

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Jeffries Analyst: Scott McFarlane Bill Number: AB 856

Related Bills: See Legislative History Telephone: 845-6075 Introduced Date: February 17, 2011

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Mortgage Forgiveness Debt Relief

SUMMARY

This bill would seek to provide tax relief to individuals who could otherwise be required to report as taxable income the amount of principal residence indebtedness that is forgiven by their lender.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Suggested Amendments

Amendment one is suggested to provide that the bill would (1) conform to the federal mortgage-forgiveness-debt-relief exclusion without modifications for discharges of qualified principal residence indebtedness occurring in 2010, 2011, and 2012, and (2) prohibit the imposition of any additions to tax with respect to discharges of qualified principal residence indebtedness that occurred during the 2010 taxable year.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to remove the current-law California modifications to the federal mortgage-forgiveness-debt-relief exclusion for discharges of qualified principal residence indebtedness occurring in 2010, 2011, and 2012.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and would be specifically operative for discharges of indebtedness occurring on or after January 1, 2010.

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ANALYSIS

FEDERAL/STATE LAW

FEDERAL LAW

Gross Income in General

Gross income is the starting point in determining an individual's taxable income. Gross income is broadly defined, and generally consists of all income from all sources, such as compensation for services, business income, interest, rents, dividends and gains from the sale of property.¹ Only items that are specifically exempt by may be excluded from gross income.

Gross Income from the 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 (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.²

¹ IRC section 61.

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."

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).

STATE LAW

California generally conforms to the federal definition of gross income, and 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/RDP 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 are not imposed with respect to 2007 or 2009 discharges.
 - California prohibits the imposition of any interest or penalties with respect to discharges of qualified principal residence that occurred during the 2007 or 2009 taxable years.
 - There is no comparable federal prohibition.

THIS BILL

This bill would add new R&TC section 17144.6 that would conform to the federal rules relating to mortgage forgiveness debt relief for discharges occurring in 2010, 2011, and 2012, except as otherwise provided; however, in R&TC section 17144.5, California already conforms to the federal mortgage-forgiveness-debt-relief rules for such discharges—with modifications. Thus, this bill would conform to the federal mortgage-forgiveness-debt-relief rules to which California is already in conformity, and current-law modifications would apply.

TECHNICAL CONSIDERATIONS

It appears that this bill would not accomplish the author's purpose of removing the current-law modifications to the federal mortgage forgiveness debt-relief exclusion. Amendment one would (1) conform to the federal mortgage-forgiveness-debt-relief exclusion without modifications for discharges of qualified principal residence indebtedness occurring in 2010, 2011, and 2012, and (2) prohibit the imposition of any additions to tax with respect to discharges of qualified principal residence indebtedness that occurred during the 2010 taxable year.

LEGISLATIVE HISTORY

AB 111 (Niello, 2009/2010) would have provided the same exclusion from gross income for mortgage forgiveness debt relief that is allowed under federal law for discharges occurring on or after January 1, 2007, and before January 1, 2013. That bill failed to pass.

AB 1580 (Calderon, 2009/2010) would have extended mortgage forgiveness debt relief through 2012, modified to provide that the total amount excludable would have been limited to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return), and qualified principal residence indebtedness would have been limited to \$800,000 (\$400,000 in the case of a married/RDP individual filing a separate return). That bill was vetoed by the Governor on October 11, 2009.

AB 1779 (Niello et al., 2009/2010) would have provided the same exclusion from gross income for mortgage forgiveness debt relief that is allowed under federal law for discharges occurring on or after January 1, 2007, and before January 1, 2013. That bill failed to pass.

ABX6 7 (Blakeslee and Niello, 2009/2010) would have provided the same exclusion from gross income for mortgage forgiveness debt relief that is allowed under federal law for discharges occurring on or after January 1, 2007, and before January 1, 2013. That bill failed to pass.

SB 97 (Calderon and Correa, 2009/2010) would have extended mortgage forgiveness debt relief through 2012, modified to provide that the total amount excludable would have been limited to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return), qualified principal residence indebtedness would have been limited to \$800,000 (\$400,000 in the case of a married/RDP individual filing a separate return), and interest and penalties would not be imposed with respect to discharges that occurred in the 2009 taxable year. That bill failed to pass.

