Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Niello	Analyst:	Scott McFarlane	Bill Number:	AB 111
Related Bills:	See Legislative History	Telephone:	845-6075	Introduced Date:	January 13, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Mortgage Forgiveness Debt Relief Extension

SUMMARY

This bill would allow a taxpayer that had all or part of the loan balance on their principal residence forgiven by their lender in 2009, 2010 or 2011 to exclude up to a maximum of $250,000 from gross income.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide some financial relief to distressed homeowners and to provide an incentive for homeowners to refinance indebtedness instead of seeking foreclosure.

EFFECTIVE/OPERATIVE DATE

As a tax levy, the bill would be effective immediately and would be operative for taxable years beginning on or after January 1, 2009.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Amendments 1 and 2 are suggested to reflect the federal extension made by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

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 forgiven, the amount received as loan proceeds is 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.

Board Position:			Department Director	Date
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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 homeowner 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.

A discussion of the tax consequences of a home foreclosure is provided in Appendix A.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

FEDERAL LAW

Income from Discharge of Indebtedness

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, certain real property business indebtedness, and qualified principal residence 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).

Mortgage Forgiveness Debt Relief

The Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142)

The Mortgage Forgiveness Debt Relief Act of 2007, enacted December 20, 2007, 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.

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343)

The Emergency Economic Stabilization Act of 2008, enacted October 3, 2008, extended the gross-income exclusion of any discharge-of-indebtedness income by reason of a discharge of qualified principal residence indebtedness by three years (i.e. the exclusion applies to discharges occurring before January 1, 2013).

[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."

STATE LAW

California generally conforms to the federal rules for the exclusion of discharge-of-indebtedness income by reason of a discharge of qualified principal residence indebtedness, with the following modifications:

- The period of discharges eligible for exclusion is shorter than the federal period.
  - The California exclusion applies to discharges of qualified principal residence indebtedness occurring on or after January 1, 2007, <u>and before January 1, 2009</u>.
  - The federal exclusion applies to discharges of qualified principal residence indebtedness occurring on or after January 1, 2007, <u>and before January 1, 2013</u>.
- The maximum amount of qualified principal residence indebtedness (i.e. the amount of principal residence indebtedness eligible for the exclusion) is reduced.
  - The California maximum amount of qualified principal residence indebtedness is <u>$800,000 ($400,000</u> in the case of a married/RDP individual filing a separate return).
  - The federal maximum amount of qualified principal residence indebtedness is <u>$2,000,000 ($1,000,000</u> in the case of a married individual filing a separate return).
- The total amount that may be excluded from gross income is limited.
  - California limits 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).
  - There is no comparable federal limitation.
- Interest and penalties shall not be imposed on 2007 discharges.
  - California prohibits the imposition of any interest or penalties resulting from a discharge of qualified principal residence that occurred during the 2007 taxable year.
  - There is no comparable federal prohibition.

Examples of how to figure the amount of discharged indebtedness income that may be excluded from California gross income are provided in Appendix B.

<u>THIS BILL</u>

This bill would provide a three-year extension on the gross-income exclusion of any discharge-of-indebtedness income (i.e. COD income) by reason of a discharge of qualified principal residence indebtedness. The exclusion would apply to discharges occurring before January 1, 2012. The California modifications would remain the same.

<u>TECHNICAL CONSIDERATIONS</u>

This bill modifies IRC section 108(a)(1)(E) as added by the Mortgage Forgiveness Act of 2007 (P.L. 110-142), enacted on December 20, 2007. IRC section 108(a)(1)(E) was subsequently amended by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), enacted on October 3, 2008. The author may want to consider amending the bill to reflect current federal law. Amendments 1 and 2 provide language to make such a change.

LEGISLATIVE HISTORY

SB 1055 (Machado/Correa, 2007/2008, Ch. 282, Laws 2008) generally conforms California law to the federal Mortgage Forgiveness Debt Relief Act of 2007, with the modifications explained in the "State Law" section in this analysis.

AB 1918 (Niello, 2007/2008) was nearly identical to SB 1055 (Machado/Correa, 2007/2008), the only difference was that it did not contain the $250,000/$125,000 limitation on the exclusion. That bill was held in the Assembly Appropriations Committee.

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 Forgiveness Debt Relief Act of 2007, and the extension provided in the federal Emergency Economic Stabilization Act of 2008.

Massachusetts and *Minnesota* conform to the IRC as of a specified date, similar to California.

