

# CRS Report for Congress

## Analysis of the Proposed Tax Exclusion for Canceled Mortgage Debt Income

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## Summary

During 2007, the rate of foreclosures and mortgage defaults has been rising to new levels. As lenders and borrowers work to resolve indebtedness issues, some transactions are resulting in cancellation of debt. Mortgage debt cancellation can occur when lenders restructure loans, reducing principal balances, or sell properties, either in advance, or as a result, of foreclosure proceedings. If a lender forgives or cancels such debt, current tax law treats it as cancellation of debt (COD) income subject to tax. There are exceptions for taxpayers who are insolvent or in bankruptcy, among others — these taxpayers may exclude canceled mortgage debt income under existing law.

The Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648), which was passed by the House by a vote of 386 to 27 on October 4, 2007, would exclude canceled qualified residential debt from income. Thus, the act would allow taxpayers who do not qualify for the existing exceptions to exclude canceled mortgage debt income. The President has expressed support for the legislation generally, but has stated a preference for a temporary tax provision — the bill's provision is permanent.

A rationale for excluding canceled mortgage debt income has focused on minimizing hardship for households in distress. Policymakers have expressed concern that households experiencing hardship and possibly losing their homes, presumably as a result of financial distress, should not incur an additional hardship by being taxed on canceled debt income. Some analysts have also drawn the connection between minimizing hardship for individuals and consumer spending; reductions in consumer spending, if significant, can lead to recession. Additionally, legislators have been pursuing Federal Housing Authority (FHA) and government-sponsored enterprise (GSE) reform efforts, in part to alleviate the current mortgage crisis. As efforts to minimize the rate of foreclosure are being made, lenders are, in some cases, renegotiating loans with borrowers to keep them in the home. For some policymakers, the exclusion of canceled mortgage debt income may be a necessary step to ensure that homeowner retention efforts are not thwarted by tax policy.

Opponents of an exclusion for canceled mortgage debt income might argue that the provision would make debt forgiveness more attractive for homeowners relative to current tax law and could encourage homeowners to be less responsible about fulfilling debt obligations.

Congress may or may not choose to enact an exclusion for canceled mortgage debt income. If this choice is made, the question arises as to whether an exclusion should be granted for all homeowners. Alternatively, the exclusion could be limited. Limits could be placed on such things as the amount of income excluded, the type of households eligible to claim the exclusion, and the type of canceled debt eligible to be excluded. Finally, the provision could be temporary rather than permanent.

This report will be updated in the event of significant legislative changes.

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# Analysis of the Proposed Tax Exclusion for Canceled Mortgage Debt Income

Mortgage debt cancellation occurs when lenders engage in loss-mitigation solutions that either (1) restructure the loan and reduce the principal balance or (2) sell the property, either in advance, or as a result of foreclosure proceedings.<sup>1</sup> Under current law, the canceled debt (sometimes referred to as discharge of indebtedness) may be income subject to taxation.

Proposals have been made to exclude canceled mortgage debt income from taxation. The rationales for these proposals are to minimize hardship for households in distress and to ensure that non-tax-related homeowner retention efforts are not thwarted by tax policy. Critics could argue that the exclusion could encourage homeowners to be less responsible about fulfilling debt obligations.<sup>2</sup> In addition, the exclusion would add to several housing subsidies provided in the tax code.

This report provides an overview and analysis of the current tax treatment of canceled debt income, describes the proposal included in H.R. 3648, and concludes with a discussion of policy options.

## Overview

For federal income tax purposes, there are two types of income that may arise when an individual's mortgage is fully or partially canceled: cancellation of indebtedness income and gain from the disposition of property.

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<sup>1</sup> In order to avoid foreclosure proceedings, lenders and homeowners may agree to “short sell” properties or “deed-in-lieu” transactions. In short sales, the property is listed for sale with the lender agreeing to take a reduced payoff on the outstanding loan amount. If the property cannot easily be sold, the homeowner may give the lender the deed to the property in lieu of foreclosure proceedings. The benefit of either option is that the homeowner does not suffer the adverse credit impacts and possible stigma of foreclosure and the lender can clear a non-performing loan without the associated costs of foreclosure, eviction, and property rehabilitation.

