishermen, and for taxpayers whose income fluctuates significantly from one installment period to the next.

Penalty for Underpayment of Estimated Tax

A penalty is imposed for the underpayment of estimated tax. The penalty is generally computed by multiplying three factors: (1) the underpayment; (2) the interest rate;[2] and (3) the number of days each installment is underpaid.

The amount of the underpayment for the taxable year is the difference between the amount of tax <u>shown on the return</u> for the taxable year and the amount of estimated tax paid. Generally, the amount of tax shown on the return for the taxable year is divided by four, and this is the amount of estimated tax due in each of the four installments. Thus, the amount of the underpayment for each installment is the estimated tax due for that quarter less the amount actually paid.

There are exceptions to the penalty, and if any are met, the penalty does not apply. Exceptions include the following:

1. If the tax liability is less than $200;
2. If there was no tax liability in the prior taxable year; and
3. If total withholding plus estimated tax payments total 90% of the tax shown on the current year return or 100% of the tax shown on the prior year's return.

Prior to the June 25, 2008, amendments, this bill would not have provided relief for penalties assessed on COD income that result from the discharge of qualified residence indebtedness during the 2007 taxable year.

[2] California conforms to the federal interest rate, which is provided in Internal Revenue Code section 6621.

THIS BILL

In General

This bill would conform to the mortgage-debt forgiveness provision of the federal Mortgage Forgiveness Debt Relief Act of 2007, with two differences: (1) the exclusion period, and (2) the maximum exclusion amount.

The difference in the exclusion *period* is:

- *Federal* - The exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2010.
- *California* – This bill would exclude discharges occurring on or after January 1, 2007, and before January 1, 2009.

The difference in the maximum exclusion *amount* is:

- *Federal* - The maximum exclusion is $2,000,000.
- *California* – The maximum exclusion is $1,000,000.

Penalty and Interest Waiver

COD income from the discharge of qualified principal indebtedness is currently required to be included in income for California purposes; therefore, any taxpayer who filed a 2007 personal income tax return was required to include any COD income that this bill would exclude. Because the underpayment of estimated tax penalty is based on the “amount of tax shown on the return,” taxpayers with COD income in 2007 may be subject to the underpayment-of-estimated-tax penalty. This bill would specifically provide that no penalties or interest shall be assessed on COD income that results from the discharge of qualified residence indebtedness during the 2007 taxable year.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses:

Estimated Revenue Impact of AB 1918 As Amended 06/25/2008 Effective for Tax Years 2007 and 2008 Enactment Assumed after 6/30/2008			
	2007-08	2008-09	2009/10
COD Exclusion	-$5,000,000[3]	-$9,000,000	-$2,000,000
Penalty Waiver	<- $150,000[4]	n/a	n/a
Total	<-4,950,000	-$9,000,000	-$2,000,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

COD EXCLUSION

The revenue impact of this bill would be determined by the amount of qualified principal residence indebtedness discharged and the marginal tax rate of taxpayers otherwise reporting this income. The revenue loss was estimated as follows. First, federal estimates by the Joint Committee on Taxation were converted to liability (tax) year estimates ($117 million and $200 million for fiscal year 2008 and 2009, respectively). The federal liability amount was prorated to California using a proration factor of 4.2% for 2007 and 5.1% for 2008. This proration factor was calculated using four factors: (1) the ratio of California foreclosure to foreclosures nationally using data from RealtyTrac (22% for 2007 and 26% for 2008 using first quarter data); (2) the ratio of median house price in California to median price nationally (145%), calculated using data from National Association of Realtors and California Association of Realtors; (3) the ratio of qualified taxpayers in California to qualified taxpayers nationally (43%), which was calculated based on assumed differences in percentage of foreclosures involving insolvency, non-recourse loans and non-qualified recourse loans; and (4) the California average marginal tax rate as a percent of the federal average marginal tax rate (31%).

[3] On a cash flow basis, the fiscal impact of the bill would be spread over 2008/09 ($14 million) and 2009/10 ($2 million). Of the $14 million loss for 2008/07, $5 million is accrued back one year to 2007/08 because the bill impacts mortgage debts discharged during 2007.

[4] For purposes of totaling, less than $150,000 is assumed to be $50,000.

The calculation for 2007, 4.2% proration factor is: 0.042 ≈ 0.22 x 1.45 x 0.43 x 0.31
The calculation for 2008, 5.1% proration factor is: 0.051 ≈ 0.26 x 1.45 x 0.43 x 0.31

The proration rate factor for 2008 is included to reflect the ratio of California foreclosure to foreclosures nationally using updated data from RealtyTrac.

The calculations for the revenue losses for the bill as amended June 25, 2008 are as follows:

- 2007 tax year: 4.2% X $117 million ≈ $4.9 million loss
- 2008 tax year: 5.1% X $200 million ≈ $10.2 million loss

These estimates were further adjusted to reflect the reduction in the maximum amount of COD excludible, which was reduced from $2 million to $1 million in the June 25, 2008, amendments. An estimated 5% reduction was made in the revenue loss to reflect the impact of the COD excludible to California. The revenue loss estimates are as follows:

- 2007 tax year: 0.95 x $4.9 million ≈ $4.7 million
- 2008 tax year: 0.95 x $10.2 million ≈ $9.69 million

Taxable year estimates are converted to fiscal year estimates in the table above.

Penalty Waiver

Two estimates are used to arrive at an estimate of the revenue loss due to a waiver of penalty for underpayment of estimated tax for tax year 2007:

- The average tax benefit for each taxpayer - approximately $1,700; and
- The number of taxpayer's impacted - approximately 3,000.

The penalty rate for underpayment of estimated tax is estimated at 4.3%, and this rate is applied to the average benefit for each taxpayer, resulting in an average penalty of $73 (4.3% of $1,700).

If 50% of taxpayers are affected (assuming 50% file an extension), then the total amount of penalty is approximately $110,000 ($73 X 1,500) for tax year 2007. The penalty waiver would lead to an insignificant loss of revenue (i.e., less than $150,000).

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