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## California Exempts Cancelled Debt from Taxation

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Under federal tax law, all income is subject to taxation, unless specifically exempted. Debt which a lender forgives or cancels – commonly referred to as cancellation of debt (COD) income – is considered to be income to the borrower and, thus, generally is subject to federal taxation. Current federal law provides for a temporary exemption for taxation of COD.

On April 13, 2010, California enacted state Senate Bill 401, which brings California state law concerning COD income substantially in accord with current federal law. Pursuant to SB 401, distressed homeowners will no longer have to pay California state income tax on debt forgiven in a short sale, foreclosure, or loan modification. For debt forgiven on a loan secured by a “qualified principal residence,” borrowers will now be exempt from both federal and state income tax consequences. The existing federal exemption is for indebtedness up to \$2 million, whereas the new California exemption is for indebtedness up to \$800,000 and forgiven debt up to \$500,000.

“Qualified principal residence” indebtedness is defined as debt incurred in acquiring, constructing, or substantially improving a principal residence. It includes both first and second trust deeds. It also includes a refinance loan to the extent the funds were used to payoff a previous loan that would have qualified.

The California exemption applies to debts discharged from 2009 through 2012. Californians who have already filed their 2009 tax returns may claim the exemption by filing a Form 540X amendment.

Taxpayers who do not qualify for the above exemptions (e.g., second home or rental property) may nevertheless be exempt under other provisions. Most notably, taxpayers who are bankrupt are exempt from debt relief income tax. Also, taxpayers who are insolvent are exempt from debt relief income tax to the extent their current liabilities exceed current assets.

Earle Law Offices provides trial and appellate litigation, as well as non-litigation, legal services in the areas of bankruptcy, business law, constitutional and civil rights law, family law, real estate law, tax law, and trusts and estates.

\* Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Fourth and Ninth Circuits, federal trial courts in the Northern District of California, and the United States Tax Court. He has served as a Judge Pro Tempore for the Santa Clara Superior Court, and is also a licensed Real Estate Broker.

Mr. Earle received his law degree from the Santa Clara University School of Law, where he served as an Editor of the school’s Law Review, and where he received awards for academic excellence. He received his undergraduate degree, with honors, in business administration from the University of La Verne.

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