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Analysis of the Tax Exclusion for Canceled Mortgage Debt Income

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Summary

During 2008, 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. Historically, if a lender forgives or cancels such debt, tax law has treated it as cancellation of debt (COD) income subject to tax. Exceptions have been available 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, P.L. 110-142, signed into law on December 20, 2007, temporarily excludes qualified COD income. Thus, the act allows taxpayers who do not qualify for the existing exceptions to exclude COD income. The provision is effective for debt discharged before January 1, 2010. The Emergency Economic Stabilization Act of 2008, P.L. 110-343, extends the exclusion of COD income to debt discharged before January 1, 2013.

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 that are in danger of losing their home, 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 a 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. The most recent changes were enacted by the Housing and Economic Recovery Act of 2008, P.L. 110-289.

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, and could encourage homeowners to be less responsible about fulfilling debt obligations.

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

Contents

List of Tables

Analysis of the 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.[1] Under current law, the canceled debt (sometimes referred to as discharge of indebtedness) may be income subject to taxation.

Recently enacted law allows canceled mortgage debt income to be excluded from taxation. The rationales for this change 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 argue that the exclusion could encourage homeowners to be less responsible about fulfilling debt obligations.[2] Critics may also argue that owner-occupied housing is sufficiently subsidized even without a COD income exclusion.

This report begins with an overview and analysis of the historical tax treatment of canceled debt income. Next, the changes enacted by P.L. 110-142 and P.L. 110-343 are discussed. A discussion of policy options concludes.

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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[1] 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.

[2] Martin Vaughn, "Taxes - Panel Poised To Approve Forgiven Mortgage Debt Bill," CongressDaily, September 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.[3] 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. Historically, there have been 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: a borrower may exclude canceled debt from gross income if (1) the debt 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).[4]

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.[5] No involvement by a court is necessary for a taxpayer to claim an insolvency exception — the taxpayer calculates his or her assets and liabilities to determine whether he or she is insolvent. For an insolvent taxpayer, the amount of COD income that may be excluded is limited to the amount by which the taxpayer is insolvent.[6]

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.[7] The attributes are reduced until the reductions generally account for the excluded amount. As a result of the attribute reduction, the taxpayer may be subject to tax on the excluded COD income in years following the year of discharge — in other words, the tax on the COD income is deferred.

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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[3] *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).

[4] *See* IRC § 108(a)(1)(A) and (B).

[5] *See* IRC § 108(d)(2).

[6] *See* IRC § 108(a)(3).

[7] *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[8] will not realize COD income.[9] Other examples of when COD income may be excluded from the borrower's income are if the cancellation was intended to be a gift[10] or was the result of a disputed debt.[11]

Gain 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.[12] If the property was held for more than 12 months, the gain is taxed at a maximum rate of 15% rather than regular income tax rates. If the property was held for less than 12 months, the gain is taxed at 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.[13] 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.[14] Additionally, other taxpayers may qualify for special treatment (e.g., members of the armed forces).[15] The exclusion can generally be used every two years.

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[8] 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.

[9] 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].

[10] *See* IRC § 102.

[11] *See* Zarin v. Comm'r, 916 F.2d 110, 115 (3rd Cir. 1990).

[12] *See* IRC §§ 61(a)(3) and 1001.

[13] 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].

[14] *See* IRC § 121(c).

[15] *See* IRC § 121(d)(9).

Legislative Developments

On December 20, 2007, The Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-149, was signed into law. The act, among other things, excludes discharged qualified residential debt from gross income. Qualified indebtedness is defined as 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 also includes refinancing of this debt, to the extent that the refinancing does not exceed the amount of refinanced indebtedness. The taxpayer is required to reduce the basis in the principal residence by the amount of the excluded income. The provision does 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 applies to debt discharges that are made on or after January 1, 2007, and before January 1, 2010. The provision has been estimated to cost $1.34 billion in reduced tax revenue from FY2008 through FY2017.[16]

On October 3, 2008, the Emergency Economic Stabilization Act of 2008, P.L. 110-343, extended the exclusion described above through the end of 2012. The extension has been estimated to cost $362 million from FY2009 through FY2018.[17]

Selected Legislation in the 109th 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.[18] 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.

