

Franchise Tax Board

**ANALYSIS OF AMENDED BILL**

Authors: Evans Analyst: Scott McFarlane Bill Number: SB 439  
 Related Bills: See Legislative History Telephone: 845-6075 Amended Date: April 21, 2014  
 Attorney: Bruce Langston Sponsor: \_\_\_\_\_

**SUBJECT:** Mortgage Forgiveness Debt Relief

**SUMMARY**

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

**RECOMMENDATION**

No position.

**Summary of Amendments**

The April 21, 2014, amendments removed provisions of the bill relating to medical marijuana and added the debt-relief provisions discussed in this analysis.

This is the department’s first analysis of this bill.

**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**

This bill would be effective on January 1, 2015, and specifically operative for discharges of qualified principal residence indebtedness occurring on or after January 1, 2013, and before January 1, 2014.

**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 Internal Revenue Service (IRS) on a Form 1099-C, Cancellation of Debt.

Board Position:	Executive Officer	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.
- Mortgage forgiveness debt relief. Certain home mortgage debts forgiven by a lender are not considered taxable income. (See below for more detail.)
- Certain farm debts.
- Non-recourse loans: A non-recourse loan is a loan for which a 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.

### *Indebtedness Incurred to Purchase a Home in California*

Section 580b of the California Code of Civil Procedure provides that indebtedness incurred to purchase a home in California is non-recourse debt.

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

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<sup>1</sup> IRC section 61.

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 (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.<sup>2</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 (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).

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<sup>2</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."

*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).

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 continuously appropriate from the General Fund to the Franchise Tax Board (FTB) amounts necessary to make payments that would be required by this bill to taxpayers who have included amounts in gross income by reason of the discharge of principal residence indebtedness that would be excluded from gross income under the terms of this bill.

## IMPLEMENTATION CONSIDERATIONS

Existing law provides that refunds under the Personal Income Tax Law shall be paid from the Tax Relief and Refund Account.<sup>3</sup> The appropriation language in this bill, which would direct the FTB to pay refunds resulting from this bill from the General Fund, appears to be inconsistent with the FTB's long-standing practice of paying refunds to Personal Income Tax taxpayers from the Tax Relief and Refund Account.

## **LEGISLATIVE HISTORY**

AB 1393 (Perea, et al., 2013/2014), similar to this bill, would provide a one-year extension of the state exclusion of mortgage forgiveness debt relief. AB 1393 is currently in the Senate Appropriations Committee.

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 is currently 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.

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<sup>3</sup> R&TC sections 19602, 19603, and 19611.

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 personal income tax; thus, this provision is not applicable to *Florida*.

### FISCAL IMPACT

This bill would impact the department's programs and operations. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

### ECONOMIC IMPACT

#### Revenue Estimate

Estimated Revenue Impact of SB 439 As Amended April 21, 2014 Assumed Enactment Before June 30, 2014 (\$ in Millions)		
2013-14	2014-15	2015-16
- \$35	- \$4	\$0

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

## **SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None provided.

## **ARGUMENTS**

Pro: Proponents may argue that this bill would provide much-needed state-level tax relief to homeowners facing financial hardship because of the mortgage crisis.

Con: Opponents may argue that an extension of mortgage forgiveness debt relief could make debt forgiveness more attractive for homeowners relative to current state tax law and may encourage homeowners to be less responsible about fulfilling their debt obligations.

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