State of California
Franchise Tax Board

Mortgage Forgiveness Debt Relief Extended - Updated 04/13/10

On April 12, 2010, SB 401, the Conformity Act of 2010 was enacted. It allows taxpayers who had all or part of the loan balance on their principal residence forgiven by their lender to exclude the forgiven debt from California gross income. The new law applies to discharges of qualified principal residence indebtedness on or after January 1, 2009, and before January 1, 2013.

New law - Taxable years 2009 through 2012

California law conforms, with modifications, to federal mortgage forgiveness debt relief for discharges that occurred in tax years 2007 through December 31, 2012. The amount of qualifying indebtedness is less than the federal amount and California imposes a state-only limitation on the total amount of relief excluded from gross income. The following summarizes the differences between the federal and California provisions. Federal provision applies to discharges occurring in 2007 through 2012, and:

- Limits the amount of qualified principal residence indebtedness to $2,000,000 for taxpayers who file as married filing jointly, single, head of household, or widow/widower, and to $1,000,000 for taxpayers who file as married filing separately.
- Does not limit the debt relief amount; it only limits the indebtedness amount used to calculate the debt relief amount.
- See the federal law Mortgage Forgiveness Debt Relief Act and Debt Cancellation for more information.

California provision applies to discharges that occurred in 2007 through 2012, and:

Taxable years 2009 through 2012

- Limits the amount of qualified principal residence indebtedness to $800,000 for taxpayers who file as married/registered domestic partners (RDP) filing jointly, single, head of household, or widow/widower, and to $400,000 for taxpayers who file as married/RDP filing separately.
- Limits debt relief to $500,000 for taxpayers who file as married/RDP filing jointly, single, head of household, or widow/widower, and to $250,000 for taxpayers who file as married/RDP filing separately.

Taxable years 2007 and 2008

- Limited the amount of qualified principal residence indebtedness to $800,000 for taxpayers who file as married/(RDP) filing jointly, single, head of household, or widow/widower, and to $400,000 for taxpayers who file as married/RDP filing separately.
- Limited debt relief to $250,000 for taxpayers who file as married/RDP filing jointly, single, head of household, or widow/widower, and to $125,000 for taxpayers who file as married/RDP filing separately.

How to File

Form 540 - Claiming mortgage forgiveness debt relief on an original tax return

You can file for debt relief on your original Form 540, California Resident Income Tax Return, or Form 540NR, California Nonresident or Part-Year Resident Income Tax Return.

If the amount of debt relief for federal purposes is the same as or less than the California limit, then no adjustment is necessary on Schedule CA (540/540NR).

If the amount of debt relief for federal purposes is more than the California limit, include the amount in excess of the California limit on Schedule CA (540/540NR) line 21f, column C.

You must include a copy of your federal return, including Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), with your original California tax return. There is no similar California form.

Form 540X - Claiming mortgage forgiveness debt relief for a previously-filed tax return

If you already filed your tax return, file a Form 540X, Amended Individual Income Tax Return, in order to claim debt relief.

If the amount of debt relief for federal purposes is the same as or less than the California limit(s), an adjustment to income is no longer necessary on Schedule CA (540/540NR). On Form 540X, simply enter on line 2e, column B, the amount originally entered on Schedule CA (540/540NR) line 21f, column C.

If the amount of debt relief for federal purposes is more than the California limit(s), complete a new Schedule CA (540/540NR) and revise the amount originally reported on line 21f, column C, attributed to federal mortgage forgiveness debt relief, to the amount in excess of the California limit. Complete Form 540X following the instructions for that form and enter on line 2e, column B the difference from the original Schedule CA (540/540NR), line 21f, column C, less the amount from the revised Schedule CA (540 or 540NR), line 21f, column C.

When filing Form 540X, write "Mortgage Debt Relief" in red across the top of your amended tax return.

Cancellation of Debt

Generally, if you have property that is used as security for a debt and that property is taken by the lender (foreclosed) in full or partial satisfaction of the debt, you are treated as having sold the property.[1] This may generate either a gain or a loss, and in some cases cancellation of debt (COD) income. A mortgage restructuring (such as reduction in principal), that reduced your debt may also generate COD income.

In the wake of the 2007 American housing market collapse and subsequent mortgage crisis, the U.S. Congress enacted the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110 142) and Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

These Acts include provisions under federal law that, subject to certain conditions, that allows taxpayers to exclude from their federal taxable income the discharge of debt on their principal residence (COD income) that they would otherwise have been required to report (2007 through 2012).[2] The special federal rules relating to qualified principal residence apply to debt reduced through mortgage restructuring, as well as to mortgage debt forgiven in connection with a foreclosure.

Property other than principal residence

The federal Mortgage Forgiveness Debt Relief Act only provides for the exclusion of COD income relating to qualified principal residence. If you have COD income as the result of a foreclosure on other property, such as a second (vacation) home, rental, or other business property, you may still be able to exclude COD income under other provisions if:

1. You were bankrupt when the discharge occurred (Title 11 discharge).
2. You were insolvent (limited to level of insolvency).
3. Qualified farm indebtedness was canceled.
4. Debt was Qualified Real Property Business Indebtedness (QRPBI)[3] and you make a federal election.

If more than one of these exceptions applies, they are applied in the above order.[4]

For more information, see IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments. The IRS Publication 4681 has a worksheet that can be used to help calculate the extent to which a taxpayer is insolvent immediately before the cancellation.

Information resources

- IRS.gov search for home foreclosure and debt cancellation.
- IRS publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments
- Federal law – Mortgage Forgiveness Debt Relief Act and Debt Cancellation
- SB 1055 – Legislative Change 08-7
- Press Release April 2010 – California Enacts Mortgage Forgiveness Debt Relief
- Tax News February 2010 – California Code of Civil Procedures and Foreclosure
- Tax News July 2009 – Foreclosure and Short Sales
- Tax News November 2009 – Documents, Second Mortgages, Tax Reporting – How to Handle a Foreclosed Home for Tax Purposes

[1]Refer to the February 2010 Tax News article California Code of Civil Procedures and Foreclosure for more information regarding how California Civil Procedure Code (CCP) Sections interact with IRC Section 108.

[2]Federal law initially applied to discharges occurring from 2007 through 2009 (the Mortgage Forgiveness Debt Relief Act of 2007, Public Law 110-142, December 20, 2007). Federal mortgage forgiveness debt relief was

subsequently extended to apply to discharges occurring from 2009 through 2012 (the Emergency Economic Stabilization Act of 2008, Public Law 111-5, October 3, 2008).

[3] The taxpayer cannot be a C corporation to use this exclusion.

[4] IRC section 108(a)(2).