Analysis of the Tax Exclusion for Canceled Mortgage Debt Income

Mark P. Keightley
Specialist in Economics

Erika Lunder
Legislative Attorney

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Summary

A home foreclosure, mortgage default, or mortgage modification can have important tax consequences. 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 excluded qualified COD income. Thus, the act allowed taxpayers who did not qualify for the existing exceptions to exclude COD income. The provision was effective for debt discharged before January 1, 2010. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the exclusion of COD income to debt discharged before January 1, 2013. The American Taxpayer Relief Act of 2012 (P.L. 112-240) subsequently extended the exclusion through the end of 2013. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the exclusion through the end of 2014. The exclusion was extended again through the end of 2016 by Division Q of P.L. 114-113—the Protecting Americans from Tax Hikes Act (or “PATH” Act). Most recently, the Bipartisan Budget Act of 2018 (P.L. 115-123) retroactively extended the exclusion through the end of 2017. The extension also allowed for debt discharged after 2017 to be excluded from income if the taxpayer had entered into a binding written agreement before January 1, 2018.

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.

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

Overview ................................................................................................................................. 1
  Cancellation of Indebtedness Income ................................................................................ 1
  Exceptions ........................................................................................................................... 2
  Gain From the Disposition of Property ............................................................................. 3
Legislative Developments ..................................................................................................... 3
Analysis .................................................................................................................................. 4
  Homeownership Retention or Loss .................................................................................... 4
  Equity Among Homeowners ............................................................................................... 5
  Data ...................................................................................................................................... 6
Policy Options .......................................................................................................................... 6
  Temporary vs. Permanent Exclusion .................................................................................... 6
  Modify Definition of Debt Eligible for Cancellation .......................................................... 7
  Modify Homeowner Eligibility ............................................................................................ 8
    Ownership Tenure .............................................................................................................. 8
    Household Income .......................................................................................................... 8
  Should Basis Be Adjusted? .................................................................................................. 8

Tables

Table 1. Tax Treatment of Canceled Debt Income Assuming No Exclusions Apply ............ 4
Table 2. Reported Canceled Debt .......................................................................................... 6

Contacts

Author Contact Information ................................................................................................. 9
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. Under current law, the canceled debt (sometimes referred to as discharge of indebtedness) may be income subject to taxation.

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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. Critics may also argue that owner-occupied housing is sufficiently subsidized even without a COD income exclusion.


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.

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. This income is typically referred to as cancellation of

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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.


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).
debtor (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 Section 108 exclusions, there are several other circumstances under which COD income may be excluded. For example, a taxpayer with 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.\(^11\)

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\(^4\) 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).

\(^8\) 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.


\(^10\) See IRC §102.

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.\(^\text{12}\) 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.\(^\text{13}\) 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.\(^\text{14}\) Additionally, other taxpayers may qualify for special treatment (e.g., members of the Armed Forces).\(^\text{15}\) The exclusion can generally be used every two years.

Legislative Developments

On December 20, 2007, The Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142) was signed into law. The act, among other things, excluded 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 was required to reduce the basis in their principal residence by the amount of the excluded income. The provision did 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 applied to debt discharges that are made on or after January 1, 2007, and before January 1, 2010.

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the exclusion described above through the end of 2012. Subsequently, the American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the exclusion through the end of 2013. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the exclusion through the end of 2014. The exclusion was extended again through the end of 2016 by Division Q of P.L. 114-113—the Protecting Americans from Tax Hikes Act (or “PATH” Act). Most recently, the Bipartisan Budget Act of 2018 (P.L. 115-123) retroactively extended the exclusion through the end of 2017. The extension

\(^\text{12}\) See IRC §§61(a)(3) and 1001.
\(^\text{13}\) 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.
\(^\text{14}\) See IRC §121(c).
\(^\text{15}\) See IRC §121(d)(9).
also allowed for debt discharged after 2017 to be excluded from income if the taxpayer had entered into a binding written agreement before January 1, 2018.

Analysis

In order to evaluate the policy of including discharged debt as income, it is helpful to understand why it exists. 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.\(^{16}\)

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 |

\(^{16}\) 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.
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, if the taxpayer owes taxes when the house is disposed. A taxpayer who retains the house and sells a later year, while accounting for the excluded COD income through basis adjustment, defers 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 is reduced in the year following discharge, as under IRC Section 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.17

**Equity Among Homeowners**

An exclusion of certain types 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 similarly situated tax units pay the same amount of tax. Like other exclusions, excluding debt forgiveness, a unique type of income, violates the standard of horizontal equity.

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 have on the tax system’s progressivity. Consider two individual homeowners, both of whom incur $20,000 in COD income. The tax benefit differs when the taxpayers are in different tax brackets.18 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 and thus in the higher 28% bracket, is $5,600. The higher income taxpayer, with presumably greater ability to pay taxes, receives a greater tax benefit than the lower income taxpayer.

Congress has provided an exclusion for COD income several times in the past, though the economic and political circumstances for relief were not the same in each case. For example, in 1986 and again in 1993, relief was provided for commercial property owners and farmers, and in 2005, for victims of Hurricane Katrina. The residential housing crisis of 2007 and subsequent recession initiated the most recent legislative action.

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17 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.