- Massachusetts conforms to the IRC as of January 1, 2005. Additional legislation would be needed in order for Massachusetts to be in conformity with the federal exclusion.
- *Minnesota* conforms to the IRC as amended through February 13, 2008; therefore, *Minnesota* conforms to the federal exclusion for discharges occurring on or before January 1, 2010.

FISCAL IMPACT

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

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 111 as Introduced January 13, 2009 Effective for Tax Years 2009, 2010 and 2011 Enactment Assumed After 6/30/2009 $ in Millions		
2009-10	2010-11	2011-12
-$9	-$8	-$6

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 is estimated as follows. First, federal estimates by the Joint Committee on Taxation are converted to liability (tax) year estimates ($233.9 million, $201.5 million and $140.6 million for 2009, 2010 and 2010, respectively). Second, the federal liability amount is prorated to California using proration factor of 4.3% for 2009 and 2010, 4.7% for 2011. These proration factors are calculated using four factors: (1) the ratio of California foreclosure to foreclosures nationally using data from RealtyTrac (26%); (2) the ratio of median house price in California to median price nationally (123%), 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% for 2009 and 2010 tax years and 47% for tax year 2011), 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%).

The proration percentages are determined as follows:

- 0.043 = 0.26 x 1.23 x 0.43 x 0.31 for 2009 and 2010
- 0.047 = 0.26 x 1.23 x 0.47 x 0.31 for 2011

The revenue loss estimates, before adjusting for the California modifications, are determined as follows:

- 2009 tax year: 0.043 x $234 million = $10.1 million
- 2010 tax year: 0.043 x $202 million = $8.7 million
- 2011 tax year: 0.047 x $141 million = $6.6 million

These estimates are then adjusted to reflect reduction in the maximum amount of qualified principal residence indebtedness ($800,000), and the exclusion limitation ($250,000). An estimated 3% reduction to the estimates is made to reflect these modifications.

The revenue loss estimates are determined as follows:

- 2009 tax year: 0.97 x $10.1 million = $9.8 million
- 2010 tax year: 0.97 x $8.7 million = $8.4 million
- 2011 tax year: 0.97 x $6.6 million = $6.4 million

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

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APPENDIX A

Tax Consequences of a Home Foreclosure

When a taxpayer loses a home through foreclosure, there are two possible tax consequences:

- Taxable COD income. (Note: As stated above, forgiveness of a non-recourse debt does not result in COD income.)

- A reportable gain from the disposition of the home (because foreclosures are treated like sales for tax purposes). (Note: Often some or all of the gain from the sale of a personal residence qualifies for exclusion from income.)

The following steps illustrate how to compute the income to be reported from a foreclosure:

<u>Step 1 - Figuring COD Income</u> (Note: For non-recourse loans, skip this step. There is no COD income.)
1. Enter the total amount of the debt immediately prior to the foreclosure.___________
2. Enter the fair market value of the property on the date of foreclosure. ___________
3. Subtract line 2 from line 1.If less than zero, enter zero. ___________

The amount on line 3 is taxable COD income, unless one of the exceptions applies.

<u>Step 2 – Figuring Gain from Foreclosure</u>
4. Enter the fair market value of the property foreclosed. For non-recourse loans, enter the amount of the debt immediately prior to the foreclosure. ________
5. Enter the adjusted basis in the property. (Usually the purchase price plus the cost of any major improvements.) ____________
6. Subtract line 5 from line 4. If less than zero, enter zero. ____________

The amount on line 6 is the gain from the foreclosure of the home. If a taxpayer has owned and used the home as a principal residence for periods totaling at least two years during the five year period ending on the date of the foreclosure, the taxpayer may generally be able to exclude up to $250,000 (up to $500,000 for married couples filing a joint return) from income. If the taxpayer does not qualify for this exclusion, or the gain exceeds $250,000 ($500,000 for married couples filing a joint return), that portion that does not qualify for the exclusion or exceeds the $250,000/$500,000 exclusion limitation is included in income as a capital gain.

More information is provided on the IRS Web site:
http://www.irs.gov/newsroom/article/0,,id=174034,00.html

APPENDIX B

How to Figure the Amount of Discharged Indebtedness Income that may be Excluded from California Gross Income

The following four examples assume a filing status other than married/RDP filing separate:[2]

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

[2] 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

Example 3: 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 not 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

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 111
As Introduced January 13, 2009

AMENDMENT 1

On page 2, line 7, after "(Public Law 110-142)", insert:

and as amended by Section 303 of Division A of the Emergency Economic Stabilization Act of 2008 (Public Law 110-343),

AMENDMENT 2

On page 2, line 8, strikeout "January 1, 2010" and insert:

January 1, 2013