SB 714

Department of Legislative Services
2013 Session

FISCAL AND POLICY NOTE

Senate Bill 714 (Senator Madaleno, *et al.*)
Budget and Taxation

Income Tax - Subtraction Modification - Student Loan Debt

This bill creates a subtraction modification against the State income tax for certain taxpayers for income resulting from the discharge of student loan debt. The subtraction modification may not exceed $15,000 for a single filer or $25,000 for a joint filer.

The bill takes effect July 1, 2013, and applies to tax year 2013 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by about $924,700 annually beginning in FY 2014 due to qualified debt income being exempted against the State income tax. General fund expenditures increase by $32,200 in FY 2014 for one-time tax form changes and computer programming modifications at the Comptroller's Office.

(in dollars)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
GF Revenue	($924,700)	($924,700)	($924,700)	($924,700)	($924,700)
GF Expenditure	$32,200	$0	$0	$0	$0
Net Effect	($956,900)	($924,700)	($924,700)	($924,700)	($924,700)

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

Local Effect: Local income tax revenues decrease by $584,000 annually beginning 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 include (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 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.

Section 108(f) of the IRC specifies the circumstances under which the discharge of student loan indebtedness is a taxable event. In general, the discharge of student loan indebtedness can be excluded if the discharge was contingent upon the borrower working for a specific number of years in certain professions. The loan must be made by the federal or state government or certain institutions and meet other specified criteria. Section 108(f)(4) also excludes any payments received under the National Health Service Corps Loan Repayment Program and similar state loan repayment programs. There are no income limitations or phase outs on the tax treatment of student loan forgiveness. Recent Internal Revenue Service (IRS) revenue rulings have also specified that the following types of student loan forgiveness are not taxable: (1) public service loan forgiveness under the Higher Education Act of 1965; (2) teacher loan forgiveness under the Higher Education Act of 1965; and (3) most law school loan repayment assistance programs. Taxable student loan discharges include specified discharges related to (1) death and disability; (2) closed school, false certification and unpaid refunds; and (3) income-contingent repayments.

Recent State Legislation

The federal 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/HB 101) permanently decoupled the State income tax from this specific COD income provision.

During the 2012 session, certain federal exclusions of COD income related to qualified principal residence indebtedness terminated at the end of 2012. Chapters 544 and 545 of 2012 (SB 580/HB 600) created a subtraction modification against the State income tax for qualified mortgage debt relief based on the expiring federal provisions, thereby extending the benefit for State income tax purposes for tax year 2013 only. The American Taxpayer Relief Act of 2012, enacted on January 3, 2013, extended the federal provision through 2013.

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 2 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 creates a subtraction modification against the State income tax for certain taxpayers for income resulting from the discharge of student loan debt. As a result, general fund revenues decrease by $924,700 beginning in fiscal 2014.

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; and
- nontaxable returns and the limitations specified by the bill reduce the revenue losses by one-third.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $32,200 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. Local income tax revenues decrease by $584,000 annually beginning in fiscal 2014.

Additional Information

Prior Introductions: None.

Cross File: HB 87 (Delegate Luedtke, *et al.*) - Ways and Means.

Information Source(s): Comptroller's Office, Internal Revenue Service, National Taxpayer Advocate, Department of Legislative Services

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