NO TAX FOR "PHANTOM INCOME": HOW CONGRESS FAILED TO ENCOURAGE RESPONSIBLE HOUSING CONSUMPTION WITH ITS RECENT TAX LEGISLATION

RUE TOLAND*

INTRODUCTION

From Fall 2007 through the start of 2009, the United States has struggled in the throes of an economic crisis driven in large part by the collapse of a housing bubble in late 2007.[1] Home sales slowed in many markets, property values plummeted, and credit markets froze.[2] This in turn triggered a liquidity crisis in the worldwide financial sectors as the values of mortgage-backed securities dropped.[3] In the U.S., businesses ground to a halt, laying off workers and spurring reductions in consumer spending, which caused even more businesses to slow and fail.[4] A major trigger: lenders granting mortgages to people without the ability to repay.[5]

Beginning in December 2007 with the Mortgage Forgiveness Debt Relief Act of 2007[6] ("MFDRA") and continuing with the Housing and Economic Recovery Act of 2008[7] ("HERA") Congress sought first to halt the downward spiral of home foreclosures and later to trigger a turnaround

* Juris Doctor candidate, Chicago-Kent College of Law, Illinois Institute of Technology, 2009. Executive Articles Editor, Chicago-Kent Law Review. The author thanks Professor Evelyn Brody for her invaluable advice and guidance in the composition of this note; Molly Brooks for her careful eye in reading multiple drafts; and her husband, Jonah, for his constant support and encouragement, not to mention the hundreds of cups of tea that he contributed to the writing process.

1. *See, e.g.*, Marc Faber, *Synchronized Boom, Synchronized Bust*, WALL ST. J., Feb. 18, 2009, at A17.

2. *See, e.g.*, Jeff Bater, *U.S. News: Home Resales Fall 5.3%; Prices Plunge*, WALL ST. J., Feb. 26, 2009, at A3. *See also*, *Heard on the Street/Financial Analysis and Commentary*, WALL ST. J., Jan. 26, 2009, at C6.

3. *See, e.g.*, Chip Cummins, *Dubai Gets $10 Billion Bailout to Ease Debt*, WALL ST. J., Feb. 23, 2009, at A1.

4. *See, e.g.*, Kelly Evans, *Hard-Hit Families Finally Start Saving, Aggravating Nation's Economic Woes*, WALL ST. J., Jan. 6, 2009, at A1.

5. In the words of President Obama: "Regulations were gutted for the sake of a quick profit at the expense of a healthy market. People bought homes they knew they couldn't afford from banks and lenders who pushed those bad loans anyway." Barack Obama, President, Address to Joint Session of Congress (Feb. 24, 2009) (transcript at http://www.whitehouse.gov/the_press_office/Remarks-of-President-Barack-Obama-Address-to-Joint-Session-of-Congress/).

6. Pub. L. No. 110-142 (2007) (codified as amended in scattered sections of 26 U.S.C.).

7. Pub. L. No. 110-289 (2008).

during a period of economic slump. In these bills, Congress employed one of the strongest motivators of widespread individual behavior at its disposal—the tax code.

This note focuses on the Congressional response to the housing component of the greater economic crisis. Specifically, it examines two provisions of the MFDRA amending the Internal Revenue Code and one such provision of the HERA, as well as the commentary about those provisions in the Congressional Record. The MFDRA expands the exceptions to income-inclusion for discharge of indebtedness (i.e. cancellation of debt) to include debt forgiveness in the context of home foreclosure. The MFDRA also allows taxpayers to deduct money they spend on premiums for private mortgage insurance. Finally, HERA grants a refundable tax credit to first-time homebuyers.

Through an explanation of the plain language of these three provisions and an analysis of the debates over them in the Congressional Record, this note will demonstrate how in the midst of a housing crisis Congress failed to see the forest for the trees. Although much of the impetus for the crisis stems from irresponsible behavior on the part of homebuyers, Congress's response not only did little to discourage irresponsible behavior but also encouraged further potentially problematic purchases. The tax provisions of MFDRA and HERA illustrate a tension between the need for long-term responsible economic behavior, short-term reversal of an economic crisis, and the legislators' own desire for reelection.

Part I of this note discusses the Mortgage Forgiveness Debt Relief Act of 2007. Part II follows with an analysis of the Housing and Economic Recovery Act of 2008.

