HB 923

Department of Legislative Services

2014 Session

FISCAL AND POLICY NOTE
Revised

House Bill 923 (Delegate Zucker, *et al.*)

Ways and Means Budget and Taxation

Income Tax Subtraction Modification - Mortgage Forgiveness Debt Relief - Extension

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This bill extends the 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 amount of the subtraction may not exceed $200,000, or $100,000 for individuals.

The bill takes effect July 1, 2014. The subtraction modification applies to tax year 2014 and 2015, and its provisions terminate June 30, 2016.

Fiscal Summary

State Effect: General fund revenues decrease by $6.6 million annually in FY 2015 and 2016 due to qualified mortgage debt relief being exempted against the State income tax. Expenditures are not affected.

($ in millions)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
GF Revenue	($6.6)	($6.6)	$0	$0	$0
Expenditure	0	0	0	0	0
Net Effect	($6.6)	($6.6)	$0	$0	$0

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

Local Effect: Local income tax revenues decrease by $4.3 million annually in FY 2015 and 2016. 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.

Chapters 544 and 545 of 2012 created 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. Chapters 544 and 545 provided 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 subtraction modification applied to tax year 2013 only, and its provisions terminate June 30, 2014.

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.

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 IRC or otherwise qualifies for exclusion. The exclusions under IRC include (1) bankruptcy; (2) insolvency; (3) qualified farm indebtedness; (4) qualified real property business indebtedness; and (5) qualified principal residence indebtedness discharged before January 1, 2014.

A taxpayer who qualifies for an exclusion 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 the 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 enacted a temporary measure that 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 American Taxpayer Relief Act of 2012 extended the exclusion through 2013.

According to RealtyTrac, short sales and foreclosure-related sales comprised 16.2% of all U.S. residential home sales in 2013, an increase over both 2011 and 2012. In the latter months of 2013, Maryland had one of the highest rates of short sales in the nation. About 8% of all Maryland home sales in December were short sales, fourth highest in the nation and above the average of 5.7%. Bank-owned property sales comprised 4% of all sales in Maryland, and an additional 1% of sales was comprised of foreclosure auctions; these rates were below the national average. In 2012, RealtyTrac estimated that the average short sale in Maryland was about $73,000.

State Revenues: The bill creates a subtraction modification against the State income tax for qualified mortgage debt relief in tax years 2014 and 2015 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. The maximum amount of the subtraction is $200,000, or $100,000 for individuals. Under current federal law, the federal provision expired on December 31, 2013.

As a result, general fund revenues decrease by $6.6 million annually in fiscal 2015 and 2016. The estimated 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 distressed housing, and State tax rates. Based on the U.S. Treasury *Making Home Affordable Data File*, it is estimated that 85% of qualified mortgage debt relief will qualify for the subtraction modification due to the maximum limitations specified by the bill.

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modification claimed. Local revenues will decrease by $4.3 million annually in fiscal 2015 and 2016.

Additional Information

Prior Introductions: None.

Cross File: SB 596 (Senator Peters, *et al.*) - Budget and Taxation.

Information Source(s): Comptroller's Office, U.S. Department of Treasury, Internal Revenue Service, U.S. Joint Committee on Taxation, RealtyTrac, Department of Legislative Services

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