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IN FOCUS

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The Tax Treatment of Canceled Mortgage Debt

Recent data indicate that the economy is weakening and that labor markets are under a great deal of strain as fallout from the COVID-19 outbreak continues. The corresponding drop in incomes is causing financial hardship for some homeowners as they struggle to make timely mortgage payments. Included in the broader third round of economic relief known as the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) were temporary forbearance for federally backed single-family and multifamily mortgages and a temporary foreclosure moratorium for federally backed single-family mortgages. These provisions are discussed in CRS Insight IN11334, *Mortgage Provisions in the Coronavirus Aid, Relief, and Economic Security (CARES) Act*, by Katie Jones and Andrew P. Scott.

Once these temporary efforts to assist homeowners expire, there may be an increased number of home foreclosures, mortgage defaults, or mortgage modifications barring additional relief efforts. Attempts to resolve mortgage indebtedness concerns may result in cancellation of debt, which can have important tax consequences. This In Focus provides a brief overview of the tax treatment of canceled mortgage debt.

Cancellation of Indebtedness Income

Historically, if a lender forgives or cancels mortgage debt (and most other debts), tax law has treated the amount of canceled debt as a cancellation of debt income (CODI) subject to ordinary income tax rates. 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). These exceptions are permanent tax provisions.

In response to the housing market turmoil of the late 2000s, some lenders made efforts to work with borrowers and avoid foreclosure. Examples of these efforts included principal reductions, which allow the homeowner to remain in the home, and "short sale" transactions. In a short sale, the property is listed for sale and the lender agrees to forgive any debt outstanding that the sale price does not cover. Both principal reductions and short sales often resulted in canceled mortgage debt and, as a result, CODI subject to tax. Other efforts, such as extending the term of the loan or interest rate reductions, however, generally did not result in CODI.

In December 2007 the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142) was enacted and provided a temporary exclusion for qualified canceled mortgage debt. This was intended to prevent homeowners who were granted principal reductions, or who entered into short sale agreements, from owing tax on top of existing financial distress. The provision was originally effective for debt discharged before January 1, 2010. The exclusion for canceled mortgage debt was subsequently extended several times, most recently by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94). That law extended the exclusion for canceled mortgage debt through the end of 2020.

The exclusion applies to qualified residential indebtedness, which 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 (e.g., cash-out refinance). Taxpayers are required to reduce the basis in their 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.

An Example

An example may be helpful in demonstrating the tax implications when CODI is *not* excluded from taxation. Consider a homeowner with a current mortgage balance of $200,000. The lender agrees to a loan restructuring that cancels $20,000 in debt and reduces the homeowner's loan balance to $180,000. The discharged debt, $20,000, is income subject to tax if no exclusion applies (e.g., the taxpayer is not insolvent). If a 24% marginal tax rate is assumed, then the homeowner would have a tax liability of $4,800 ($20,000 multiplied by 24%) from the debt cancelation.

Alternatively, the home could have been sold as a result of foreclosure along with a lender agreement to cancel the remaining debt. If the home were to sell for $180,000 then this would result in $20,000 of remaining debt. The $20,000 of discharged debt would be income assuming no exclusion applies, and also still assuming a 24% marginal tax rate, would generate the same tax liability as in the previous scenario. This is in addition to any taxes the taxpayer may owe on the gain from the sale of the house.

Policy Issues

Rationales put forth when the exclusion provision was originally enacted included minimizing hardship for distressed households, lessening the risk that nontax

homeownership retention efforts would be thwarted by tax policy (e.g., short sales), and assisting in the recovery of the housing market and, in turn, the overall economy. Arguably, these same rationales still apply in the current environment.

An argument against the exclusion that was made at the time the provision was first being debated was that it makes debt forgiveness more attractive for homeowners, which could encourage homeowners to be less responsible about committing to and fulfilling debt obligations. Given that the current concerns over default and foreclosure are being driven by the fallout from a global pandemic, this view may not be held by as many people as it was during the Great Recession.

Another concern some had at the time involved the equity of the provision. A standard of fairness frequently invoked by public finance economists in evaluating tax policies is "horizontal equity"—a standard that is met when similarly situated taxpayers pay the same amount of tax. Like other tax exclusions, excluding forgiven debt—a unique type of income—violates the standard of horizontal equity.

As the exclusion for canceled mortgage debt is set to expire after 2020, Congress may choose to extend the exclusion again, either temporarily or permanently, or may allow it to expire. If Congress decides to extend the exclusion it may also consider modifications to the provision. Which modifications, if any, are enacted will depend on policymakers' goals.

Temporary vs Permanent Exclusion

One consideration for Congress is whether the exclusion provision should be temporary or permanent. The exclusion has been part of tax law since 2007, but its extension has often happened retroactively, creating some uncertainty and anxiety both for impacted homeowners and for lenders and servicers, which may influence the options they present to homeowners. Extending the exclusion from 2021 (or further) would presumably help alleviate the concerns of distressed homeowners.

Another option would be to make the exclusion of forgiven mortgage debt permanent. It would also address an inequity that some perceive exists because borrowers in distress after the provision's expiration are treated differently than those before its expiration. A permanent extension, however, would have a cost in terms of reduced revenue for which the Joint Committee on Taxation (JCT) would provide an estimate. An argument could also be made that such an extension would introduce a permanent discrepancy in the tax code between how different types of debt are treated.

Eligible Debt Limits

Congress could consider adjusting the eligible amount of debt that qualifies for the exclusion. The exclusion is currently limited to $2 million ($1 million if married filing separately) of qualified mortgage debt. Increasing the limit would likely increase the revenue loss associated with the exclusion, whereas decreasing the limit would have the opposite effect. Decreasing the exclusion limit might also reduce the benefit to upper-income taxpayers who are subject to higher marginal tax rates and thus receive a greater benefit in terms of tax savings per dollar of exclusion. For example, individuals in the 22%, 32%, and 37% tax brackets benefit differently from the same $20,000 of forgiven mortgage debt—$4,400, $6,400, and $7,400 in reduced taxes, respectively. Arguably, policymakers could set the debt limits to those of the mortgage interest deduction, which are, depending on when the home was purchased, $1 million ($500,000 if married filing separately) or $750,000 ($375,000 if married filing separately).

Income Limits

Income limits could be enacted and the exclusion made unavailable to those households with income above the ceiling. It would seem that income and foreclosure would be correlated because lower-income taxpayers may be more financially constrained than higher-income taxpayers. But given the severity of across-the-board financial distress this latest economic downturn could cause, the correlation could be weaker than in past downturns. Regardless, it could be argued that household income is not relevant if the exclusion's objective is to provide relief to households in financial distress. This option could reduce the revenue loss associated with the provision, but would add complexity to the administration and tax filing process

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