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.

SBX6 14 (Calderon, et al., 2009/2010) would extend mortgage forgiveness debt relief through 2012, modified to provide that the total amount excludable would be limited to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return), qualified principal residence indebtedness would be limited to \$800,000 (\$400,000 in the case of a married/RDP individual filing a separate return), and interest and penalties would not be imposed with respect to discharges that occurred in the 2009 taxable year. That bill failed to pass.

SBX8 25 (Calderon and Correa, 2009/2010) would extend mortgage forgiveness debt relief through 2012, modified to provide that the total amount excludable would be limited to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return), qualified principal residence indebtedness would be limited to \$800,000 (\$400,000 in the case of a married/RDP individual filing a separate return), and interest and penalties would not be imposed with respect to discharges that occurred in the 2009 taxable year. That bill failed to pass.

SBX8 32 Wolk, Leno, and Calderon, 2009/2010) would have extended mortgage forgiveness debt relief through 2012, modified to provide that the total amount excludable would have been limited to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return), qualified principal residence indebtedness would have been limited to \$800,000 (\$400,000 in the case of a married/RDP individual filing a separate return), and interest and penalties would not have been imposed with respect to discharges that occurred in the 2009 taxable year. That bill was vetoed by the Governor on March 25, 2010.

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 failed to pass.

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/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.

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. *Illinois, Michigan, and New York* automatically conform each taxable year to the IRC; thus, these states conform to the federal mortgage-forgiveness-debt-relief rules.

Minnesota, Massachusetts, and Florida conform to the IRC as of a specified date, similar to California. *Massachusetts* generally conforms to the IRC as amended through January 1, 2005, and *Minnesota* generally conforms to the IRC as amended through March 18, 2010; thus, Minnesota conforms to the federal mortgage-forgiveness-debt-relief rules, and Massachusetts does not. *Florida* does not impose personal income tax; thus, this provision is not applicable to *Florida*.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: This bill would convey the author's intent to remove the California limitations that apply to federal mortgage forgiveness debt relief for discharges of indebtedness occurring in 2010, 2011, and 2012.

Con: This bill would not achieve its author's intended purpose.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 856
As Introduced February 17, 2011

AMENDMENT 1

On page 1, ~~strikeout~~ lines 1 and 2, and on page 2, ~~strikeout~~ lines 1 to 8, inclusive, and insert:

SECTION 1. Section 17144.5 of the Revenue and Taxation Code, as amended by section 14 of Chapter 14 of the Statutes of 2010, is amended to read:

17144.5. (a) ~~Section 108(a)(1)(E) of the Internal Revenue Code and Section 108(h) of the Internal Revenue Code, relating to special rules relating to qualified principal residence indebtedness, shall apply.~~ is modified to provide that the amount excluded from gross income shall not exceed \$500,000 (\$250,000 in the case of a married individual filing a separate return).

(b) ~~Section 108(h)(2) of the Internal Revenue Code, is modified by substituting the phrase "(within the meaning of section 163(h)(3)(B), applied by substituting '\$800,000 (\$400,000' for '\$1,000,000 (\$500,000' in clause (ii) thereof)" for the phrase "(within the meaning of section 163(h)(3)(B), applied by substituting '\$2,000,000 (\$1,000,000' for '\$1,000,000 (\$500,000' in clause (ii) thereof)" contained therein.~~

(c) ~~Notwithstanding This section shall apply to discharges of indebtedness occurring on or after January 1, 2007, and, notwithstanding any other law to the contrary, no penalties or interest shall be due with respect to the discharge of qualified principal residence indebtedness during the 2007 or 2009 taxable year regardless of whether or not the taxpayer reports the discharge on his or her return for the 2007 or 2009 taxable year.~~

(d) Notwithstanding any other law to the contrary, no additions to tax shall be due with respect to an underpayment of estimated tax to the extent that the underpayment was created or increased by the discharge of qualified principal residence indebtedness during the 2010 taxable year, regardless of whether the taxpayer reports the discharge on his or her return for the 2010 taxable year.

(e) The amendments made to this section by the act amending this subdivision shall apply to discharges of indebtedness occurring on or after January 1, 2010.