<sup>2</sup> Martin Vaughn, “Taxes - Panel Poised To Approve Forgiven Mortgage Debt Bill,” *CongressDaily*, Sept. 26, 2007.

## Cancellation of Indebtedness Income

When all or part of a taxpayer's debt is forgiven, the amount of the canceled debt is ordinarily included in the taxpayer's gross income.<sup>3</sup> This income is typically referred to as cancellation of debt (COD) income. The borrower will realize ordinary income to the extent the canceled debt exceeds the value of any cash or property given to the lender in exchange for cancelling the debt. Lenders report canceled debt to the Internal Revenue Service (IRS) using Form 1099-C, and borrowers must generally include the amount in gross income in the year of discharge.

**Exceptions.** Under current law, there are several exceptions to the general rule that canceled debt is included in the gross income of the borrower. Section 108 of the Internal Revenue Code (IRC) contains two exceptions that are particularly relevant in the case of canceled home mortgage debt: canceled debt is not included in the borrower's gross income if (1) it is discharged in Title 11 bankruptcy or (2) the borrower is insolvent (that is, has liabilities that exceed the fair market value of his or her assets, determined immediately prior to discharge).<sup>4</sup>

In the case of the bankruptcy exception, the debt must be discharged by the court overseeing the bankruptcy proceedings or pursuant to a plan approved by that court.<sup>5</sup> On the other hand, no involvement by a court is necessary for a taxpayer to claim an insolvency exception — the taxpayer calculates his or her assets and liabilities and then includes the information on tax returns filed with the IRS. For an insolvent taxpayer, the amount of COD income that may be excluded is limited to the amount by which the taxpayer is insolvent.<sup>6</sup>

For both the bankruptcy and insolvency exceptions, a taxpayer who excludes canceled debt must essentially give back some of the benefit of the exclusion. Specifically, the taxpayer must reduce certain beneficial tax attributes, including basis in property, that would otherwise decrease the taxpayer's income or tax liability in future years.<sup>7</sup> The attributes are reduced until the reductions generally account for the excluded amount. As a result, the taxpayer may be subject to tax on the excluded COD income in years following the year of discharge. Only when a taxpayer does not have sufficient attributes to account for the entire excluded COD income is he or she never subject to tax on that income.

In addition to the IRC § 108 exclusions, there are several other circumstances under which COD income may be excluded. For example, a taxpayer with

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<sup>3</sup> See IRC § 61(a)(12); *see also*, U.S. v. Kirby Lumber Co., 284 U.S. 1 (1931)(holding, prior to the IRC explicitly addressing the treatment of COD income, that a taxpayer had realized income from the discharge of a debt).

<sup>4</sup> See IRC § 108(a)(1)(A) and (B).

<sup>5</sup> See IRC § 108(d)(2).

<sup>6</sup> See IRC § 108(a)(3).

<sup>7</sup> See IRC § 108(b). The taxpayer reduces basis in property in the order set out by Treasury Regulation § 1.1017-1. Basis reduction occurs in the taxable year following the debt discharge. *See* IRC § 1017(a).

nonrecourse, as opposed to recourse, debt<sup>8</sup> will not realize COD income.<sup>9</sup> Other examples of when COD income may be excluded from the borrower's income are if the cancellation was intended to be a gift<sup>10</sup> or was the result of a disputed debt.<sup>11</sup>

## Gains From the Disposition of Property

When an individual sells property, the excess of the sales price over the original cost plus improvements (adjusted basis) is normally gain subject to tax.<sup>12</sup> If the property was held for more than 12 months, the gain is taxed at a maximum rate of 15% rather than the regular income tax rates. If the property was held for less than 12 months, the gain is taxed at the regular income tax rates.

In situations involving canceled home mortgage debt, if the lender takes the home in exchange for the debt cancellation, the homeowner realizes gain from the disposition of property in the amount that the property's fair market value (or the amount of outstanding debt, in the case of nonrecourse debt) exceeds the taxpayer's adjusted basis in the property.<sup>13</sup> A taxpayer may have both gain from the disposition of property and COD income.

