Analysis of Original Bill

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Subject: Mortgage Forgiveness Debt Relief within Federal Disaster Areas

Summary

This bill would, under the Personal Income Tax Law (PITL), provide an exclusion for mortgage debt relief related to the loss of a qualified principal residence in a federally declared disaster area.

Recommendation – No position.

Reason for the Bill

The reason for the bill is to provide relief to those in disaster zone areas who have their mortgages forgiven as a result of the disaster.

Effective/Operative Date

As an urgency measure, this bill would be effective immediately upon enactment, and specifically operative for discharges of indebtedness occurring on or after January 1, 2017, and before January 1, 2019.

Federal/State Law

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.
When COD Income is Taxable

While COD income is generally includable as taxable income, there are some exceptions, such as:

- Bankruptcy,
- Insolvency, and
- 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.

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 (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 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.
Recourse vs Non-recourse Debt in Home Purchases

California Civil law\(^2\) generally provides that all “purchase money loan” mortgages (whether refinanced or not) are non-recourse debt. Non-recourse debt is generally not taxable as COD income when forgiven or cancelled.

A “purchase money loan” is a loan obtained by a buyer that is used exclusively to purchase a home.

Federal and California law lack an exclusion specifically related to mortgage debt forgiveness in a disaster zone.

This Bill

This bill would, under the PITL, allow as an exclusion from income, discharge of indebtedness related to the loss of a qualified principal residence occurring on or after January 1, 2017, and before January 1, 2019, within a federally declared disaster area.

The bill would also provide that no penalties or interest would be due with respect to the discharge of a qualified principal residence indebtedness during the 2017 or 2018 taxable year regardless of whether the taxpayer reports the discharge on the taxpayer’s 2017 or 2018 tax return.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

Legislative History

Research of recent legislative history identified no similar legislative efforts.

Other States’ Information

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide an exclusion comparable to the exclusion allowed by this bill. The laws of these states were selected due to their similarities to California’s economy, business entity types, and tax laws.

\(^2\) Civil Procedures Code section 580b.
**Fiscal Impact**

The department’s costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified.

**Economic Impact**

Revenue Estimate

There would be a revenue loss to the general fund, but the amount is unknown. This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Due to the lack of available data, it is difficult to predict the amount of acquisition indebtedness that would not be covered by insurance and discharged by banks in federally declared disaster zones. Therefore, we cannot provide an annual estimate. However, the department estimates that for every $20 million in qualified acquisition indebtedness discharged and not covered by insurance, the resulting revenue loss would be $1.3 million.

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