I. THE MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007

A. The Plain Language

Two provisions of the Mortgage Forgiveness Debt Relief Act of 2007 ("MFDRA") forgives and encourages risky behavior by homebuyers: (1) the discharge of indebtedness provision[8] and (2) the extension of the sunset provision for treating mortgage insurance premiums as interest paid[9].

1. Discharge of Indebtedness

Section two of the MFDRA amends the Internal Revenue Code to add

8. Mortgage Forgiveness Debt Relief Act of 2007 §§ 2(a), (b).
9. Mortgage Forgiveness Debt Relief Act of 2007 § 3.

a fifth[10] option by which a taxpayer may exclude income from the discharge of indebtedness under § 108.[11] Under this new provision, gross income does not include as income "qualified principal residence indebtedness which is discharged before January 1, 2010."[12] Since the MFDRA applies to any tax returns filed after its date of enactment[13], this provision applies to any qualified discharge of indebtedness that occurred between January 1, 2007 and December 31, 2009.

Nevertheless, this provision is not, as it may appear, a "get out of jail free card." Congress enacted certain limitations to the provision that contain its effectiveness within a defined sphere of activity. First, the provision only applies to qualified principal residence indebtedness[14], with "principal residence" sharing the same meaning as used in I.R.C. § 121 (Code § 121 excludes from income, in general, the first $250,000 ($500,000 in the case of a joint return) in gain from the sale of a taxpayer's principal residence)[15]. Therefore, the new § 108 exclusion does not apply to second homes, vacation residences, or investment property. Those residences still generate taxable cancellation of indebtedness income.

Second, the provision caps the amount of qualified principal residence indebtedness at $2,000,000 ($1,000,000 in the case of a married taxpayer filing a separate return).[16] In other words, when a lender forgives the debt on the taxpayer's home mortgage, up to $2,000,000 of the amount forgiven does not count as income to the taxpayer. Any amount forgiven that exceeds the $2,000,000 cap will count as income on that year's tax return.

The indebtedness here covers not only acquisition indebtedness, but also home equity debt used to improve the residence where the residence

10. The original four options consist of (1) bankruptcy cases, (2) insolvency, (3) qualified farm indebtedness, and (4) qualified real property business indebtedness. *See* I.R.C. § 108(a)(1) (2008).

11. Mortgage Forgiveness Debt Relief Act of 2007 § 2(a).

12. Mortgage Forgiveness Debt Relief Act of 2007 § 2(a).

13. The Mortgage Forgiveness Debt Relief Act of 2007 was signed by President Bush on December 20, 2007.

14. Mortgage Forgiveness Debt Relief Act of 2007 § 2(a).

15. Section 2(b), amended subsection (h)(1) of I.R.C. § 108. I.R.C. § 121(a) defines property as "principal residence" if "during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating [two] years or more." Mortgage Forgiveness Debt Relief Act of 2007 § 2(b).

16. Section 2(b), amended subsection (h)(2) of I.R.C. § 108 to define "qualified principal residence indebtedness" as "acquisition indebtedness" under I.R.C. § 163(h)(3)(B), which "(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and (II) is secured by such residence" and also includes "indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of [I.R.C. § 163(h)(3)(B)(i)] . . . but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness." Mortgage Forgiveness Debt Relief Act of 2007 § 2(b).

collateralized the loan.[17] Qualifying home equity debt does not include home equity debt that was used for other expenses, such as medical bills or college tuition.

Third, this exclusion from income only applies to discharges that arise directly from the declining value of the residence or the distressed financial position of the taxpayer.[18] It disqualifies discharges of loans on account of "services performed for the lender"—an undefined term. Therefore, the exclusion of discharge of indebtedness income applies only to discharges made in concert with deficiency sales to satisfy the debt and negotiated settlements in which the lender renegotiates the terms of the mortgage and allows the taxpayer to remain in the residence.

Fourth, only the portion of the discharged loan that is qualified principal residence indebtedness can be excluded from income.[19] For example, consider a taxpayer living in a principal residence valued at $500,000 who took out a home equity loan for $100,000. Of that $100,000 the taxpayer used $50,000 to remodel the kitchen and $50,000 to pay a child's college expenses. Assuming that the taxpayer's financial condition caused him to default on the loan (i.e. that he did not repay any of the $100,000) and the lender discharged the debt, the taxpayer could only exclude $50,000 of the discharge of indebtedness from his income. He would have to pay taxes on the $50,000 that he used to pay college expenses.

