Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Machado, et al.	Analyst:	Scott McFarlane	Bill Number:	SB 1055
Related Bills:	See Prior Analysis	Telephone:	845-6075	Amended Date:	August 11, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Mortgage Forgiveness Debt Relief

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ____________.

__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 AMENDED August 5, 2008, STILL APPLIES.

__X__ OTHER – See comments below.

SUMMARY

This bill would generally conform California law to the 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 August 11, 2008, amendments do the following:

- Shorten the exclusion period by one year to omit discharges occurring in 2009. The exclusion would apply to discharges of qualified principal residence indebtedness occurring on or after January 1, 2007, and before January 1, 2009.
- Reduce the maximum amount of qualified principal residence indebtedness to $800,000 ($400,000 in the case of a married/registered domestic partner (RDP) individual filing a separate return).
- Limit the total amount that may be excluded from gross income to $250,000 ($125,000 in the case of a married/RDP individual filing a separate return).

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	8/20/08
____ N	____ OUA	__X__ PENDING		

As a result of the amendments, the "THIS BILL" and "ECONOMIC IMPACT" discussions included in the analysis of the bill as amended August 5, 2008, have been revised. Except for the discussion in this analysis, the remainder of the department's analysis of the bill as amended August 5, 2008, still applies.

THIS BILL

This bill would exclude from the gross income of a taxpayer discharge of indebtedness income up to $250,000 ($125,000 in the case of a married/RDP individual filing a separate return) by reason of a discharge of qualified principal residence indebtedness occurring on or after January 1, 2007, and before January 1, 2009. Discharge of indebtedness income is commonly referred to as cancellation-of-debt (COD) income.

Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of Internal Revenue Code (IRC) section 163(h)(3)(B)), up to $800,000.[1] Acquisition indebtedness with respect to a principal residence[2] 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.

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, up to $250,000 ($125,000 in the case of a married/RDP individual filing a separate return).

The attached Appendix provides examples of how to figure the amount of discharged indebtedness income that is excluded from gross income.

---

[1] Under federal law, the maximum amount of qualified principal residence indebtedness is $2 million.

[2] The term "principal residence" has the same meaning as the home sale exclusion rules under IRC section 121. Refer to federal Treasury Regulation section 1.121-1 for the facts and circumstances used to determine "principal residence."

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact of SB 1055 as Amended 08/11/2008 Effective for Tax Years 2007 and 2008 Enactment Assumed After 6/30/2008			
	2007-08	2008-09	2009-10
COD Exclusion	-$4,000,000	-$7,000,000	-$1,500,000
Penalty Waiver	-< $150,000[3]	n/a	n/a
Total	-$4,050,000	-$7,000,000	-$1,500,000

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

Revenue Discussion

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 are converted to liability (tax) year estimates ($117 million and $200 million for 2007 and 2008, respectively). The federal liability amount is prorated to California using proration factor of 4.2% for 2007 and 5.1% for 2008. These proration factors are calculated using four factors: (1) the ratio of California foreclosure to foreclosures nationally using data from RealtyTrac (22% for 2007 and 26% for 2008); (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%).

Proration factor applied to federal amount:

- 2007 tax year: 0.042 = 0.22 x 1.45 x 0.43 x 0.31
- 2008 tax year: 0.051 = 0.26 x 1.45 x 0.43 x 0.31

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

The revenue loss estimates, prior to the application of limitations, are as follows:

- 2007 tax year: 0.042 x $117 million = $4.9 million
- 2008 tax year: 0.051 x $200 million = $10.2 million

Limitations: The estimates were adjusted to reflect:

1. The reduction in the maximum amount of qualified principal residence indebtedness, which was reduced from $1 million ($500,000 in the case of a married/RDP individual filing a separate return) to $800,000 ($400,000 in the case of a married/RDP individual filing a separate return); and,
2. The $250,000 ($125,000 in the case of a married/RDP individual filing a separate return) limitation on the total amount of discharge of indebtedness income (i.e. COD income) that may be excluded from gross income.