IRC § 121 provides an exclusion for gain from the sale or disposition of a personal residence. The provision excludes gain of up to \$250,000 for single taxpayers and \$500,000 for married couples filing joint returns if the taxpayer meets a use test (has used the house as the principal residence for at least two of the last five years) and an ownership test (has owned the house for at least two of the last five years). A taxpayer who does not meet the qualifications may be eligible for a partial exclusion if the home was sold because of a change in employment or health or due to unforeseen circumstances.<sup>14</sup> Additionally, other taxpayers may qualify for special treatment (e.g., members of the armed forces).<sup>15</sup> The exclusion can generally be used every two years.

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<sup>8</sup> Recourse debt is debt for which the borrower is personally liable if he or she defaults on the loan. Nonrecourse debt is secured by property, and the borrower is not personally liable for the debt; if he or she defaults on the loan, the lender's only remedy is to seize the property.

<sup>9</sup> For more information, see U.S. Department of the Treasury, Internal Revenue Service, *Questions and Answers on Home Foreclosure and Debt Cancellation*, available at [<http://www.irs.gov/newsroom/article/0,,id=174034,00.html>].

<sup>10</sup> See IRC § 102.

<sup>11</sup> See *Zarin v. Comm'r*, 916 F.2d 110, 115 (3<sup>rd</sup> Cir. 1990).

<sup>12</sup> See IRC §§ 61(a)(3) and 1001.

<sup>13</sup> For more information, see U.S. Department of the Treasury, Internal Revenue Service, *Questions and Answers on Home Foreclosure and Debt Cancellation*, available at [<http://www.irs.gov/newsroom/article/0,,id=174034,00.html>].

<sup>14</sup> See IRC § 121(c).

<sup>15</sup> See IRC § 121(d)(9).

## Legislative Developments

### The Mortgage Forgiveness Debt Relief Act (110<sup>th</sup> Congress)

The Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) was passed by the House on October 4, 2007, by a vote of 386 to 27. The act would, among other things, exclude discharged qualified residential debt from gross income. Qualified indebtedness would be debt, limited to \$2 million (\$1 million if married filing separately), incurred in acquiring, constructing, or substantially improving the taxpayer's principal residence that is secured by such residence. It would also include refinancing of this debt, to the extent that the refinancing does not exceed the amount of refinanced indebtedness. The taxpayer would be required to reduce the basis in the principal residence by the amount of the excluded income. The provision would not apply if the discharge was on account of services performed for the lender or any other factor not directly related to a decline in the residence's value or to the taxpayer's financial condition. The provision would apply to debt discharges that are made on or after January 1, 2007. The provision has been estimated to cost \$1.34 billion in reduced tax revenue from FY2008 through FY2017.<sup>16</sup>

The President has stated general support for an exclusion of canceled residential debt income, but supports a temporary provision rather than the permanent relief proposed in H.R. 3648.<sup>17</sup>

### Selected Legislation in the 109<sup>th</sup> Congress

Debt cancellation relief was enacted by the Katrina Emergency Tax Relief Act of 2005 (KETRA; P.L. 109-73), which became law in September 2005. That legislation contained temporary tax relief provisions intended to directly and indirectly assist individuals in recovering from the devastation of Hurricane Katrina.<sup>18</sup> Included in KETRA was a temporary exclusion for non-business debt that was forgiven by a governmental agency or certain financial institutions. If the discharge occurred between August 24, 2005, and January 1, 2007, eligible individuals (e.g., those with their principal place of abode on August 25, 2005, in the core disaster area) were able to exclude the COD income.

### Selected Proposals Made Prior to the 109<sup>th</sup> Congress

A provision enacted in the Tax Reform Act of 1986 (P.L. 99-514, § 405) allows farmers who are solvent to treat certain COD income as if the farmer were insolvent. Essentially, discharged, qualified farm debt is excluded from taxation if canceled by

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<sup>16</sup> U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 3648*, JCX-98-07, Oct. 5, 2007.

<sup>17</sup> U.S. President (Bush), "Fact Sheet: New Steps to Help Homeowners Avoid Foreclosure," website [<http://www.whitehouse.gov/infocus/economy/>] visited Oct. 4, 2007.

