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The Subprime Mortgage Crunch: Providing Tax Relief for Ex-Homeowners

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On August 31, President Bush offered a small package of initiatives to address developments in the housing and mortgage markets. One element of the package was a proposal to provide special and temporary tax relief to those who lose their homes during the current period. The Administration's tax proposal, while well intentioned, is nevertheless misguided and all the more unfortunate because the Administration missed an opportunity to provide tax relief through sound tax reform.

A Tax Balm for the Subprime Pain. This paper does not detail the many factors that have contributed to the current troubles in the mortgage and housing industries. In summary, a great many home buyers, mortgage companies, and investors made a lot of bad decisions, often by misunderstanding and misusing some new, valuable financial innovations.

As a consequence of these bad decisions, credit and housing markets are going through a period of painful adjustment. Many families are going to lose their homes. Whatever the Administration proposes and Congress enacts in the coming months, policymakers must recognize that their actions will not alter this fact.

Adding insult to injury, the tax code today heaps an extra and excessive tax burden on families who lose their homes. The tax code treats the value of cancelled mortgage debt as taxable income. For example, when a family loses its home, the house becomes the property of the lender, who then tries to sell it to recover as much of the original loan's value as possible. If the house sells for $300,000 and the outstanding mortgage was for $400,000, then the difference of $100,000 represents a loss for the lender. That $100,000 is the value of the cancelled mortgage debt for the former homeowner; thus, under current law, it is added to the family's taxable income.

The Administration proposes to exclude, on a temporary basis, cancelled mortgage debt from taxable income. To be clear, this policy is not intended to help the housing or financial markets through the adjustment period. Its sole intent and consequence would be to provide some tax relief to former homeowners.

The Administration's desire to help these families is well intentioned, but the proposed solution is off base. If done on a permanent basis, eliminating the tax on cancelled mortgage debt would provide an unwarranted and distortionary tax loophole under certain economic outcomes. The value of the cancelled mortgage is a beneficial gain to the former borrower which, under income tax principles, should be subject to tax. Eliminating the tax altogether would be, in effect, a tax-based mini-bailout for former borrowers who, it must be remembered, are in their current straights largely as a result of their own poor decisions.

This paper, in its entirety, can be found at:
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The Administration's proposal is inappropriate even on a temporary basis. There is no reason to exempt an individual from this tax simply because he or she is joined by thousands of others and to restore the tax for a normal year when only a few hundred people must pay it.

Missed Opportunity. A better way to provide tax relief to homeowners would be through sound tax reform. The tax code treats cancelled debt as taxable income. Cancelled debt should be treated as a capital gain and, in almost all instances, as a long-term capital gain. As such, it would be subject to, at most, a 15 percent tax rate. If the tax relief resulting from this reform were not enough, the Administration could have proposed allowing homeowners to delay recognition of the gain for a year or two. The delay would give families time to restore their finances before facing a tax hit. The additional relief would constitute "special treatment" for these families, but such are the proper decisions for policymakers as long as the relief is permanent.

Treating cancelled mortgage debt as a capital gain makes sense in a couple ways. One way is to think of debt as a negative asset. If an asset like a bond rises in price, the increase is capital gain; if it falls in price, the reduction is capital loss. If debt is considered a negative asset to the debtor, then a decline in the value of the debt should carry the same tax consequence as a rise in the value of any asset—namely, as a capital gain.

Also, the current treatment of cancelled mortgage debt violates the principle of symmetry that underpins much of a proper income tax. Under this principle, for example, wages are taxable to workers, and the symmetrical treatment is that they are deductible to businesses. Borrowers can normally deduct interest expense from their income, while lenders must normally include interest income in their taxable income. When mortgage debt is cancelled, the lender suffers a capital loss; the debt, which is an asset held by the lender, is wiped from its books. In that instance, the principle of symmetry should deem that the original borrower has received a capital gain.

Correcting the tax treatment of cancelled mortgage debt would give these families a significant dose of tax relief. A taxpayer in the 15 percent income tax bracket faces a 5 percent capital gains tax rate. Thus, treating $10,000 in cancelled debt as capital gain rather than income cuts this taxpayer's associated tax liability by two-thirds, or by $1,000. For a taxpayer in the 28 percent income tax bracket, capital gains treatment cuts the taxpayer's tax burden by almost half, or by $1,300.

Conclusion. A sound and sensible means to reduce the bite of the federal income tax on families who have recently lost their homes to foreclosure is to correct the tax treatment of cancelled mortgage debt. The current treatment as taxable income violates normal income tax principles. The correct treatment would be as capital gain and, in almost all instances, long-term capital gain. If additional tax relief for these families is deemed appropriate, Congress can allow them to delay, for a year or two, payment of the tax on the capital gain.

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