An estimated 16% reduction to the estimates was made to reflect these limitations. The revenue loss estimates are as follows:

- 2007 tax year: 0.84 x $4.9 million = $4.1 million
- 2008 tax year: 0.84 x $10.2 million = $8.6 million

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

LEGISLATIVE STAFF CONTACT

Legislative Analyst
Scott McFarlane
(916) 845-6075
scott.mcfarlane@ftb.ca.gov

Revenue Manager
Rebecca Schlussler
(916) 845-5986
rebecca.schlussler@ftb.ca.gov

Legislative Director
Brian Putler
(916) 845-6333
brian.putler@ftb.ca.gov

APPENDIX

The following four examples assume a filing status other than married/RDP filing separate:[4]

Example 1: 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, figured using the following steps:

Step 1: Compute the amount of indebtedness that is not qualified principal residence indebtedness:

1.	Amount of the loan immediately before the discharge:	$1,000,000
2.	Maximum amount of qualified principal residence indebtedness:	-$ 800,000
3.	Amount that is not qualified principal residence indebtedness:	$ 200,000

Step 2: Compute the amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness:

1.	Amount of debt discharged:	$ 300,000
2.	Amount that is not qualified principal residence indebtedness:	-$ 200,000
3.	Amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness (if zero or less, enter zero):	$ 100,000

Step 3: Apply the $250,000 limitation:

1.	Amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness:	$ 100,000
2.	Exclusion limitation:	$ 250,000
3.	If the amount on line 1 is less than the amount on line 2, enter the amount from line 1. If the amount on line 2 is less than the amount on line 1, enter the amount from line 2. This is the amount of discharged debt that may be excluded from gross income:	$ 100,000

[4] Generally, the amounts would be reduced by 50% in the case of a married/RDP individual filing a separate return.

Example 2: Assume that a principal residence is secured by an indebtedness of $900,000, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $600,000 and $300,000 debt is discharged, then only $200,000 of the amount discharged may be excluded from gross income under this provision, figured using the following steps:

Step 1: Compute the amount of indebtedness that is not qualified principal residence indebtedness:

1.	Amount of the loan immediately before the discharge:	$ 900,000
2.	Maximum amount of qualified principal residence indebtedness:	-$ 800,000
3.	Amount that is not qualified principal residence indebtedness:	$ 100,000

Step 2: Compute the amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness:

1.	Amount of debt discharged:	$ 300,000
2.	Amount that is not qualified principal residence indebtedness:	-$ 100,000
3.	Amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness (if zero or less, enter zero):	$ 200,000

Step 3: Apply the $250,000 limitation:

1.	Amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness:	$ 200,000
2.	Exclusion limitation:	$ 250,000
3.	If the amount on line 1 is less than the amount on line 2, enter the amount from line 1. If the amount on line 2 is less than the amount on line 1, enter the amount from line 2. This is the amount of discharged debt that may be excluded from gross income:	$ 200,000

<u>Example 3</u>: Assume that a principal residence is secured by an indebtedness of $700,000, of which $700,000 is qualified principal residence indebtedness. If the residence is sold for $400,000 and $300,000 debt is discharged, then only $250,000 of the amount discharged may be excluded from gross income under this provision, figured using the following steps:

Step 1: Compute the amount of indebtedness that is <u>not</u> qualified principal residence indebtedness:

1.	Amount of the loan immediately before the discharge:	$ 700,000
2.	Maximum amount of qualified principal residence indebtedness:	-$ 700,000
3.	Amount that is not qualified principal residence indebtedness:	$ 0

Step 2: Compute the amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness:

1.	Amount of debt discharged:	$ 300,000
2.	Amount that is not qualified principal residence indebtedness:	-$ 0
3.	Amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness (if zero or less, enter zero):	$ 300,000

Step 3: Apply the $250,000 limitation:

1.	Amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness::	$ 300,000
2.	Exclusion limitation:	$ 250,000
3.	If the amount on line 1 is less than the amount on line 2, enter the amount from line 1. If the amount on line 2 is less than the amount on line 1, enter the amount from line 2. This is the amount of discharged debt that may be excluded from gross income:	$ 250,000

Example 4: Assume that a principal residence is secured by an indebtedness of $900,000, of which $450,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $200,000 debt is discharged, then none of the amount discharged may be excluded from gross income under this provision, figured using the following steps:

Step 1: Compute the amount of indebtedness that is not qualified principal residence indebtedness:

1.	Amount of the loan immediately before the discharge:	$ 900,000
2.	Maximum amount of qualified principal residence indebtedness:	-$ 450,000
3.	Amount that is not qualified principal residence indebtedness:	$ 450,000

Step 2: Compute the amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness:

1.	Amount of debt discharged:	$ 200,000
2.	Amount that is not qualified principal residence indebtedness:	-$ 450,000
3.	Amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness (if zero or less, enter zero):	$ 0

Step 3: Apply the $250,000 limitation:

1.	Amount of discharged debt that exceeds the portion of the debt that is not qualified principal residence indebtedness:	$ 0
2.	Exclusion limitation:	$ 250,000
3.	If the amount on line 1 is less than the amount on line 2, enter the amount from line 1. If the amount on line 2 is less than the amount on line 1, enter the amount from line 2. This is the amount of discharged debt that may be excluded from gross income:	$ 0