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Tax Policy Analysis

H.R. 285 (116th Congress) - The Mortgage Debt Tax Forgiveness Act of 2018

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IRC Section 61(a)(11) specifies that a debt that is forgiven or canceled by a lender is considered taxable income to the debtor in the year discharged. Section 108 describes circumstances under which income from discharge of indebtedness can be excluded from gross income. The debt does not have to be included in taxpayer's gross income if it meets a specified exclusion(s). The main exclusions: debt cancelled in a bankruptcy proceeding or when the person is insolvent. The taxpayer is also allowed to exclude a certain amount from gross income if the discharged debt is associated with the primary residence; but only if the discharge occurs before January 1, 2018.¹

In order to meet the qualified as principal residence requirement, the debt must be acquisition indebtedness within Section 163(h)(3)(B), and the home must be used only as a principal residence as defined at Section 121. An owner of a residence with this qualified discharged debt can exclude up to \$2 million (or \$1 million if married and filing separate returns) of cancellation debt income.

The tax exclusion under Section 108(a)(1)(E) and (h) expired on December 31, 2017. However, on January 8, 2019, the proposal to make permanent the exclusion from gross income of discharge of qualified principal residence indebtedness was introduced in the House of Representatives by Representative Brownley of California (D-CA). The proposal was referred to the House Committee on Ways and Means.

Application of Principles of Good Tax Policy

This section analyzes H.R. 285, the Mortgage Debt Forgiveness Act, using the twelve principles set out in the AICPA's *Guiding principles of good tax policy: A framework for evaluating tax proposals*.²

¹ Section 108(a)(1)(E).

² American Institute of Certified Public Accountants (AICPA) Tax Division. (January 2017). *Tax Policy Concept Statement 1 - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*; available at <https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf>.

Criteria	Does the proposal satisfy the criteria? (explain)	+/-
<p><i>Equity and Fairness</i> – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual’s income level and where they live.</p>	<p>There are two types of equity that should be considered. Horizontal equity is met when similarly situated taxpayers are treated similarly for tax purposes. This principle is not met in the proposal. For two individuals with the same level of income, the benefit of the exclusion depends on the amount of the mortgage. For one person, the discharged amount not included in the gross income could be \$100,000 whereas another person can exclude the whole \$2 million. Moreover, neighbors living side by side in a similarly valued homes might not be treated similarly. For example, two neighbors acquire their principal residences utilizing debts in the same amounts and of the same terms. One neighbor pays the mortgage over the full term of the loan and the other defaults on his/her mortgage and is able to bear no consequences of his/her actions. Finally, a single taxpayer can exclude the same amount of qualified debt as a married couple, so taxpayers are not treated similarly based on their marital status.</p> <p>Vertical equity stands for situations when a person with the greater ability to pay should pay more tax. There is no phase out for higher earning taxpayers. In addition, only homeowners benefit from the exclusion and there is no similar proposal to help financially strapped renters. Thus, vertical equity is also not met.</p> <p>Neither horizontal nor vertical equity principle is met and making the law permanent will not change this.</p>	-
<p><i>Certainty</i> – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?</p>	<p>The amount excluded from income tax needs to be entered on the federal tax return. H.R. 285 clearly states the definition of qualified home indebtedness and the definitions of primary residence and acquisition debt. Reporting is also clear: Form 982, <i>Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)</i>, needs to be attached to a taxpayer’s federal income tax return to report the excluded cancellation of debt income amount.</p>	+

