BILL ANALYSIS

Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	**Perea, et al.**	**AB 1393**

SUBJECT

Mortgage Forgiveness Debt Relief

SUMMARY

This bill would extend the state exclusion of mortgage forgiveness debt relief for one year, through 2013.

REASON FOR THE BILL

The reason for the bill is to prevent undue hardship to taxpayers who would otherwise be subject to taxation resulting from having all or part of their loan balance on their principal residence forgiven by their lender.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective immediately, and would be specifically operative for discharges of qualified principal residence indebtedness occurring on or after January 1, 2013, and before January 1, 2014.

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. Only items that are specifically exempt 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).

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Mortgage Forgiveness Debt Relief

The Mortgage Forgiveness Debt Relief Act of 2007 (Public Law 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 (Public Law 110-343)

The Emergency Economic Stabilization Act of 2008, enacted October 3, 2008, extended the gross-income exclusion of 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).

The American Taxpayer Relief Act of 2012 (Public Law 112-240)

The American Taxpayer Relief Act of 2012, enacted January 2, 2013, extended the gross-income exclusion of discharge-of-indebtedness income by reason of a discharge of qualified principal residence indebtedness by one year (i.e., the exclusion applies to discharges occurring before January 1, 2014).

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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."

STATE LAW

California generally conforms to the federal definition of gross income, including income from the discharge of indebtedness, and conforms to the federal rules for the exclusion of discharge-of-indebtedness income by reason of a discharge of qualified principal residence indebtedness (i.e., mortgage forgiveness debt relief), with the following modifications:

- The exclusion does not apply to discharges occurring in 2013.
  - The California exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2013.
  - The federal exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2014.
- 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 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 extend California's modified conformity to mortgage forgiveness debt relief for one year, through 2013. Specifically,

- The California exclusion would be extended to apply to discharges occurring on or after January 1, 2013, and before January 1, 2014,
- The maximum amount of qualified principal residence indebtedness would be $800,000 ($400,000 in the case of a married/RDP individual filing a separate return), and
- The total amount excludable from gross income would be limited to $500,000 ($250,000 in the case of a married/RDP individual filing a separate return).

This bill would also prohibit the imposition of any interest or penalties with respect to discharges of qualified principal residence indebtedness during the 2013 taxable year, regardless of whether a taxpayer reports the discharge on his or her income tax return for the 2013 taxable year.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs or operations.

LEGISLATIVE HISTORY

AB 2358 (Harkey, 2013/2014), similar to this bill, would provide a one-year extension of the state exclusion of mortgage forgiveness debt relief. AB 2358 is currently in the Assembly Revenue and Taxation Committee.

SB 30 (Calderon et al., 2013/2014), similar to this bill, would have provided a one-year extension of the state exclusion of mortgage forgiveness debt relief. SB 30 was held in the Assembly Appropriations Committee.

SB 339 (Canella and Gray, 2013/2014), similar to this bill, would provide a one-year extension of the state exclusion of mortgage forgiveness debt relief. SB 339 is currently in the Assembly Committee on Rules.

SB 439 (Evans, 2013/2014), similar to this bill, would provide a one-year extension of the state exclusion of mortgage forgiveness debt relief. SB 439 is currently in the Assembly Committee on Health.

SB 401 (Wolk, 2009/2010, Chapter 14, Statutes of 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, Chapter 282, Statutes of 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, Massachusetts, Michigan*, *Minnesota* and *New York* conform to the federal mortgage-forgiveness-debt-relief exclusion rules. *Florida* does not impose a personal income tax; thus, this provision is not applicable to *Florida*.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1393 Assumed Enactment After June 30, 2014 ($ in Millions)			
Fiscal Year	2013-14	2014-15	2015-16
Income Exclusion	- $35	- $4	$0
Penalty/Interest Waiver	- $0.8	$0	$0
Total	- $35.8	- $4	$0

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

<u>Revenue Discussion</u>

This revenue estimate is based upon a proration of the Joint Committee on Taxation (JCT) estimate for the extension of the federal exclusion for mortgage forgiveness debt relief . In January 2013, the JCT estimated the one-year extension of the federal exclusion would cost $1.4 billion. In addition to the general proration of the federal estimate to account for California's average marginal tax rate as a percentage of the federal average marginal tax rate, the following adjustments were made to the JCT estimate to arrive at the estimated loss for California:

1. California's share of foreclosures, short sales, and loan modifications relative to the nation;
2. California's housing prices relative to national housing prices; and
3. California's share of qualified taxpayers.

With these modifications, the prorated estimated revenue loss for the one-year extension of mortgage forgiveness debt relief is $39 million in fiscal years 2014-15 and 2015-16.

Additionally, it is estimated that approximately 25 percent of taxpayers would file a return with discharge of qualified principal residence indebtedness income prior to the enactment of this bill and thus would incur penalties, and waiving such penalties is estimated to result in a loss of approximately $800,000.

The estimated loss is accrued back one year and fiscalized as shown in the table above.

APPOINTMENTS

None.

VOTES

	Date	Yes	No
Concurrence	07/03/14	76	0
Assembly Floor[2]	04/18/13	76	0
Senate Floor	06/30/14	34	0

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[2] When the Assembly voted on April 18, 2013, this bill did not pertain to mortgage forgiveness debt relief; instead, this bill would have transferred the administration of the Safe Drinking Water State Revolving Fund to the State Water Resources Control Board.