SB 580

Department of Legislative Services
2012 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 580 (Senator Peters, *et al.*)

Budget and Taxation Ways and Means

Income Tax - Subtraction Modification - Mortgage Forgiveness Debt Relief

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This bill creates a subtraction modification against the State income tax for qualified mortgage debt relief. The subtraction modification is equal to the amount of the discharge of qualified principal residence indebtedness allowable under the federal Mortgage Forgiveness Debt Relief Act of 2007, as amended.

The maximum value of the subtraction modification is limited to $1.0 million for individuals and $2.0 million for joint returns. The bill provides for recapture of the tax benefit if the taxpayer claiming the subtraction modification sells or otherwise disposes of the property for which the subtraction modification is claimed.

The bill takes effect July 1, 2012. The subtraction modification applies to tax year 2013 only, and its provisions terminate June 30, 2014.

Fiscal Summary

State Effect: General fund revenues decrease by $4.9 million in FY 2014 due to qualified mortgage debt relief being exempted against the State income tax. This estimate does not account for the recent mortgage settlement agreement, which may substantially increase the revenue loss resulting from the bill. General fund expenditures increase by $22,000 in FY 2014 for one-time tax form changes and computer programming modifications at the Comptroller's Office.

($ in millions)	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017
GF Revenue	$0	($4.9)	$0	$0	$0
GF Expenditure	$0	$.0	$0	$0	$0
Net Effect	$.0	($4.9)	$.0	$.0	$.0

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Under the assumptions above, local income tax revenues decrease by $3.1 million in FY 2014. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law: The State generally conforms to the federal tax treatment of canceled debts, foreclosures, repossessions, and abandonments. The amount of income that must be realized or excluded for State income tax purposes in these circumstances is determined under the federal income tax.

Background:

Federal Cancellation of Debt Income Provisions

When an individual borrows money the loan proceeds are not recognized as income because there is an obligation to repay the lender. Under the federal income tax if an individual borrows money from a commercial lender and the lender later cancels or forgives the debt, the cancelled amount of debt is required to be reported as income under certain circumstances. For example, if an individual borrows $10,000 and defaults on the loan after paying back $2,000 and the lender is unable to collect the remaining debt, there is a cancellation of debt of $8,000. This income is referred to as cancellation of debt (COD) income under the Internal Revenue Code (IRC) and is taxable as ordinary income.

The IRC provides that a taxpayer must report only taxable COD income, which may be less than total COD. Certain COD income is not taxable if it qualifies for an exception under Section 108 of the IRC or otherwise qualifies for exclusion. The exclusions under the IRC are: (1) bankruptcy; (2) insolvency; (3) qualified farm indebtedness; (4) qualified real property business indebtedness; (5) qualified principal residence indebtedness; and (6) certain nonbusiness debt of a qualified individual related to specified Midwestern natural disasters.

A taxpayer who qualifies for one of the exclusions listed above may be required to reduce (but not below zero) certain tax attributes based on the amount of canceled debt excluded. Tax attributes are certain credits, losses, and deductions that provide a tax benefit. The reduction of tax attributes is made after determination of your tax liability for the year of the discharge. The order in which tax attributes are reduced depend on the reason why the canceled debt was excluded from income.

The American Recovery and Reinvestment Act of 2009 contained a provision that allowed certain businesses to elect to defer, and include ratably over five tax years, any income from the discharge of business debt arising from the reacquisition of certain specified types of business debt repurchased in 2009 and 2010. The Budget

Reconciliation and Financing Act of 2009 (Chapter 487) permanently decoupled the State income tax from this specific COD income provision.

Qualified Principal Residence Indebtedness

The federal Mortgage Forgiveness Debt Relief Act of 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 includes:

- any debt incurred in acquiring, constructing, or substantially improving a principal residence and which is secured by the principal residence; and
- any debt secured by the principal residence resulting from the refinancing of debt incurred to acquire, construct, or substantially improve a principal residence, but only to the extent the amount of the debt does not exceed the amount of the refinanced debt.

The maximum amount that can be treated as qualified principal residence indebtedness is $2.0 million ($1.0 million if married filing separately).

