

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Galgiani Analyst: Scott McFarlane Bill Number: SB 907
Related Bills: See Legislative History Telephone: 845-6075 Introduced Date: January 25, 2016
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Mortgage Forgiveness Debt Relief

SUMMARY

This bill would extend the state exclusion of mortgage forgiveness debt relief for three years, to generally apply to discharges occurring in 2014, 2015, and 2016.

RECOMMENDATION

No position.

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.

Summary of Suggested Amendments

Technical amendments are suggested.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective immediately, and would be operative for discharges of qualified principal residence indebtedness occurring on or after January 1, 2014, and before January 1, 2017, and for any such discharges occurring after January 1, 2017, if the discharges are pursuant to an arrangement entered into and evidenced in writing prior to January 1, 2017.

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.

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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.
- Mortgage forgiveness debt relief. (Certain home mortgage debts forgiven by a lender are not considered taxable income, as described below.)
- 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.

ANALYSIS

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 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).

¹ IRC section 61.

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.²

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 Title 11 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 insolvency 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 for three years (i.e., the exclusion applied 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 for one year (i.e., to discharges occurring before January 1, 2014).

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."

The Tax Increase Prevention Act of 2014 (Public Law 113-295)

The Tax Increase Prevention Act of 2014 (Public Law 113-295), enacted December 19, 2014, extended the gross-income exclusion of discharge-of-indebtedness income by reason of a discharge of qualified principal residence indebtedness for one year (i.e., to discharges occurring before January 1, 2015).

The Protecting Americans from Tax Hikes Act of 2015 (Division Q of Public Law 114-113)

The Protecting Americans from Tax Hikes Act of 2015 (Division Q of Public Law 114-113), enacted December 18, 2015, extended the gross-income exclusion of discharge-of-indebtedness income by reason of a discharge of qualified principal residence indebtedness for two years (i.e., the federal exclusion currently applies to discharges occurring before January 1, 2017). The Act also provides for an exclusion from gross income in the case of those taxpayers whose qualified principal residence indebtedness is discharged on or after January 1, 2017, if the discharge is pursuant to an arrangement entered into and evidenced in writing prior to January 1, 2017.

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 after 2013.
 - The California exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2014.
 - The federal exclusion generally applies to discharges occurring on or after January 1, 2007, and before January 1, 2017.³
- 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).

³ The federal exclusion also applies in the case of those taxpayers whose qualified principal residence indebtedness is discharged on or after January 1, 2017, if the discharge is pursuant to an arrangement entered into and evidenced in writing prior to January 1, 2017.

- For discharges occurring in 2009, 2010, 2011, 2012, or 2013, 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, 2009, or 2013 discharges.
 - California prohibits the imposition of any interest or penalties with respect to discharges of qualified principal residence that occurred during the 2007, 2009, or 2013 taxable years.
 - There is no comparable federal prohibition.

THIS BILL

This bill would extend California's modified conformity to mortgage forgiveness debt relief for three years, generally through 2016. Specifically,

- The California exclusion would be extended to generally apply to discharges occurring on or after January 1, 2014, and before January 1, 2017,⁴
- 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),
- 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), and
- No penalties or interest would be imposed with respect to discharges occurring in the 2014 or 2015 taxable years.

IMPLEMENTATION CONSIDERATIONS

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

TECHNICAL CONSIDERATIONS

Amendments 1 through 14 are suggested to make technical modifications.

LEGISLATIVE HISTORY

AB 99 (Perea, et al., 2015/2016), would have provided a one-year extension of the state exclusion of mortgage forgiveness debt relief, for discharges occurring in 2014, with prior-law modifications to the total amount of qualified principal residence indebtedness and the maximum amount excludable (i.e., the modifications provided by SB 401), and would have provided that penalties and interest would not apply to discharges that occurred in the 2013 taxable year. AB 99 was vetoed by Governor Brown on October 10, 2015, and the reason for the veto provided by the Governor is: "Despite strong revenue performance over the past few years, the state's budget has remained precariously balanced due to unexpected costs and the provision of new

⁴ California would additionally conform, with its modifications and limitations, to the federal provision that provides for an exclusion from gross income in the case of those taxpayers whose qualified principal residence indebtedness is discharged on or after January 1, 2017, if the discharge is pursuant to an arrangement entered into and evidenced in writing prior to January 1, 2017.

services. Now, without the extension of the managed care organization tax that I called for in special session, next year's budget faces the prospect of over \$1 billion in cuts. Given these financial uncertainties, I cannot support providing additional tax credits that will make balancing the state's budget even more difficult. Tax credits, like new spending on programs, need to be considered comprehensively as part of the budget deliberations.”

AB 1393 (Perea, et al., 2013/2014, Chapter 152 of the Statutes of 2014), provided a one-year extension of the state exclusion of mortgage forgiveness debt relief, for discharges occurring in 2013, with prior-law modifications to the total amount of qualified principal residence indebtedness and the maximum amount excludable (i.e., the modifications provided by SB 401), and provided that penalties and interest do not apply to discharges that occurred in the 2013 taxable year.