<p><i>Convenience of payment</i> – is the tax due at a time that is convenient for the payor?</p>	<p>The benefit of the exclusion will not be received until the taxpayer files his/her federal income tax return. The form is filed at the same time the federal return is filed.</p>	<p>+</p>
<p><i>Effective Tax Administration</i> – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax or change.</p>	<p>The Section 108 rule for excluding certain residence debt that is forgiven was put in place in 2007 and it has been renewed a few times. The change to a permanent exclusion would not be too onerous on the IRS since the tax forms in the past already included the field for entering this exclusion. There is also guidance from the IRS on how to ensure compliance with the rule when it was enacted as a temporary provision and there is no need to issue new guidance if the rule becomes permanent. Making the law permanent might actually reduce costs to the IRS as the forms will not need to be updated as was the case when the law was extended from year to year.</p>	<p>+</p>
<p><i>Information Security</i> – Will taxpayer information be protected from both unintended and improper disclosure?</p>	<p>Cancellation of mortgage debt is normally reported to the borrower and the IRS by the lender using Form 1099-C, Cancellation of Debt, or Form 1099-A, Acquisition or Abandonment of Secured Property. There have been issues with the form being sent to the primary residence after the owners were forced to move, which caused privacy concerns and data security issues, as well as reporting issues when the taxpayer doesn't receive the tax form. Making the exclusion permanent will not improve this issue as there is nothing in the proposal about lenders having to find the current address of the borrower or being required to use a truncated social security number for the borrower on the reporting form provided to the borrower.</p>	<p>-</p>
<p><i>Simplicity</i> - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?</p>	<p>Form 982 needs to be attached to the taxpayer's return. The form is complex, and a lot of taxpayers do not know that they need to fill it out. Making the law permanent will not solve this issue. In addition, many people are unaware that they qualify for a gross income exclusion if they are insolvent or in bankruptcy. As long as they receive a 1099 Form from the lender about the discharge of indebtedness, they generally feel obligated to enter the amount on their Form 1040 as taxable income.</p>	<p>-</p>

<p><i>Neutrality</i> - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p>The proposal might encourage some individuals buying a primary residence to borrow more than they would otherwise have done or buy a property that is too expensive for their income level. If they end up not being able to make mortgage payments they know that they might be able to have their mortgage debt canceled, without tax consequences. In addition, they might decide to invest using leverage in their residence rather than other types of investments (like stocks or bonds) because they will be less risk associated with the residence investment. Thus, the proposal could affect a taxpayer's decision making.</p> <p>On the other hand, a "typical" home buyer wants to own a house based on their existing level of income, preferable size and/or location. Losing jobs and becoming insolvent is something that generally, households don't plan or anticipate when they buy a home. Moreover, defaulting on a debt can affect a person's credit status, so it is a situation that people usually avoid. A typical homeowner does not want to make an investment to try to game the tax system. Thus, the existence of the exclusion should not affect the decision making for most homeowners.</p>	<p>-/+</p>
<p><i>Economic growth and efficiency</i> – will the tax unduly impede or reduce the productive capacity of the economy?</p>	<p>The proposal might unduly impede the productive capacity of the economy. Taxpayers may take on more risk because they are not fully responsible financially for the consequences of their actions due to the exclusion for the cancelation of home indebtedness if permanent. This represents the idea of a moral hazard. Making the law permanent might incentivize taxpayers to take on even more risk since there is no sunset to the provision. Moreover, the forgiven mortgage results in costs to banks, other borrowers, and the government. While one particular discharge of indebtedness would not destroy the financial health of a lender, mass discharge due to the economic downturn can. Also, every time an individual excludes the discharged income from his gross income, the government loses revenue.</p>	<p>-</p>

<p><i>Transparency and Visibility</i> – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</p>	<p>Taxpayers might not know that discharged debt might be taxable and that there are exclusions to the rule. In addition, taxpayers may not be aware that the exclusion expired as well as whether it has been restored. Moreover, temporary proposals that become active and non-active from time to time make it difficult for an average taxpayer to track. People might be confused whether this exclusion exists this year or not because they, for example, heard it expired last year. Making the law permanent would improve transparency, especially if certain steps to inform people are made.</p> <p>To improve transparency even further taxpayers could be educated on this tax rule. Currently, the instructions for Form 1099-A only warn taxpayers that the amounts reported on the form could be included in gross income and taxable. Adding a note that the amounts might be excludible from gross income in specified circumstances and referring recipients of the reporting form to Publication 4681, <i>Canceled Debts, Foreclosures, Repossessions, and Abandonments (For Individuals)</i>, for more details would make more people aware of the law and how it works. Another way to improve transparency would be to provide information when borrowers sign the home closing and mortgage documents. Then, they could be informed about the law before they decide on a home purchase using debt. To summarize, an overview of the law on the loan documents and/or a note on the Form 1099-A would be a good way to inform and educate borrowers and improve transparency.</p>	<p>+</p>
<p><i>Minimum tax gap</i> – is the likelihood of intentional and unintentional non-compliance likely to be low? Is there any way people may intentionally or unintentionally avoid or evade this tax or rule?</p>	<p>If the exclusion becomes permanent, it would generally improve compliance. Tracking if the exclusion is in effect or not during a specific year is generally difficult for taxpayers. As a result, people might unintentionally include or exclude their discharged debt from the gross income. Making the law permanent would give more certainty to taxpayers. As was discussed in the Transparency section, Form 1099-A, <i>Acquisition or Abandonment of Secured Property</i>, could include a separate section with an advice to taxpayers about the possibility of exclusion. This should help the proposal to better meet principles of transparency and minimum tax gap simultaneously.</p>	<p>+</p>