In addition to these limitations on the applicability of the exclusion, § 2 of the MFDRA also amends Code § 108 to require a reduction of the basis of the taxpayer's principal residence by the amount of discharge of indebtedness that was excluded from the taxpayer's income.[20] The basis reduction states that "the amount excluded from gross income by reason of subsection (a)(1)(E) [of I.R.C. § 108] shall be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer."[21] For taxpayers who lose their principal residence to foreclosure, this provision will have little, if any, effect. However, for taxpayers who renegotiate the

17. I.R.C. § 163(h)(3)(B)(i)(I) (2008).

18. Section 2(b), amended subsection (h)(3) of I.R.C. § 108:

> EXCEPTION FOR CERTAIN DISCHARGES NOT RELATED TO TAXPAYER'S FINANCIAL CONDITION.—Subsection (a)(1)(E) [of I.R.C. § 108] shall not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

Mortgage Forgiveness Debt Relief Act of 2007 § 2(b).

19. Mortgage Forgiveness Debt Relief Act of 2007 § 2(b) amended subsection (h)(4) of I.R.C. § 108.

20. Mortgage Forgiveness Debt Relief Act of 2007 § 2(b) amended subsection (h)(1) of I.R.C. § 108.

21. Mortgage Forgiveness Debt Relief Act of 2007 § 2(b).

terms of their mortgage, including receiving discharge of part of the loan from their lender, and stay in the house, this provision merely defers the tax consequences of the discharge of indebtedness if the value of the house recovers by more than the § 121 exclusion amount.[22]

For example, consider a taxpayer having a principal residence with a basis of $500,000. That principal residence, now valued at $500,000, secures mortgage obligations worth $800,000. Assume that this taxpayer avoids foreclosure and renegotiates the terms of his mortgage with his lender to lower his monthly payment and discharge $300,000 of the debt. This would result in a residence valued at $500,000 and encumbered by mortgage obligations of $500,000. Under amended § 108 and § 1017, this arrangement will also reduce the taxpayer's basis in his home from $500,000 to $200,000. Thus if the taxpayer later sells the residence for $500,000 he will have realized a gain of $300,000 for tax purposes, only $250,000 of which he can exclude under § 121.[23] Therefore the taxpayer will have to pay capital gains taxes on $50,000 from the sale of the house that he would not have had to pay had he sold the house for the same price prior to the enactment of the MFDRA. Admittedly, the situation in this example is extreme. Many taxpayers to whom amended § 108 would apply will likely not realize gains on a later sale of their principal residence that would exceed the amount allowable under the § 121 exclusion.

This basis reduction already existed for taxpayers who renegotiated their mortgages in the broader context of insolvency.[24] Separately, § 108(a)(1)(B) of the Internal Revenue Code has long allowed a taxpayer to exclude from gross income any discharge of indebtedness that occurs when a taxpayer is insolvent.[25] However, the MFDRA gives precedence to the basis reduction provisions of the amended section (a)(1)(E).[26] Thus any discharge of indebtedness that qualifies as an exclusion under both the principal residence provision and the insolvency provision will be subject to the basis reduction unless the taxpayer elects to apply the insolvency provision of I.R.C. § 108(a)(1)(B).[27] Nevertheless, the MFDRA does not appear to give precedence to the principal residence exclusion over an alternative exclusion arising out of a discharge in bankruptcy.[28] In practice,

22. Under I.R.C. § 121(b)(2)(A) taxpayers may exclude $250,000 ($500,000 for married taxpayers filing jointly) of the gain realized upon sale of a principal residence.

23. I.R.C. § 121(b)(1) (2008).

24. Mortgage Forgiveness Debt Relief Act of 2007 § 2(c).

25. I.R.C. § 108(a)(1)(B) (2008).

26. Mortgage Forgiveness Debt Relief Act of 2007 § 2(c).

27. *Id.*

28. I.R.C. § 108(a)(1)(A); *See* Mortgage Forgiveness Debt Relief Act of 2007 § 2(c).

these ordering rules may allow taxpayers additional avenues of recourse outside the context of bankruptcy.