<sup>18</sup> For more information, see CRS Report RS22269, *Katrina Emergency Tax Relief Act of 2005*, by Erika Lunder.

a qualified person. This debt relief is not exclusively mortgage related but has to have been incurred directly from the operation of a farming business.

In the past, Congress has provided tax relief when mortgage debt is forgiven. In August 1993, the Omnibus Budget Reconciliation Act (P.L. 103-66, § 13150) enacted a provision for permanent tax relief to owners of commercial real estate when some portion of the debt on commercial and investment property was forgiven. At that time, the conference committee stated the following:

The committee understands that real property has declined in value in some areas of the nation, in some cases to such a degree that the property can no longer support the debt with which it is encumbered. The committee believes that where an individual has discharge of indebtedness that results from a decline in value of business real property securing that indebtedness, it is appropriate to provide for deferral, rather than current inclusion, of the resulting income. Generally, that deferral should not extend beyond the period that the taxpayer owns the property.<sup>19</sup>

In 1999 and 2000, the House and Senate, respectively, each passed a tax bill that provided tax relief for mortgage cancellation, but neither bill was enacted. During that time period, several regional markets had experienced severe housing slumps and falling property values. In subsequent years that legislation was reintroduced (H.R. 666 in the 108<sup>th</sup> Congress; H.R. 3458 in the 109<sup>th</sup> Congress).

## Analysis

In order to evaluate the policy of including discharged debt as income, it is helpful to understand how it works. According to economic theory, one way of defining income is as the change (over the period in question) in a person's net worth — that is, the change in the value of the person's assets minus the change in their liabilities. By this definition, a forgiven loan is income: a canceled debt reduces a taxpayer's liabilities, and thus increases net worth. Current tax law generally adheres to this concept by providing that if the obligation to repay the lender is forgiven, the amount of loan proceeds that is forgiven is reportable income subject to tax.<sup>20</sup>

This portion of the report provides analysis of the issues associated with the tax treatment of canceled mortgage debt income.

## Homeownership Retention or Loss

In some instances, lenders may restructure or rearrange debt, cancel some debt, and allow the homeowner to retain ownership of the home. Then, all other things

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<sup>19</sup> U.S. Congress, House Committee on the Budget, *Omnibus Budget Reconciliation Act of 1993*, H.Rept. 103-111, May 25, 1993.

<sup>20</sup> This tax treatment applies to many different kinds of debt, such as auto loans and credit cards, in addition to mortgage debt. As mentioned previously, if taxpayers are insolvent or bankrupt, they are fully or partially exempt from taxation on the canceled debt.



being equal, the borrower's net worth has increased as liabilities have declined and assets have remained unchanged. Alternatively, homeowners may experience debt cancellation while losing their home, through foreclosure or as a result of voluntarily deeding the property back to the lender. Tax law treats the loss of the home in this situation as a disposition of property that gives rise to gain or loss. The homeowner no longer has the asset and, to the extent the asset value exceeded liabilities, may be worse off as a result of declining net worth. Additionally, he or she may realize gains or losses, which may make the taxpayer better or worse off as well.

The current tax treatment of COD income, assuming equal amounts of canceled debt, is the same regardless of whether the home is retained or lost. An illustration is shown in **Table 1**. Assuming residential debt of \$200,000, a loan restructuring could occur, after which the homeowner owes \$180,000 and the lender has agreed to cancel the remaining amount. The discharged debt, \$20,000, is income subject to tax if no exclusion applies (e.g., the taxpayer is not insolvent) — if a rate of 28% is assumed, the tax liability is \$5,600. Alternatively, the home could have been sold as a result of foreclosure with a sales price of \$180,000 along with a lender agreement to cancel the remaining debt. The \$20,000 discharge is income and, assuming no exclusion applies and the same tax rate, generates the same tax liability. This is in addition to any taxes the taxpayer may owe on the gain from the sale of the house.

