

Department of Legislative Services
2019 Session

FISCAL AND POLICY NOTE
Third Reader

House Bill 380
Ways and Means

(Delegate Walker)

Budget and Taxation

Income Tax Subtraction Modification - Mortgage Forgiveness Debt Relief -
Extension

This bill repeals the termination date of the State income tax subtraction modification for qualified mortgage debt relief. **The bill takes effect June 1, 2019.**

Fiscal Summary

State Effect: General fund revenues decrease by about \$200,000 annually beginning in FY 2020 due to qualified mortgage debt relief being exempted against the State income tax. Expenditures are not affected.

(in dollars)	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024
GF Revenue	(\$200,000)	(\$200,000)	(\$200,000)	(\$200,000)	(\$200,000)
Expenditure	0	0	0	0	0
Net Effect	(\$200,000)	(\$200,000)	(\$200,000)	(\$200,000)	(\$200,000)

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

Local Effect: Local income tax revenues decrease by about \$137,000 annually beginning in FY 2020. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law: Subject to specified exceptions, 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.

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. The exclusion most typically applies to real estate short sales, loan modifications, and foreclosures. 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 mortgage principal prior to refinancing.

The maximum amount that can be treated as qualified principal residence indebtedness is \$2.0 million (\$1.0 million if married filing separately). Subsequent federal legislation extended the exclusion; however, the provision generally terminated after tax year 2016. The exclusion may only apply if the indebtedness is discharged after December 31, 2016, if the discharge is subject to a prior written agreement.

Chapters 544 and 545 of 2012 created a subtraction modification against the State income tax in tax year 2013 for qualified mortgage debt relief. The subtraction modification was 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 Acts 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. Chapters 528 and 529 of 2014 extended the subtraction modification to tax years 2014 and 2015 and specified that the maximum amount of the subtraction may not exceed \$100,000 (\$200,000 if married filing jointly). Since the federal exclusion was extended through tax year 2016, the State subtraction modification generally did not apply.

Chapter 231 of 2017 reestablished the subtraction modification and applied to tax years 2017 and 2018. The subtraction modification terminates June 30, 2019.

Background: 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 income under the Internal Revenue Code and is taxable as ordinary income.

During the subprime mortgage crisis and the economic recession many homeowners found themselves struggling to make mortgage payments on homes that had lost much of their value. In many instances mortgage lenders forgave or canceled some of the mortgage debt as part of a mortgage restructuring agreement or foreclosure. This is also known as mortgage forgiveness. However, even though a person may no longer owe that amount of debt to the mortgage lender, the cancelled amount is now generally considered taxable given the federal subtraction modification has expired. The number of mortgage restructurings and foreclosures has decreased significantly as the housing market has recovered. In tax year 2017, 176 taxpayers claimed the State subtraction modification for qualified mortgage debt relief.

State Revenues: The bill repeals the termination date of the subtraction modification for qualified mortgage debt relief. Under current law, subtraction modifications may be claimed through tax year 2018. Based on the number of recent taxpayer claims, general fund revenues will decrease by about \$200,000 annually beginning in fiscal 2020.

This estimate assumes that the housing market will remain relatively unchanged. Revenue losses will be greater to the extent that foreclosures and mortgage restructurings increase.

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modifications claimed. Local revenues will decrease by about \$137,000 annually beginning in fiscal 2020.

Additional Information

Prior Introductions: None.

Cross File: SB 265 (Senator Zucker, *et al.*) - Budget and Taxation.

Information Source(s): Comptroller's Office; Department of Legislative Services

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