P.L. 110-343 extended the exclusion of COD income contained in KETRA to individuals located in the Midwestern disaster area. To be eligible for the exclusion, the discharge of debt must occur before January 1, 2010.

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[16] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 3648*, JCX-98-07, October 5, 2007.

[17] U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Tax Provisions Contained in an Amendment in the Nature of a Substitute to H.R.. 1424* , JCX-78-08, October 1, 2008.

[18] For more information, see CRS Report RS22269, *Katrina Emergency Tax Relief Act of 2005*, by Erika Lunder.

Selected Proposals Made Prior to the 109th 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 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.[19]

In 1999 and 2000, the House and Senate, respectively, each passed a tax bill (H.R. 3081 in the 106th Congress) 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 108th Congress; H.R. 3458 in the 109th 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. In the past, tax law has generally adhered 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.[20]

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

[20] 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.

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 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. 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.

If the taxpayer is not able to exclude the COD income, then the tax consequences of the COD income, assuming equal amounts of canceled debt, are 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. 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

On the other hand, if the taxpayer is able to exclude the COD income, as is temporarily allowed in certain circumstances, then the $20,000 discharge is not included in gross income and the taxpayer does not owe the $5,600 tax liability. As previously mentioned, current law stipulates that the excluded COD income be accounted for through reducing the basis in the residence.

The impact of such basis adjustment could differ, depending on whether the home is retained or lost, in the event that the taxpayer owes taxes when the house is disposed. A taxpayer who retains the house and sells it in a later year, while accounting for the excluded COD income through basis adjustment, is able to defer taxes owed on the disposition until the year of sale.

In contrast, the tax consequences would depend on the timing of the basis adjustment for a taxpayer that loses a home. If basis was required to be reduced in the year following discharge, as under IRC § 1017, then the excluded COD income could not be accounted for because the taxpayer had already disposed of the home. If basis was required to be reduced earlier (e.g., at the time of discharge), then the excluded COD income would be accounted for through basis adjustment and the taxpayer would be worse off than a similarly situated taxpayer who had retained the house and was able to defer taxes until the year of sale.[21]

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 violates 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 income can also reduce the tax system's progressivity — in other words, likely favor upper-income individuals. This is likely to occur because an exclusion of a given amount is more valuable to persons with higher marginal tax rates. This effect is magnified if homeownership is more concentrated among upper income individuals.

At this point, an example may be useful for illustrating the effect income tax exclusions can potentially have on the tax system's progressivity. Consider 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.[22] 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.

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[21] 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.

[22] COD income may cause a taxpayer to move to a higher tax bracket.

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 essentially allowing the taxpayer to defer the income subject to tax because an adjustment to basis was required.[23]

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.[24]

Consistent with the 1986 enactment, one rationale expressed in 2008, during the consideration of the current proposed exclusion of canceled residential debt income, was the prevention of 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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[23] U.S. Congress, House Committee on the Budget, *Omnibus Budget Reconciliation Act of 1993*, H.Rept. 103-111, May 25, 1993.

[24] U.S. Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 109-072, 109th Cong., 2nd 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. The 2005, 2006, and 2007 data are projections.

Policy Options

The changes enacted by P.L. 110-149 and then extended by P.L. 110-343 are temporary and set to expire on January 1, 2013. Congress may choose to let the changes expire, thus returning the treatment of canceled mortgage debt income to its original status. Canceled debt income would then be subject to taxation unless the taxpayer meets a qualified exception (e.g., the taxpayer is insolvent).