**Table 1. Current Tax Treatment of Canceled Debt Income  
Assuming No Exclusions Apply**

Qualified residential debt	\$200,000
Loan is renegotiated or property disposed of	(\$180,000)
Remaining balance of debt , which is forgiven	\$20,000
Tax liability (assume 28% rate) on canceled debt of \$20,000	\$5,600

Source: CRS

If current law was amended to exclude such COD income, then the \$20,000 discharge would not be included in gross income and the taxpayer would not owe the \$5,600 tax liability. If, as in H.R. 3648, taxpayers had to account for the excluded COD income by reducing basis in the residence, the impact of such adjustment could differ, depending on whether the home is lost or retained, for the taxpayers who owe taxes on the gain from disposing of the house. If such a taxpayer loses the house, the tax consequences would depend on the timing of the basis adjustment. If basis was reduced in the year following discharge, as under current law, then the excluded COD income would not be accounted for because the residence was disposed of prior to the required basis adjustment. If basis was reduced prior to disposition (e.g., at the time of discharge), then the excluded COD income would be accounted for. For homeowners with taxable gain who retain the house and sell it in a later year, the basis would be adjusted by the time of the sale to account for the excluded income, but the taxes owed on the disposition would be deferred until that time. Thus, the taxpayer who retains the house would be better off than a similarly situated taxpayer

who loses it and was taxed on the same gain in the year of discharge.<sup>21</sup> However, as noted, it is possible, depending on the timing of the basis adjustment, that the homeowner losing the house would not account for the excluded COD income.

## Equity Among Homeowners

An exclusion of income can result in individuals with identical incomes paying different amounts of tax. A standard of fairness frequently invoked by public finance analysts in evaluating tax policy is “horizontal equity” — a standard that is met when persons with identical incomes pay the same amount of tax. Like other exclusions, an exclusion for debt forgiveness would violate the standard of horizontal equity. Specifically, a person who has no forgiven debt might pay more taxes than a person who has the same amount of income, a part of which constitutes canceled debt.

An exclusion of forgiven debt may also reduce the tax system’s progressivity — the proposed provision, in other words, would likely favor upper-income individuals. This would occur because an exclusion of a given amount is more valuable to persons with higher marginal tax rates. This effect would be magnified if homeownership is more concentrated among upper income individuals.

An example of the effect an income tax exclusion has on the tax system’s progressivity can be seen by identifying two individual homeowners, both of whom incur \$20,000 in COD income. The tax benefit to the two differs if they are in different tax brackets.<sup>22</sup> The value of the exclusion for a homeowner with lower income, who may be in the 15% income tax bracket, is \$3,000, while the value to another homeowner, with higher income in the 28% bracket, is \$5,600. Thus, the higher income taxpayer, with presumably greater ability to pay taxes, receives a greater tax benefit than the lower income taxpayer.

## Past Enactments

Over the past quarter century, Congress has enacted tax relief for canceled debt in several instances, including assisting Hurricane Katrina victims in 2005 and commercial property owners and farmers during economic downturns in 1986 and 1993. The 2005 legislation was temporary while the others were permanent.

It could be argued that the market conditions that led to the 1986 and 1993 congressional enactments also exist today. Specifically, property values may be declining such that the property no longer supports the debt with which it is encumbered. Currently, the policy issue is posed by residential housing; in 1986, the problem was the business property of farmers; and in 1993, the issue was business real property. In providing the 1993 exclusion, Congress acknowledged it was

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<sup>21</sup> The time value of money asserts that the present value of a certain amount of money is greater than the future value of that same amount. Thus, the cost of a tax payment of \$5,600 today is more than the same amount paid in the future.

<sup>22</sup> COD income may cause a taxpayer to move to a higher tax bracket.

essentially allowing the taxpayer to defer the income subject to tax because an adjustment to basis was required.<sup>23</sup>

The 1986 exclusion of COD income for farmers may provide the most relevant reference for analysis of the current issues. At the enactment of the exclusion,

Congress was concerned that pending legislation providing Federal guarantees for lenders participating in farm-loan write-downs would cause some farmers to recognize large amounts of income when farm loans were canceled. As a result, these farmers might be forced to sell their farmland to pay the taxes on the canceled debt. This tax provision was adopted to mitigate that problem.<sup>24</sup>

Consistent with the 1986 enactment, one rationale expressed for the current proposed exclusion of canceled residential debt income is to prevent unintended adverse consequences resulting from foreclosure prevention efforts. Specifically, as lenders are being encouraged to write-down, or work out, loans with distressed borrowers, these efforts could be diminished by the income taxation of canceled debt.