2. Mortgage Insurance Premiums

Section three of the MFDRA extends the sunset provision of I.R.C. § 163(h)(3)(E)(iv) on the deductibility of mortgage insurance premiums for an additional three years.[29] Prior to its amendment by the MFDRA, § 163(h)(3)(E) terminated the treatment of mortgage insurance premiums as deductible interest on December 31, 2007.[30] The MFDRA now allows treatment of mortgage insurance premiums as interest until December 31, 2010.[31] However, this extension only applies to premiums paid or accrued after December 31, 2007.[32]

Generally, interest paid or accrued on indebtedness within the taxable year is deductible.[33] However, personal interest cannot be deducted unless it is "qualified residence interest" within the meaning of § 163(h)(3).[34] Prior to the enactment of § 163(h)(3)(E), "qualified residence interest" included only the interest paid or accrued on "(i) acquisition indebtedness with respect to any qualified residence of the taxpayer or (ii) home equity indebtedness with respect to any qualified residence of the taxpayer."[35] Section 163(h)(3)(E) expanded the definition of "qualified residence interest" to include that "[p]remiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness with respect to a qualified residence of the taxpayer shall be treated for purposes of this section as interest which is qualified residence interest."[36]

In essence, § 163(h)(3)(E) encourages taxpayers to purchase bigger homes than they otherwise would since it reduces the sting of mortgage insurance, which lenders require when a mortgagor seeks a mortgage to cover more than 80 percent of the purchase price of a residence. Prior to the enactment of § 163(h)(3)(E), when only the true interest on a mortgage was deductible, the tax policy provided an incentive to taxpayers to save before purchasing a home. By saving at least twenty percent of the purchase price of the residence, home buyers could avoid paying for private mortgage

29. Mortgage Forgiveness Debt Relief Act of 2007 § 3(a).
30. *Id. See also* I.R.C. § 163(h)(3)(E)(iv) (2008).
31. Mortgage Forgiveness Debt Relief Act of 2007 § 3(a).
32. I.R.C. § 163(h)(3)(E)(iii); Mortgage Forgiveness Debt Relief Act of 2007 § 3(a).
33. I.R.C. § 163(a).
34. I.R.C. § 163(h)(2)(D).
35. I.R.C. § 163(h)(3)(A).
36. I.R.C. § 163(h)(3)(E)(i).

insurance. That twenty percent down payment could serve as a cushion in times of market turmoil, ensuring that taxpayers retained equity in their homes even if market prices dropped. Now § 163(h)(3)(E) encourages the opposite: purchasing the biggest home possible without regard to creating an equity cushion. With the MFDRA Congress has continued this federal disincentive to saving until December 31, 2010.[37] The phaseout provision of I.R.C. § 163(h)(3)(E)(ii) targets this disincentive at middle-income families who are perhaps least able to weather a market crisis that saps the equity from their homes.[38]

B. Congressional Policy Behind the Language

Two statements by Congressmen Rangel (D – N.Y.) and McCrery (R – La.) from October 4, 2007, exemplify two competing philosophies of the current housing crisis at work in the Mortgage Forgiveness Debt Relief Act of 2007.[39] The first philosophy embodies a desire to cast a lifeline to suffering middle- and working-class homeowners who have become ensnared in the morass of subprime mortgages and other risky financial instruments.[40] According to Rep. Charles Rangel:

> It's a commonsense piece of legislation that when the banks and those that hold the mortgage decide to give forgiveness on some parts of that loan, that these parts of the loan not be considered as income and does not create a taxable event. . . . We passed it out by vote because it just made a lot of sense.[41]

This point of view includes notions of basic fairness and a desire to protect individuals from "'kick-'em-when-they're-down' feature[s] of the tax code."[42] On the other end of the spectrum, the second philosophy is grounded in traditional conservative notions of personal responsibility.[43] In

37. I.R.C. § 163(h)(3)(E)(iv); Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, § 3(a) (2007) (codified as amended in scattered sections of 26 U.S.C.).

38.

> Phaseout. The amount otherwise treated as interest under clause (i) shall be reduced (but not below zero) by 10 percent of such amount for each $1,000 ($500 in the case of a married individual filing a separate return) (or fraction thereof) that the taxpayer's adjusted gross income for the taxable year exceeds $100,000 ($50,000 in the case of a married individual filing a separate return).

I.R.C. § 163(h)(3)(E)(ii).

39. Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142.

