Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	**Machado**	**SB 1055**

SUBJECT

Mortgage Forgiveness Debt Relief

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 of $2 million.

PURPOSE OF BILL

According to the author's office, the purpose of this bill is to provide some financial relief to homeowners who have found themselves the victims of the recent sub-prime mortgage crisis.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and would be operative January 1, 2007.

ANALYSIS

BACKGROUND

Cancellation of Debt (COD)

If a taxpayer borrows money from a commercial lender and the lender later cancels ("forgives") the debt, the taxpayer may have to include the cancelled amount in income for tax purposes. When the taxpayer borrowed the money, the loan proceeds were not required to be included in income because the taxpayer had an obligation to repay the lender. When that obligation is subsequently extinguished, the amount received as loan proceeds is often reportable as income because there is no longer an obligation to repay the lender. The lender is usually required to report the amount of COD to the taxpayer and the IRS on a Form 1099-C, Cancellation of Debt.

Example: A taxpayer borrows $10,000 and defaults on the loan after paying back $2,000. If the lender is unable to collect the remaining debt, there is a cancellation of debt of $8,000, which generally is taxable income.

When COD Income is Taxable

While COD income is generally includable as taxable income, there are some exceptions:

- Bankruptcy: Debts discharged through bankruptcy are not considered taxable income.
- Insolvency: If a taxpayer is insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable. A taxpayer is insolvent when the taxpayer's total debts are more than the fair market value of the taxpayer's total assets.
- Certain farm debts.
- Non-recourse loans: A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue the borrower personally in case of default. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in COD income. However, it may result in other tax consequences, such as capital gain.

Note: Section 580b of the California Code of Civil Procedure provides that indebtedness incurred to purchase a home in California is non-recourse debt. Therefore, in general, first mortgages in California are non-recourse debt. If a California homeowner refinances that debt, or takes out a home equity loan, the refinanced indebtedness or the home equity loan is generally recourse debt.

<u>FEDERAL/STATE LAW</u>

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 present-law 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 present-law exclusion apply.

State Law

COD Income from the Discharge of Qualified Principal Residence Indebtedness

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

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[1] 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."

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.

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.

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

THIS BILL

In General

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.

Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of Internal Revenue Code (IRC) section 163(h)(3)(B)), up to $800,000[3] ($400,000 in the case of a married/registered domestic partner (RDP) individual filing a separate return).

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).

Penalty and Interest Waiver

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.

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. *Florida* does not impose a personal income tax, therefore a comparison to Florida is not relevant.

Michigan, *New York*, and *Illinois* automatically conform each taxable year to the IRC. Accordingly, these states conform to the federal Mortgage Debt Forgiveness Act of 2007, and the exclusion provided by that Act is applicable.

Minnesota and *Massachusetts* conform to the IRC as of a specified date, similar to California. *Minnesota* conforms to the IRC as amended through May 18, 2006; *Massachusetts* conforms to the IRC as of January 1, 2005. Additional legislation would be needed for these states to be in conformity with the federal Act.

FISCAL IMPACT

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

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

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[4]	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

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 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

[4] 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.

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).

Appointments

None.

Support/Opposition

Support:

California Association of Mortgage Brokers
California Association of Realtors
California Bankers Association
California Chamber of Commerce
California Credit Union League
Center for Responsible Lending
City of Sacramento
Spidell Publishing, Inc
The Greenlining Institute

Opposition:

VOTES

Assembly Floor – Ayes: 34, Noes: 0
Senate Floor – Ayes: 76, Noes: 1
Concurrence – Ayes: 38, Noes: 0

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