



# CBA Regulatory Compliance Bulletin

August 4, 2014

## State Restores Tax Relief For Cancelled Home Mortgage Debt

Governor Brown signed into law a bill ([AB 1393](#)) sponsored by the California Bankers Association that extends tax relief to borrowers who are the beneficiaries of forgiven residential mortgage debt for the 2013 tax year. Except as discussed below, cancellation of debt is normally treated as taxable income. In 2008 Congress enacted the Mortgage Forgiveness Debt Relief Act in order to discharge mortgage indebtedness for federal tax purposes in the 2007 and 2008 tax years. That Act limited relief to purchase money debt (“acquisition indebtedness” within the meaning of IRC Section 163(h)(3)(b)) that is secured by the borrower’s principal residence.<sup>1</sup> Congress renewed the legislation each year through the 2013 tax year, and the California legislature enacted bills to apply the same treatment under California law, except for last year.

In 2013 two measures, SB 30 and AB 42, failed to clear the committee hearing process, meaning that homeowners who received a principal reduction in 2013 would have owed state income tax on the amount of forgiven debt to the extent of gain. AB 1393 was enacted this year as an urgency measure to apply retroactively to the 2013 tax year, and is effective immediately. The bill provides that no penalties or interest will be due with respect to the discharge of qualified principal residence indebtedness during the 2013 taxable year, regardless of whether the taxpayer reported the discharge on his or her income tax return for the 2013 taxable year. Homeowners who paid taxes because of the treatment of

discharged mortgage debt as income can apply to the Franchise Tax Board for a refund.

AB 1393 would also apply to certain debt forgiven in connection with a short sale. SB 931 was enacted in 2010 and, as amended in 2011 by SB 458, created new Code of Civil Procedure Section 580e which provides that no judgment shall be rendered for any deficiency on a short sale where the note is secured by a deed of trust encumbering a dwelling of not more than four units. The coverage of these bills on short sales is broader than the tax relief coverage under AB 1393. The anti-deficiency protections under Section 580e apply to any deed of trust or mortgage, not just purchase money first deeds. Section 580e is also not limited to loans secured by a borrower’s principal residence but by any dwelling of not more than four units.

The California Franchise Tax Board has indicated that it takes a broader position with regard to tax relief on short sales. On its [website](#) the FTB refers to what it believes to be the IRS’s position that an obligation involved in a sale pursuant to Section 580e would be treated as a non-recourse obligation for federal income tax purposes. This means that because cancellation of nonrecourse debt results in no taxable income, the federal tax relief legislation does not apply (since there is no income to forgive). The FTB concludes thus:

“California conforms to the relevant portions of the federal tax law governing the forgiveness of nonrecourse and recourse debt, so if the lender agrees to the short sale as full consideration of the mortgage debt,

<sup>1</sup> See [IRC Section 108\(h\)](#).

• 2 August 4, 2014

for tax purposes, the loan will be nonrecourse thus, there is no cancellation of indebtedness income for California tax purposes.”

The FTB partly relied on an [IRS letter](#) addressed to Senator Barbara Boxer analyzing short sales under Section 580e for federal tax purposes. The IRS sent a follow up letter to Senator Boxer [dated April 29, 2014](#) narrowing the scope of its earlier letter (upon which the FTB relied). In the second letter the IRS expressed its view that not all Section 580e short sale transactions are treated as nonrecourse. The author believes the scope of Section 580e includes non-purchase money loans which, in California, “generally appear to be

recourse loans from their inception.” The letter concludes that its analysis should have been limited to loans covered by CCP Section 580b(a)(3) (purchase- money loans secured by a borrower’s primary residence are non-recourse), which would include certain short sales.

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