40. *See, e.g.*, Elizabeth Razzi, *Talk to Me; Woman Who Once Originated Subprime Mortgages Now Spends Her Days Answering Desperate Calls from People in Danger of Foreclosure*, WASH. POST, Mar. 1, 2009, at W12.

41. 153 CONG. REC. H11,289 (daily ed. Oct. 4, 2007) (statement of Rep. Rangel).

42. 153 CONG. REC. H11,289 (daily ed. Oct. 4, 2007) (statement of Rep. McCrery).

43. *See, e.g.*, Thomas W. Ross, *The Faith-Based Initiative: Anti-Poverty or Anti-Poor?*, 9 GEO. J. ON POVERTY L. & POL'Y 167, 171–75 (2002).

the words of Rep. Jim McCrery, "While we are all ultimately responsible for the contracts we sign, there were clearly failures in the market that led people to buy homes larger or more expensive than they could really afford, or to accept mortgage terms that might quickly become unsustainable."[44] Under this philosophy, homeowners should bear some of the responsibility for getting entangled in loans that "quickly bec[a]me unsustainable."[45] The provisions of the Mortgage Forgiveness Debt Relief Act display this tension between Democratic notions of fair play and Republican ideals of personal responsibility.[46] One possible source of this tension, party politics aside, lies in the variety of strategies employed in the MFDRA as an attempt to halt the housing crisis: (1) appeals to fairness, (2) notions of "phantom income", and (3) deductibility of private mortgage insurance.

1. Fairness

The trope of fairness pervades statements made on the House floor in discussion of the MFDRA. Rep. Levin (D – Mich.) expressed the issue bluntly: "On the Democratic side we've been emphasizing the importance of fairness in the [tax] code, of equity in the code, the ability to go home, meet our constituents, look them squarely in the eye and say that we're taking steps to make the Tax Code more equitable."[47] While many of Rep. Levin's colleagues have cited "fairness" as their motivation for supporting the MFDRA, none have spoken of the legislators' compelling interest in re-election. Thus Rep. Levin's remarks suggest that "fairness" is a codeword for re-election since the Tax Code itself represents a constantly chancing compromise between fairness and efficiency (and sometimes simplicity).

2. "Phantom Income"

Aside from appealing to general notions of fairness, nearly every Representative who spoke in favor of the MFDRA described the cancellation of debt scheme prior to the amendments of the MFDRA as taxation on "phantom income."[48] As Rep. English (R – Pa.) described the scheme, "[u]nder [previous] law, a homeowner [had to] pay taxes at ordinary income rates on the fictitious income never realized by the homeowner when a lender for-

44. 153 CONG. REC. H11,289 (daily ed. Oct. 4, 2007) (statement of Rep. McCrery).

45. *Id.*

46. Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142 (2007) (codified as amended in scattered sections of 26 U.S.C.).

47. 153 CONG. REC. H11,290 (daily ed. Oct. 4, 2007) (statement of Rep. Levin).

48. 153 CONG. REC. H11,290 (daily ed. Oct. 4, 2007) (statement of Rep. Lewis).

gives part of the debt owed on a mortgage."[49] This scheme, he argued, created a situation "simply unfair . . . when lenders do the right thing and try to work to keep working families in their homes during tough times, that the taxman then comes and presents that family with a bill on money that they never saw."[50] He continued:

> The kicker . . . is that were the homeowner to realize a gain on selling their home, the situation is a very different matter. In that instance, the seller of the home would only be required to pay tax, and at the capital gains rate versus the income tax rate on the amount above an exclusion. Yet, for the homeowner facing a short sale or participating in a debt forgiveness proposal in order to keep them in their home, no such help is extended through the Tax Code.[51]

These comments fail to realize that cancellation of debt income is not "phantom income." The concept that debt forgiveness constitutes income to the taxpayer is not hidden deep within the bowels of the Tax Code; rather, it can be found in the general definition of "income."[52] "Gross income means all income from whatever source derived, including (but not limited to) . . . income from discharge of indebtedness."[53] First, the example offered by Rep. English incorrectly analogizes the situation of a cancellation of debt transaction with that of a sale. In the case of a sale of a residence, the taxpayer gives the purchaser legal title to the residence in exchange for value, i.e., the purchase price. If the purchase price of the residence exceeds the taxpayer's basis in the residence (i.e., if the taxpayer realized a gain on the transaction), the taxpayer would then be liable for any gain that exceeded the exclusion amounts in I.R.C. § 121 and that gain would be taxed at the rate for long-term capital gains.[54] The rationale for taxing this gain as long-term capital gains rather than ordinary income is that the residence increased in value over time (the length of time the taxpayer owned the residence), rather than only during the tax year in which the sale took place.