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to the amount discharged that 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 $1.0 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 income under this provision. Loan proceeds that are not used to acquire, build, or improve a principal residence, such as paying off credit cards or purchasing a vehicle, are not eligible for the exclusion. The individual's adjusted basis in the principal residence is reduced by the amount excluded from income under the Act.

The Emergency Economic Stabilization Act of 2008 extended the exclusion for tax years 2010 through 2012.

The Comptroller's Office reviews federal tax legislation and estimates any potential impact the legislation will have on State revenues. Based on the federal Joint Committee on Taxation's estimated cost of the Mortgage Forgiveness Debt Relief Act of 2007, the Comptroller's Office estimated in 2008 that the federal mortgage forgiveness debt relief provision would decrease State revenues by $445,000 in fiscal 2008 and by $267,000 in fiscal 2010. The committee's initial estimate of the impact on federal revenues, about $200.0 million annually, has increased in its most recent estimate to a $1.0 billion annual revenue loss.

Mortgage Settlement Agreement

On February 9, 2012, the U.S. Department of Justice, U.S. Department of Housing, and 49 state attorneys general announced an agreement with five major banks providing for compensation for damages arising from improper foreclosure procedures and to provide relief to states and homeowners from underwater mortgages. The value of the settlement ranges from $26.0 billion to $39.0 billion, and will be distributed based on a formula contained within the agreement. Maryland is expected to receive a total of $960.0 million in funding over the program, which is about 7% of the total settlement. Due to the recent announcement and complexity of the agreement, many of the details of the settlement, including when the money will be received, are still unclear.

The settlement agreement has four primary components:

- *Principal Reduction:* ($17 billion to $32 billion) A minimum of $17 billion will be allocated to mortgage debt forgiveness/loan modifications, forbearance, short sales, and other assistance to homeowners, primarily by reducing the principal on mortgages that have negative equity and are delinquent. It is estimated that the funding could benefit up to 1 million homeowners nationally. Maryland expects to receive $808.5 million in funding under this program.
- *Refinancing:* Homeowners who have negative equity but are current on their mortgages will receive about $3.0 billion in refinancing; up to 750,000 homeowners could be eligible for this refinancing. Maryland expects to receive $64.0 million in refinancing funds.
- *Payments to Foreclosed Homeowners:* About $1.5 billion is allocated to homeowners who had their homes foreclosed upon between January 1, 2009, and December 31, 2011, and who meet specified criteria. Maryland's share of payments is expected to total $24.1 million.
- *Government Payments:* The federal government will receive $750 million under the settlement. States will receive $2.75 billion to help fund consumer protection and state foreclosure protection efforts. Maryland expects to receive $62.5 million.

State Revenues: The bill creates a subtraction modification against the State income tax for qualified mortgage debt relief in tax year 2013 only. The exemption is equal to the amount of the discharge of qualified principal residence indebtedness allowable under the Mortgage Forgiveness Debt Relief Act of 2007, as amended. Under current federal law, the federal provision will expire on December 31, 2012.

As a result, general fund revenues may decrease by $4.9 million in fiscal 2014. The estimated State fiscal impact is based on the federal Joint Committee on Taxation estimates for the federal tax effect of the discharge of qualified principal residence indebtedness, adjusted for estimated federal effective tax rates, Maryland's estimated share of the national economy, and State tax rates. This estimate does not account for the likely increase in mortgage refinancing and loan modifications provided by the recent mortgage settlement agreement. The substantial funding provided to Maryland will likely lead to a significant increase in the estimated revenue loss in fiscal 2014, but cannot be reliably estimated at the time.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $22,000 in fiscal 2014 to add the subtraction modification to the personal income tax return. This includes data processing changes to the SMART income tax return processing and imaging systems and system testing.

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modification claimed. Under the assumptions above, local revenues will decrease by $3.1 million in fiscal 2014.

Additional Information

Prior Introductions: None.

Cross File: HB 600 (Delegate Zucker, *et al.*) - Ways and Means.

Information Source(s): Council of State Governments, Internal Revenue Service, Joint Committee on Taxation, Department of Legislative Services

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