SB 401 (Wolk, 2009/2010, Chapter 14 of the Statutes of 2010) generally conformed 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 applied to discharges occurring in 2009, 2010, 2011, and 2012; (2) the total amount of qualified principal residence indebtedness was limited to \$800,000 (\$400,000 in the case of a married/RDP individual filing a separate return); (3) the total amount excludable was limited to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return); and (4) interest and penalties were not imposed with respect to discharges that occurred in the 2009 taxable year.

SB 1055 (Machado/Correa, 2007/2008, Chapter 282 of the Statutes of 2008) generally conformed California law to the federal Mortgage Forgiveness Debt Relief Act of 2007, with the following modifications: (1) the exclusion applied to discharges occurring in 2007 and 2008; (2) the total amount of qualified principal residence indebtedness was limited to \$800,000 (\$400,000 in the case of a married/RDP individual filing a separate return); (3) the total amount excludable was limited to \$250,000 (\$125,000 in the case of a married/RDP individual filing a separate return); and (4) interest and penalties were 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, there is no similar provision under *Florida* law.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 907 As Introduced January 25, 2016 Assumed Enactment After June 30, 2016 (\$ in Millions)		
2015-16	2016-17	2017-18
- \$95	- \$45	- \$12

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

Revenue Discussion

This estimate is based on a proration of the Joint Committee on Taxation's (JCT's) estimated revenue effects of the Tax Increase Prevention Act of 2014 (Public Law 113-295) and the Protecting Americans From Tax Hikes Act of 2015 (Division Q of Public Law 114-113), for the extensions of federal mortgage forgiveness debt relief made by those Acts; the JCT estimates the revenue impact for the three-year period of those extensions to be a loss of \$8.3 billion (generally for discharges occurring in tax years 2014, 2015, and 2016).⁵ The prorated loss for California is estimated to be approximately \$150 million.

To determine California's prorated amount of the federal loss, the federal estimate is reduced to reflect California's approximate 15-percent share of the national housing market, then reduced by 60 percent to account for the differences between federal and state law of the allowable amounts of acquisition indebtedness and the limitation on the amount excludable from income, and finally reduced by an additional 70 percent to reflect the differences between federal and state tax rates, resulting in an estimated loss of \$150 million.

It is estimated that the prohibition of interest and penalties on discharges would result in an additional loss of \$3.5 million, which is calculated by assuming that approximately 25 percent of the total amount that would be excluded from gross income by this bill would have been reported as income on tax returns filed by taxpayers who were unable to pay the tax attributable to that income when the returns were filed.

Due to the assumed enactment date, this bill would affect taxpayers who have filed prior-year returns. Because these taxpayers would file amended returns, amounts from such returns are accrued back one year.

The total estimated loss is converted to fiscal years and then rounded to arrive at the estimates shown in the table above.

⁵ The federal estimated loss includes allowing an exclusion from gross income for those taxpayers whose qualified principal residence indebtedness is discharged on or after January 1, 2017, if the discharge is pursuant to an arrangement entered into and evidenced in writing prior to January 1, 2017.

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.

LEGISLATIVE STAFF CONTACT

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FTB'S PROPOSED AMENDMENTS TO SB 907
AS INTRODUCED JANUARY 25, 2016

AMENDMENT 1

On page 2, line 7, after "Code," insert:

relating to qualified principal residence indebtedness,

AMENDMENT 2

On page 2, line 18, strikeout "2007 or 2009", and insert:

2007, 2009, or 2013

AMENDMENT 3

On page 2, line 20, strikeout "2007 or 2009", and insert:

2007, 2009, or 2013

AMENDMENT 4

On page 2, strikeout lines 21 through 32, inclusive.

AMENDMENT 5

On page 2, line 33, strikeout "(e)(1)", and insert:

(d)(1)

AMENDMENT 6

On page 2, line 35, strikeout “Code”, and insert:

Code, relating to income from discharge of indebtedness,

AMENDMENT 7

On page 3, line 6, strikeout “(f)(1)”, and insert:

(e)(1)

AMENDMENT 8

On page 3, line 7, strikeout “(Public”, and insert:

(Division Q of Public

AMENDMENT 9

On page 3, line 8, strikeout “Code”, and insert:

Code, relating to income from discharge of indebtedness,

AMENDMENT 10

On page 3, line 17, after “Code,” insert:

relating to income from discharge of indebtedness,

AMENDMENT 11

On page 3, line 31, strikeout “(Public”, and insert:

(Division Q of Public

AMENDMENT 12

On page 3, line 32, after “Code,” insert:

relating to income from discharge of indebtedness,

AMENDMENT 13

On page 3, line 34, ~~strikeout~~ “January 1, 2017.”, and insert:

January 1, 2017, except for any discharge of qualified principal residence indebtedness that is subject to an arrangement that is entered into and evidenced in writing before January 1, 2017, in which case the amendments made by this act to conform to the amendments made by Section 151 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Public Law 114-113) apply to principal residence indebtedness that is discharged after January 1, 2017.

AMENDMENT 14

On page 3, line 40, ~~strikeout~~ “(Public”, and insert:

(Division Q of Public