## Data

Lenders report canceled debt income on IRS Form 1099-C. The data reported include all types of debt, not just residential. As shown in **Table 2**, the number of Forms 1099-C filed rose by 112% from 2003 through 2007. The amount of canceled debt also increased from 2003 to 2004, although data for subsequent years are not available. While specific conclusions about mortgage debt cancellation cannot be drawn from these data, to the extent that debt cancellation represents financial distress, the data suggest that the number of financially distressed taxpayers might be increasing. Alternatively, the rise in debt cancellations may be associated with increases in the number of debt transactions. In this case, the number of debt cancellations as a portion of debt may be proportionally the same.

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<sup>23</sup> U.S. Congress, House Committee on the Budget, *Omnibus Budget Reconciliation Act of 1993*, H.Rept. 103-111, May 25, 1993.

<sup>24</sup> U.S. Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 109-072, 109<sup>th</sup> Cong., 2<sup>nd</sup> sess., p. 220.

**Table 2. Reported Canceled Debt**

Tax Year	Number of Forms	Amount of Debt Claimed (\$1,000)
2003	968,991	\$6,229,584
2004	1,048,284	\$7,144,087
2005	1,369,459*	na
2006	1,942,694*	na
2007	2,058,600*	na

**Source:** U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Division, reported on Sept. 17, 2007.

**Note:** The 2005, 2006, and 2007 data are projections.

## Policy Options

Congress may choose not to alter the current tax law as it pertains to canceled debt income; in this case, no legislative action is required.<sup>25</sup> If the treatment remains unaltered, canceled mortgage debt income is subject to tax unless the taxpayer meets an exception to the provision (e.g., the taxpayer is insolvent).

In lieu of legislative changes, improving awareness about the existing exclusions that apply when there is canceled debt, such as for insolvency or bankruptcy, may be an option to pursue. Also, it may be important to ensure that taxpayers know what to do if lenders misreport information on the Form 1099-C, which could make it appear that the taxpayer has canceled debt income that has not actually occurred.

Congress may choose to enact an exclusion for canceled mortgage debt income. As discussed above, existing law provides an exclusion of COD income for, among others, taxpayers who are insolvent or in bankruptcy. A proposal to exclude residential COD income would apply to taxpayers who do not currently qualify for exclusion because, for example, they are solvent.

An exclusion for canceled mortgage debt income would have different impacts on taxpayers, depending on a variety of circumstances. If an exclusion is pursued, several choices about the level of detail in the policy may be explored. The choices about the provision may depend on its purpose. One stated purpose is to minimize hardship for households in distress. Another stated purpose is to eliminate the adverse consequence of a tax for those homeowners able to renegotiate loans with their lenders, thus, to some extent, encouraging loan forgiveness, rather than foreclosure.

The potential minimization of hardship for financially distressed households has another, broader relevance. In the wake of foreclosures and housing market

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<sup>25</sup> Unlike appropriations, tax provisions do not require reauthorization.

disruptions, financial distress to households could reduce consumer spending. A decline in consumer spending could cause or contribute to a recession. While an exclusion of residential COD income cannot prevent a recession, it might minimize financial distress for borrowers and contribute to minimizing adverse consequences vis-a-vis consumer spending.

## What Kind of Exclusion?

One consideration for Congress is whether an exclusion provision should be temporary or permanent. As noted earlier, H.R. 3648 proposes permanence, whereas the Administration has suggested the provision should be temporary.

The current treatment of canceled debt income has existed in tax law for decades. Some argue that current housing market conditions, where there are a large number of “upside down” (the debt owed on the property exceeds the value of the property) homeowners, warrant a temporary solution for a crisis that is not expected to last. If the primary purpose of the policy is to minimize adverse consequences associated with loan renegotiations in the short-term (and minimize any potential economic downturn associated with housing market problems), then a temporary measure seems consistent with these purposes.