18 COD income may cause a taxpayer to move to a higher tax bracket.
Analysis of the Tax Exclusion for Canceled Mortgage Debt Income

Data

Lenders report canceled debt income to the IRS on Form 1099-C. A copy is also sent to the borrower who reports the amount as income. Form 1099-C is used to report all types of canceled debt, not just residential. As shown in Table 2, the number of 1099-C forms filed and the amount of canceled debt rose during and following the financial crisis. Canceled debt peaked in 2011 at $13.8 billion. The most recent data available shows that the amount of canceled debt has fallen 50% from its peak, but still remains elevated relative to the start of the financial crisis suggesting that some taxpayers are still experiencing financial distress. Unfortunately, the data do not allow for specific conclusions to be drawn about mortgage-related debt.

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Number of Forms</th>
<th>Amount of Debt Claimed ($1,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>271,290</td>
<td>$1,881,848</td>
</tr>
<tr>
<td>2008</td>
<td>341,992</td>
<td>$4,192,002</td>
</tr>
<tr>
<td>2009</td>
<td>490,846</td>
<td>$9,115,329</td>
</tr>
<tr>
<td>2010</td>
<td>634,797</td>
<td>$10,327,231</td>
</tr>
<tr>
<td>2011</td>
<td>669,605</td>
<td>$13,796,728</td>
</tr>
<tr>
<td>2012</td>
<td>769,859</td>
<td>$12,424,870</td>
</tr>
<tr>
<td>2013</td>
<td>770,756</td>
<td>$10,013,641</td>
</tr>
<tr>
<td>2014</td>
<td>740,343</td>
<td>$9,228,543</td>
</tr>
<tr>
<td>2015</td>
<td>678,073</td>
<td>$6,954,736</td>
</tr>
</tbody>
</table>


Policy Options

The changes enacted by P.L. 110-149 and then extended by P.L. 110-343, P.L. 112-240, P.L. 113-295, P.L. 114-113, P.L. 115-123 are temporary and are scheduled to expire at the end of 2017. Congress may choose to allow the latest extension to expire, thus subjecting canceled mortgage debt income to its traditional tax treatment after 2017. If this were to happen, canceled debt income would be subject to taxation unless the taxpayer meets a qualified exception (e.g., the taxpayer is insolvent). If the exclusion on canceled debt income were to expire, improving awareness about the existing exclusions for canceled debt, such as for insolvency or bankruptcy, may be an option to pursue. Congress may choose to extend the exclusion of canceled debt income again, either temporarily or permanently, possibly with some modifications. Which modifications, if any, are enacted will depend on the goal of policymakers.

Temporary vs. Permanent Exclusion

One consideration for Congress is whether the exclusion provision should be temporary or permanent. Some argue that housing market conditions have improved significantly since conditions bottomed, and therefore warrant a temporary solution for those still feeling the lingering effects of the crash. A temporary exclusion of canceled debt income would appear to be
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, the exclusion of gain on the sales of homes, and the deduction of state and local real estate taxes. When combined these three provisions result in over $125 billion in reduced federal revenue annually. 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.

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 2010, when foreclosure rates were relatively high compared to three or four years from now, when foreclosure rates may be lower. If the intent is to minimize hardship when taxpayers experience distress, then making the provision permanent would seem consistent with that objective.

Modify Definition of Debt Eligible for Cancellation

Several options are possible for determining in what situations canceled mortgage debt income may be excluded from taxation. The broadest modification would exclude all canceled residential debt from income. Currently, only debt associated with the primary (or principal) residence of a taxpayer may be excluded and not vacation homes or investment property.

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.

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 the stated 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.

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20 For an economic analysis of the mortgage interest and property tax deductions, see CRS Report R41596, The Mortgage Interest and Property Tax Deductions: Analysis and Options, by Mark P. Keightley.
21 H.R. 1876/S. 1394 (110th Congress) would have limited the exclusion to the residence of the taxpayer, but not the principal residence; H.R. 3506 (110th Congress) would have limited the exclusion to the principal residence.
Modify Homeowner Eligibility

Policymakers could modify homeowner eligibility requirements based on ownership tenure or income.

Ownership Tenure

The exclusion for canceled debt income could be limited to homeowners who meet certain ownership and/or use tests similar to other housing related tax provisions. 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 Section 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 exclude capital gains from taxation.

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 add complexity to the reporting and filing processes and thus the tax code. In addition, it could be argued that tenure is not relevant to the stated policy goals of mortgage debt cancellation.

Household Income

Some policymakers 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. It would seem that income and foreclosure would be highly correlated because lower income taxpayers may be more financially constrained than higher-income taxpayers. Regardless of whether this is true, 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.

Should Basis Be Adjusted?

As discussed above, current law requires that taxpayers who exclude COD income must “return” some tax benefit by reducing other 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 accounting for the excluded COD income. Taxpayer preference between the second option and the third option would depend on his or her circumstances (e.g., whether the taxpayer

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22 H.R. 3506 (110th Congress) proposed a limit of $100,000 for the household income of eligible taxpayers ($200,000 for married taxpayers filing jointly).
Analysis of the Tax Exclusion for Canceled Mortgage Debt Income

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 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.

Author Contact Information

Mark P. Keightley
Specialist in Economics
mkeightley@crs.loc.gov, 7-1049

Erika Lunder
Legislative Attorney
elunder@crs.loc.gov, 7-4538