Department of Legislative Services
2017 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 1033 (Delegate Flanagan, *et al.*)
Ways and Means

Income Tax - Subtraction Modification - Discharged Student Loan Debt

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This bill creates a subtraction modification against the State income tax for specified income resulting from the discharge of student loan debt. The maximum amount of the subtraction may not exceed $50,000 ($100,000 if married filing jointly). A taxpayer may not claim the proposed subtraction modification if the taxpayer claims the existing subtraction modification for income resulting from the discharge of student loan debt due to total and permanent disability or death.

The bill takes effect July 1, 2017, and applies to tax year 2017 and beyond.

Fiscal Summary

State Effect: General fund revenues may decrease by about $532,000 annually beginning in FY 2018 due to qualified debt income being exempt from the State income tax. General fund expenditures increase by $53,000 in FY 2018 due to one-time computer programming expenses at the Comptroller's Office.

(in dollars)	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
GF Revenue	($532,000)	($532,000)	($532,000)	($532,000)	($532,000)
GF Expenditure	$53,000	$0	$0	$0	$0
Net Effect	($585,000)	($532,000)	($532,000)	($532,000)	($532,000)

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

Local Effect: Local income tax revenues may decrease by $336,000 annually beginning in FY 2018. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law/Background: 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.

A student loan may be discharged or forgiven if specified conditions are met. A taxpayer whose student loan is discharged or forgiven is required to report the amount of the discharged or forgiven loan as income for federal income tax purposes (and is subject to tax), except if specified circumstances are met.

Except as discussed below, the amount of a discharged or forgiven student loan is taxable for State income tax purposes if it is taxable for federal income tax purposes. Chapters 320 and 321 of 2014 created a subtraction modification against the State income tax for income resulting from the discharge of student loan debt due to total and permanent disability or death. State income tax would not be owed on the amount of the student loan discharged under these circumstances, even if the amount is taxable under the federal income tax. Taxpayers claiming the subtraction modification must provide the Comptroller a copy of a notice stating that a loan has been discharged due to total and permanent disability or death.

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 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 that must be reported as income by the taxpayer. This income is referred to as cancellation of debt (COD) income under the Internal Revenue Code (IRC) and is taxable as ordinary income.

In certain situations, the U.S. Department of Education may cancel, forgive, or discharge a federal student loan. These circumstances include if the borrower (1) dies; (2) has a total and permanent disability; (3) works for a specific number of years in certain professions; (4) files bankruptcy and the bankruptcy court rules that the loan repayment poses an undue hardship; (5) could not complete an educational program because the school closed while the borrower was enrolled or recently enrolled (closed school discharge); or (6) if the loan was discharged due to a legal infirmity, most commonly if the borrower establishes that the school engaged in a fraudulent manner (defense to repayment discharge). Section 108 of the IRC and several recent Internal Revenue Service (IRS) revenue procedures specify the circumstances under which the forgiveness or discharge of student loan indebtedness is a taxable event. In general, certain taxpayers may qualify to exclude from income a student loan that was discharged due to a closed school, defense to repayment, or bankruptcy. Taxable student loan discharges include specified discharges related to death and disability.

National Taxpayer Advocate Analysis

The Taxpayer Advocate Service, an independent organization within the IRS, helps taxpayers resolve problems and works with the IRS to correct systemic and procedural problems. The leader of the service, the National Taxpayer Advocate, is required by law to identify the most serious taxpayer problems and make administrative and legislative recommendations to protect taxpayer rights and mitigate taxpayer problems. Over the last several years, the reports have identified significant problems in the administration of federal COD income provisions, which were found to be unnecessarily complex. The 2010 report estimated that creditors issued two million COD income statements. Credit card debt comprised about one-half of all statements, followed by mortgages (15%) and automobile loans (6%). All other debts and unidentified debts were the remaining one-third of all statements. Most taxpayers reported less than $10,000 in COD income.

State Revenues: The bill establishes a subtraction modification for income resulting from the discharge of student loan debt. As a result, general fund revenues may decrease by $532,000 annually beginning in fiscal 2018.

The estimated State fiscal impact is based on the forecasted amount of loans discharged and the following facts and assumptions:

- in tax year 2009, a total of $9.1 billion of COD income was reported on U.S. federal tax returns;
- discharged student loan debt comprises about one-fifth of all COD income;
- about one-third of all student loans that are discharged or forgiven do not qualify for the existing State subtraction modification and are reported on a taxable return; and
- the limitations specified by the bill reduce revenue losses by about 5%.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $53,000 in fiscal 2018 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 modifications claimed. Local income tax revenues may decrease by $336,000 annually beginning in fiscal 2018.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office; U.S. Department of Education; Internal Revenue Service; Department of Legislative Services

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