It could be argued that a provision providing for the exclusion of residential COD income should be temporary because owner-occupied housing is heavily subsidized even without a COD income exclusion. There are three principal tax provisions for owner-occupied housing currently in the tax code. The deduction for mortgage interest is the most costly provision, with an estimate of \$85.2 billion in revenue loss for FY2008.<sup>26</sup> The exclusion of gain on the sales of homes is the second largest tax provision for homeowners, with an estimate of \$30.1 billion in tax revenue loss for FY2008.<sup>27</sup> The deduction of state and local real estate taxes is the third provision, with an estimate of \$14.2 billion in tax revenue loss for FY2008.<sup>28</sup> Some economists feel that this preferential tax treatment encourages households to overinvest in housing and less in business investments that might contribute more to increasing the nation’s productivity and output.<sup>29</sup>

On the other hand, some analysts might argue that the provision should be permanent. A case could be made that a temporary provision is unfair because there is no difference between an individual experiencing canceled debt income in 2007, when foreclosure rates may be high, relative to three or four years from now, when foreclosure rates may be lower. If the policy purpose is to minimize hardship when taxpayers experience distress, then making the provision permanent would seem consistent with that purpose.

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<sup>26</sup> U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007 to 2011*, JCS-3-07 (Washington: GPO, 2007), p. 27.

<sup>27</sup> *Ibid.*

<sup>28</sup> *Ibid.*

<sup>29</sup> N. Edward Coulson, “Housing Policy and the Social Benefits of Homeownership,” *Business Review - Federal Reserve Bank of Philadelphia*, Second Quarter 2002, p. 8.

## What Types of Canceled Debt?

Several options are possible in determining what type of canceled mortgage debt income may be excluded from taxation. All canceled residential debt could be excluded from income, or alternatively, only certain kinds of debt could be allowed. H.R. 3648 proposes to limit the provision to debt associated with the primary residence of a taxpayer, rather than, for instance, a vacation home or investment property.

Some policy analysts have suggested disallowing second liens as qualified residential debt. The legislation proposed does not include a restriction against second liens. H.R. 3648, however, restricts qualified debt to include debt incurred in acquiring, constructing, or substantially improving the taxpayer's principal residence.

For some individuals, second liens may be home equity lines of credit, for others, second liens may be debt incurred as part of the purchase of the home. To the extent that home equity lines of credit are used to enhance the home and make capital improvements, it may be consistent with stated policy goals to include this debt as eligible for the exclusion. Yet, home equity lines of credit can also be used to finance consumption, such as vacations or paying off other debt. It may not be consistent with policy goals, some might argue, to include this type of debt in the exclusion.

Congress may also wish to consider limiting the amount of canceled debt that is excluded from income. As in the case of capital gains exclusion on sales of primary residences, a ceiling amount may be designated, such that any COD income below that level is excluded and COD income above that level is taxed. H.R. 3648 limits excluded COD income to \$2 million (\$1 million if married filing separate returns).

This option could reduce the amount of income excluded from taxation and thus limit the revenue loss associated with enacting an exclusion. The restriction might also reduce the benefit to upper income taxpayers. Limiting the amount of canceled debt income excluded would increase, albeit perhaps only slightly, complexity for tax filers and for tax administration, but would be unlikely to alter the reporting requirements of lenders.

## Which Homeowners Should Be Eligible?

Policy makers would need to decide whether to exclude canceled debt income for all households or only some.

**Ownership Tenure.** As with the exclusion for gain on owner-occupied housing, the exclusion for canceled debt income could be limited to homeowners who meet certain ownership tests. As mentioned previously, taxpayers must meet both an ownership and a tenure test to be eligible to claim the exclusion for gain under IRC § 121. Taxpayers are eligible if they have met the use test (have lived in the house for at least two years out of the last five years) and the ownership test (have owned the house, also for two years out of the last five). Limiting the exclusion of

capital gains in this manner was designed to minimize the possibility that investors, rather than owner-occupants, would be able to exclude capital gains from taxation. Alternatively, it could be argued that in the case of mortgage debt cancellation, tenure is not relevant to the stated policy goals for the legislation.

