

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Calderon and Correa Analyst: Scott McFarlane Bill Number: SBX6 14
Related Bills: See Legislative History Telephone: 845-6075 Introduced Date: March 11, 2010
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, 2011, or 2012 to exclude up to a maximum of \$500,000 from gross income.

Note: The changes that would be made by this bill were made by SB 401 (Wolk, 2009/2010, Ch. 14, Laws 2010), enacted on April 12, 2010.

PURPOSE OF THE BILL

It appears the purpose of the bill is to prevent undue hardship to taxpayers who would otherwise have been subject to taxation and penalties resulting from having all or part of their loan balance on their principal residence forgiven by their lender.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and would be retroactively operative for discharges of indebtedness occurring on or after January 1, 2009.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Amendments one through four are suggested to make technical corrections.

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.

Table with Board Position (S, NA, NP, SA, O, NAR, N, OUA, X PENDING) and Department Director/Date (Selvi Stanislaus, 04/27/10)

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.

## **ANALYSIS**

### FEDERAL/STATE LAW

#### 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.<sup>1</sup>

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.)

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<sup>1</sup> 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 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 \$800,000 (\$400,000 in the case of a married/registered domestic partner (RDP) individual filing a separate return).
  - The federal maximum amount of qualified principal residence indebtedness is \$2,000,000 (\$1,000,000 in the case of a married individual filing a separate return).
- The total amount that may be excluded from gross income is limited.
  - For discharges occurring in 2007 or 2008, 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).
  - For discharges occurring in 2009, 2010, 2011 or 2012, California limits the total amount that may be excluded from gross income to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return).
  - There is no comparable federal limitation in any year.
- Interest and penalties shall not be imposed on 2007 or 2009 discharges.
  - California prohibits the imposition of any interest or penalties resulting from a discharge of qualified principal residence that occurred during the 2007 or 2009 taxable years.
  - There is no comparable federal prohibition.

## THIS BILL

This bill would:

- Provide a four-year extension on the gross-income exclusion of any discharge-of-indebtedness income (i.e., cancellation-of-debt (COD) income) by reason of a discharge of qualified principal residence indebtedness. The exclusion would apply to discharges occurring on or after January 1, 2009, and before January 1, 2013;
- Increase the total amount that may be excluded from gross income from \$250,000 (\$125,000 in the case of a married/RDP individual filing a separate return) to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return); and,
- Provide that no interest or penalties shall be assessed on COD income that results from the discharge of qualified residence indebtedness during the 2009 taxable year.

Additionally, this bill would retain the prior-law maximum amount of qualified principal residence indebtedness (i.e., the amount of principal residence indebtedness eligible for the exclusion); the California maximum amount of qualified principal residence indebtedness would be \$800,000 (\$400,000 in the case of a married/registered domestic partner (RDP) individual filing a separate return).

Note: The changes that would be made by this bill were made by SB 401 (Wolk, 2009/2010, Ch. 14, Laws 2010), enacted on April 12, 2010.

## **LEGISLATIVE HISTORY**

AB 111 (2009/2010, Niello) was similar to this bill, except it would not provide that interest and penalties would not be imposed with respect to discharges that occurred in the 2009 taxable year. That bill was held in the Senate Revenue and Taxation Committee.

AB 1580 (2009/2010, Calderon) would have extended mortgage forgiveness debt relief through 2012, with the same modifications that are in this bill, except that bill would not have provided that interest and penalties would not apply with respect to discharges that occurred during the 2009 taxable year. That bill was vetoed by the Governor on October 11, 2009.

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

SB 401 (Wolk, 2009/2010, Ch. 14, Laws 2010) generally conforms California law to the federal extension of mortgage forgiveness debt relief provided in the Emergency Economic Stabilization Act of 2008, with the following modifications: (1) the exclusion applies to discharges occurring in 2009, 2010, 2011, and 2012; (2) the total amount of qualified principal residence indebtedness is limited to \$800,000 (\$400,000 in the case of a married/RDP individual filing a separate return); (3) the total amount excludable is limited to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return); and (4) interest and penalties are not imposed with respect to discharges that occurred in the 2009 taxable year.

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 following modifications: (1) the exclusion applies to discharges occurring in 2007 and 2008; (2) the total amount of qualified principal residence indebtedness is limited to \$800,000 (\$400,000 in the case of a married/registered domestic partner (RDP) individual filing a separate return); (3) the total amount excludable is limited to \$250,000 (\$125,000 in the case of a married/RDP individual filing a separate return); and (4) interest and penalties are not imposed with respect to discharges that occurred in the 2007 taxable year.

SBX8 25 (2009/2010, Calderon and Correa) is identical to this bill. That bill failed to pass out of the Eighth Extraordinary Session, which adjourned on March 11, 2010.

SBX8 32 (2009/2010, Wolk, Leno, and Calderon) would extend mortgage forgiveness debt relief through 2012, with the same modifications that are in this bill. That bill was vetoed by the Governor on March 25, 2010.

## TECHNICAL CONSIDERATIONS

Technical amendments are suggested and provided at the end of this analysis.

## **FISCAL IMPACT**

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

## **ECONOMIC IMPACT**

No impact. The changes that would be made by this bill were made by SB 401 (Wolk, 2009/2010, Ch. 14, Laws 2010), enacted on April 12, 2010.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SBX6 14  
As Introduced March 11, 2010

AMENDMENT 1

On page 2, line 16, strikeout "(Public Law 110-142), is additionally", and insert:

(Public Law 110-142) and amended by Section 303 of the Emergency Economic Stabilization Act of 2008 (Public Law 110-343), is

AMENDMENT 2

On page 3, lines 18-19, strikeout "Mortgage Forgiveness Debt Relief Act of 2007 (Public Law 110-142)", and insert:

Emergency Economic Stabilization Act of 2008 (Public Law 110-343)

AMENDMENT 3

On page 3, line 19, strikeout "and", and insert:

of

AMENDMENT 4

On page 3, line 25, after "(Public Law 110-142)", insert:

and the Emergency Economic Stabilization Act of 2008 (Public Law 110-343)