<p><i>Accountability to taxpayers</i> – Do taxpayers have access to information on tax laws and their development, modification and purpose; is the information visible?</p>	<p>Although the IRS tries to post on its website a good deal of tax information, taxpayers generally do not know about the modifications and development of the tax law.³ The publications and instructions are posted by the IRS, but those do not reveal <i>why</i> the rules were enacted and why they were temporary.</p> <p>Is this legislation needed? Congress passed the legislation initially in 2007 and it was good for three years. It was then extended several times. In 2007 the economy entered a mortgage crisis which lasted for an extended period of time, and it threatened the economic recovery in the country. Now the mortgage crisis is mostly behind us, so there is less need to support homeowners who face financial troubles beyond the existing and permanent exclusions for individuals who are insolvent or in bankruptcy.</p> <p>In addition, it is a generous provision as most homes in the U.S. are worth well below \$2 million. According to the U.S. Census Bureau website, the median home price in the United States is \$308,000 and for southern California (where the representative sponsoring the bill is from) the median price is \$518,000.⁴</p>	<p>-</p>
<p><i>Appropriate government revenues</i> – will the government be able to determine how much tax revenue will likely be collected and when?</p>	<p>The proposal meets the principle of appropriate government revenues as the government could estimate the budget effect of modification of discharge of indebtedness on a principal residence excluded from gross income of individuals, as was done in the report presented for the Tax Relief Extension Act of 2015.⁵ This means that the government has the ability to estimate the effect of the proposal. Making the exclusion permanent will lower revenues for the government. The economic situation in the country, however, could shift the trends in claiming the exclusion, but the government should be able to adjust the estimates accordingly.</p>	<p>+</p>

³ In fact, many people likely were not aware when the exclusion for discharge of qualified principal residence debt was enacted.

⁴ Median and Average Sales Prices of New Homes Sold in United States, Census.gov; accessed July 17, 2019; <https://www.census.gov/construction/nrs/pdf/uspricemon.pdf>.

⁵ Joint Committee on Taxation, "A Report to the Congressional Budget Office of the Macroeconomic Effects of the "Tax Relief Extension Act of 2015", Aug. 4, 2015, p. 4; accessed July 17, 2019; www.jct.gov/publications.html?func=download&id=4807&chk=4807&no_html=1.

Summary

In conclusion, the proposal does not meet all of the twelve principles for good tax policy. The analysis helps to discover the strengths and weaknesses of the proposal, and it reveals that there are more weaknesses than strengths. Although it might sound like a good proposal aiming to help people going through financial difficulties, making it permanent could create additional problems. In particular, as the analysis shows, the equity principle is not satisfied, so taxpayers may be frustrated that the exclusion might be limited for married individuals or those whose forgiven debt exceeds an allowed amount. If the exclusion becomes permanent, so the attitude about the exclusion will become lasting.

Another problem with the proposal is that it would reduce the revenue collection for the government. Improving the simplicity and transparency would most likely decrease the revenues for the government as the compliance and appropriateness in claiming of the exclusion would improve. The principle of neutrality is satisfied for typical homebuyers who do not plan for debt relief when they borrow, but the proposal may affect the decision making of investors who could try to abuse the exclusion.

Furthermore, making the exclusion permanent might lead to adverse economic effects such as over-investment in residential real estate using debt versus other investment vehicles (stocks, bonds, etc.). Over-investment might lead to another housing financial crisis. The provision, if made permanent, might incentivize taxpayers to take unusual risks because there are no adverse tax consequences associated with defaulting on a mortgage. The tax system should not be used to subsidize and encourage one particular type of risk. Based on these factors, the proposal would not be a good idea. In addition, borrowers who find themselves in unexpected financial problems resulting in foreclosure might qualify for the permanent exclusions for insolvency or bankruptcy.

Something that can improve the proposal is to adjust the exclusion amount for the areas with lower and higher real estate prices. Also, adding a phase-out for higher income taxpayers would address the issue of vertical equity. If the IRS includes information about the Section 108 exclusions on Forms 1099-A and 1099-C, taxpayers' awareness of the tax rules on cancellation of debt income and possible exclusions would greatly improve and compliance would be better. In this case, taxpayers would be more informed, and the principle of transparency would be met.