If this kind of restriction were applied to an exclusion of COD income, the number of tax filers eligible to claim the exclusion might be reduced. This reduction in filers may result in lower revenue loss. This policy option would add complexity to the reporting and filing processes and thus the tax code.

**Household Income.** Some policy makers have suggested that foreclosure assistance be provided only to households with low and moderate incomes. As with other housing tax incentives, such as the mortgage revenue bond program and the first-time homebuyer tax credit for District of Columbia residents, income levels could be capped and the exclusion made unavailable to those households with income above the ceiling set by the legislation. It would seem that income would be highly correlated with foreclosure, in that those with lower income are experiencing hardship. Regardless of whether this is borne out by the data, it could be argued that household income is not relevant to the stated policy goals for the legislation.

This option could reduce the revenue loss associated with the provision, but would add complexity to the administration and tax filing process, relative to an exclusion without such a restriction.

## Should Basis Be Adjusted?

As discussed above, current law requires that taxpayers who exclude COD income must essentially give back some of benefit by reducing tax attributes, such as basis in property. As a result of the reduction, taxpayers increase their income or tax liability in later years to account for the excluded COD income, so that only taxpayers without sufficient attributes to account for the entire amount are not taxed on it. Several policy issues arise from this rule.

The first is which tax attributes, if any, should be adjusted to account for excluded canceled mortgage debt income. One option is that there be no attribute reduction requirement. Alternatively, homeowners could be required to reduce specified tax attributes that include, but are not limited to, basis in the principal residence (e.g., taxpayers would be able to reduce basis in property other than the home subject to the discharged mortgage). A third option would be to require basis reduction in the taxpayer's principal residence. All taxpayers would benefit from the first option by not having to account for the excluded COD income. Whether a taxpayer would prefer the second option over the third one would depend on his or her circumstances (e.g., whether the taxpayer has basis in other property that would have to be reduced in the event of insufficient basis in the residence). H.R. 3648 uses the third option — it would require the homeowner to reduce basis in the principal residence to account for the excluded COD income.

Another issue is when tax attributes should be adjusted. If basis is adjusted, one option could be to make the proposal consistent with current law, under which basis adjustment occurs in the year following discharge of the debt. Alternatively, basis

adjustment could occur at the time of discharge or exclusion. If basis adjustment occurred in the year after discharge, homeowners losing their home at the time of debt cancellation would have already disposed of the property. H.R. 3648 does not explicitly address timing.

The restriction in H.R. 3468 requiring basis adjustment by the amount of cancelled debt suggests a desire by policymakers for homeowners to have to account for the benefit of the cancelled debt. Basis adjustment results in the taxation of cancelled debt income to the extent that gain from the disposition of the home is taxable; however, the timing of the basis adjustment may result in different tax consequences for taxpayers who lose their home.

The exclusion of COD income may result in differential treatment of taxpayers depending on the circumstances of basis adjustment timing, eligibility for exclusion of gain from the disposition of the residence, and homeownership retention. Policymakers may wish to account for that differential treatment, although doing so may add complexity and administrative cost to the proposal relative to its current state.

## Conclusion

H.R. 3648 (the Mortgage Debt Forgiveness Relief Act of 2007), which was passed by the House on October 4, 2007, would exclude qualified canceled residential debt from taxation. This bill may help to accomplish the policy goals of minimizing hardship in the event of foreclosures and ensuring homeownership retention efforts are not thwarted by tax policy. Additional limitations could be imposed to restrict the exclusion. In doing so, the revenue loss resulting from the bill could be reduced, though certain restrictions may be inconsistent with the policy goals.

The exclusion of COD income may make debt forgiveness more attractive for homeowners relative to the current tax law. Some might argue, therefore, that this proposal could encourage homeowners to be less responsible about fulfilling debt obligations. These opponents might argue that the current exclusion available for those homeowners filing bankruptcy or claiming insolvency is sufficient. Another argument that could be made opposing the provision is that homeownership is already heavily subsidized.<sup>30</sup>

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<sup>30</sup> As mentioned earlier in this report, the current tax subsidies for homeownership are estimated to cost nearly \$130 billion.