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California won't tax forgiven home debt

Tax relief is on the way for thousands of fearful California mortgage borrowers. Most no longer face a double whammy of losing their homes – and then paying a big state tax bill on the forgiven debt.

State lawmakers Thursday passed SB 401, a bill by Sen. Lois Wolk, D-Davis, to exempt borrowers who lost homes to foreclosure or short sales in 2009 from state taxes that can run into thousands of dollars. The same is true for certain types of loan modifications. State tax officials say 100,000 people statewide will be spared paying tax they otherwise would owe. A spokesman for Gov. Arnold Schwarzenegger said he will sign the bill.

Here's what it does:

SB 401 aligns much of California's tax code with that used by the Internal Revenue Service nationally. The U.S. government has banned the IRS from taxing forgiven mortgage debt as extra household income from 2007 through the end of 2012. California did the same for the 2007 and 2008 tax years. The bill extends the state ban from 2009 through the end of 2012. It also bans state taxes on federal stimulus grants for renewable energy projects.

"It will be great for everybody in my situation. This is a big, big relief," said Sara Palasch, who sold her Bakersfield house through a short sale last year and now lives in Georgia. Weeks ago, she got a state tax bill for $10,500. Also relieved is Debbie Wong of Sacramento, who received a state tax bill for $7,500. She sold her Elk Grove condo last year through a short sale. The forgiven debt gave her a state taxable income of $108,000 when her salary was $13,000, she said. "I don't have the $7,500," she said Thursday.

Who is affected:

Primarily, the bill affects people who had debt forgiven as they lost homes in foreclosures, short sales and deeds in lieu of foreclosure last year – and through 2012 now. Also affected: those who got loan modifications that cut the amount they owe the bank. In short sales, a bank might accept a sales price of $250,000 when it is still owed $350,000 on the home. In deeds in lieu of foreclosure, the bank simply takes back the house and may forgive what's still owed. The difference is the forgiven debt. Borrowers can avoid state taxes on up to $500,000 in forgiven debt.

The Franchise Tax Board says the tax forgiveness measure mostly applies to people who refinanced their homes to get better interest rates or extract equity, and then had a short sale or foreclosure where debt was forgiven. But the tax board also warned that refinanced dollars taken out as cash and spent on items other than home improvements may be taxable.

Who is not affected:

Those who bought houses and never refinanced before doing a short sale, loan modification or foreclosure are unaffected. In most cases the banks just take back the houses. There is no forgiven debt, and no tax bill, said the tax board. Investors are also unaffected. They still must pay state taxes on forgiven debt. The bill affects only people who live in their home.

What people should do now when filing their taxes:

The Franchise Tax Board says: "Once the governor signs this into law, California taxpayers will not have to do anything. If they qualify for federal relief on the mortgage debt forgiven, then they will also qualify for state income tax purposes. California Form 540 starts with federal adjusted gross income so there will be no adjustment necessary to properly reflect the state adjusted gross income amount for this issue."

What this will cost the state:

The tax board estimates it will collect about $34 million less in taxes as a result of the bill in this and coming years. The bill will grant relief to about 100,000 taxpayers statewide from now through 2012, agency spokeswoman Brenda Voet said Thursday. The tax board couldn't estimate Thursday how many of those would be in the Sacramento region.