If the exclusion on canceled debt income is allowed to expire, 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 extend the exclusion of canceled debt income. Additionally, modifications to the exclusion could be made. There are a number of choices with respect to possible modifications. Which modifications, if any, are enacted will depend on the goal of policy makers.

What Kind of Exclusion?

One consideration for Congress is whether an exclusion provision should be temporary or permanent. Early versions of H.R. 3648 (the bill that later became P.L. 110-142) proposed a permanent exclusion, whereas the Administration had suggested the provision should be temporary.[25]

Some argue that current housing market conditions, where there are a large number of homeowners that are "upside down" (the debt owed on the property exceeds the value of the property), warrant a temporary solution for a crisis that is not expected to last. A temporary exclusion of canceled debt income would appear to be

[25] H.R. 3506 and H.R. 1876/S. 1394 also propose a permanent provision.

consistent with a policy of minimizing adverse consequence associated with loan renegotiations in the short-term.

It could also be argued that the temporary exclusion of residential COD income is preferable because owner-occupied housing is already heavily subsidized even without a COD exclusion. Three principal tax provisions for owner-occupied housing currently exist in the tax code. The deduction for mortgage interest is the most costly provision, with an estimate of $79.9 billion in revenue loss for FY2008.[26] The exclusion of gain on the sales of homes is the second largest tax provision for homeowners, with an estimate of $29 billion in tax revenue loss for FY2008.[27] The deduction of state and local real estate taxes is the third provision, with an estimate of $14.3 billion in tax revenue loss for FY2008.[28] 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.[29]

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 2008, 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.

What Types of Canceled Debt?

Several options are possible in determining what type of canceled mortgage debt income may be excluded from taxation. The broadest modification would allow all canceled residential debt to be excluded from income. Currently, only debt associated with the primary (or principal) residence of a taxpayer may be excluded, rather than, for instance, a vacation home or investment property.[30]

Some policy analysts have suggested disallowing second liens as qualified residential debt. Second liens are not directly ineligible for the exclusion, although currently, qualified debt is restricted to include debt incurred in acquiring, constructing, or substantially improving the taxpayer's principal residence.

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[26] 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.

[27] Ibid.

[28] Ibid.

[29] N. Edward Coulson, "Housing Policy and the Social Benefits of Homeownership," *Business Review - Federal Reserve Bank of Philadelphia*, Second Quarter 2002, p. 8.

[30] As mentioned previously, H.R. 1876/S. 1394 limits the exclusion to the residence of the taxpayer, but not the *principal* residence; H.R. 3506 limits the exclusion to the 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 changing the limit on the amount of canceled debt that can be excluded from income. P.L. 110-142 imposed a limit of $2 million ($1 million if married filing separate returns). Increasing the limit would likely increase revenue loss associated with the exclusion, while decreasing the limit would have the opposite effect. Decreasing the exclusion limit might also reduce the benefit to upper income taxpayers.

Which Homeowners Should Be Eligible?

Policy makers could limit the ability of homeowners to exclude canceled debt income according to certain eligibility requirements.

Ownership Tenure. The exclusion for canceled debt income could be limited to homeowners who meet ceratin ownership and/or use tests. For example, a homeowner must meet both an ownership and use test in order to claim the exclusion for gain on owner-occupied housing that is available under IRC § 121. The ownership test requires the taxpayer to have owned the house for two of the last five years, while the use test requires the owner to have lived in the house for at least two years out of the last five years. 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 tenure is not relevant to the stated policy goals of mortgage debt cancellation.

If an ownership and/or use test 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 also 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.[31] 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.

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[31] H.R. 3506 proposes a limit of $100,000 for the household income of eligible taxpayers ($200,000 for married taxpayers filing jointly).

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. 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 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 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). The temporary exclusion of COD income enacted by P.L. 110-142 uses the third option — homeowners are required 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 earlier (e.g., 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.

The requirement that a basis adjustment in 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 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.