On the other hand, cancellation of debt presents an entirely different scenario and accompanying set of policies. This scenario begins when a taxpayer purchases a residence by paying a percentage of the purchase price with his own money and the remainder with money borrowed from a bank. In exchange for the loan, the taxpayer grants the lender a security interest in the residence and promises to pay back the loan over time. Thus the taxpayer has both the residence and an obligation to the lender. Some-

49. 153 CONG. REC. H11,291 (daily ed. Oct. 4, 2007) (statement of Rep. English).
50. *Id.*
51. *Id.*
52. I.R.C. § 61(a) (2008).
53. I.R.C. § 61(a)(12).
54. I.R.C. § 1(h) (2008).

time later, when the taxpayer becomes unable to make his periodic payments on the mortgage, the lender might renegotiate the terms of the mortgage and forgive a percentage of the principal of the loan. At the end of this transaction, the taxpayer has his residence and a *smaller* obligation than what he had immediately prior to the renegotiation. However, this situation is fundamentally different from a sale exchange, where the taxpayer gives his residence in exchange for payment of the purchase price, because here the taxpayer gives the lender nothing that he has not already given before—namely a promise to pay off his obligation. While the lender has several sound business reasons for forgiving a portion of the debt (i.e., the high cost of foreclosure proceedings or the likelihood of a greater return on investment from renegotiation rather than forced sale),[55] that does not change the fact that the debtor gave nothing new in return for the debt forgiveness.

Case law exploring the contours of the Tax Code agrees with this distinction. One of the earliest cases arising under U.S. tax law stands for the proposition that when a third-party discharges a legal obligation of the taxpayer, that discharge can constitute taxable income to the taxpayer.[56] In *Old Colony Trust Co. v. Commissioner*, the taxpayer had entered into an agreement with his employer under which the employer would pay the taxpayer's personal income taxes.[57] When the taxpayer did not include the amount of tax paid on his behalf by his employer on his income tax returns, the I.R.S. began deficiency proceedings against him.[58] The United States Supreme Court reasoned that because the employer paid the taxpayer's income tax obligations in exchange for the taxpayer's services to the employer—in other words, that they constituted consideration for services rendered—the discharge of the taxpayer's obligation was income to the taxpayer under the Tax Code.[59] The Court rejected the taxpayer's argument that the payment of his tax obligation should be considered a gift because the facts indicated that the discharge was compensation for services rendered.[60]

While *Old Colony Trust* does not fit squarely with the facts of debt forgiveness, it is nevertheless helpful in establishing that the discharge by

55. Lenders lose between 30% and 60% of the outstanding balance on a mortgage through "legal fees, foregone interest[,] and property expenses" if they pursue foreclosure. Linling Wei, *Lenders Get Help to Prevent Foreclosures*, WALL ST. J., Nov. 1, 2006, at B3B.

56. Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929).

57. *Id.* at 719–20.

58. *Id.*

59. *Id.* at 729. Income, as defined by the Tax Code, includes "compensation for services, including fees, commissions, fringe benefits, and similar items." I.R.C. § 61(a)(1) (2008).

60. *Old Colony Trust*, 279 U.S. at 730.

one party of an obligation of another can constitute income within the Tax Code.[61] The case also raises the question of whether the lender's forgiveness of a portion of a taxpayer's mortgage debt should be considered a gift from the lender to the taxpayer.[62] After all, according to the hypothetical mortgage forgiveness situation described above, the lender is giving the taxpayer something for nothing, a transaction that sounds very much like a gift in common parlance.

However, there are specific requirements for a transfer to be considered a gift under the Tax Code and thus excluded from a taxpayer's income.[63] The situation discussed above does not fit those requirements. First, forgiveness of a loan does not fit squarely within the definition of an excludable gift. Under the Tax Code, a taxpayer may exclude from his income "the value of property acquired by gift."[64] This leads to two questions: Is loan forgiveness property? And, if so, what is its value?

In addition, unlike the common law where a gift is merely a transfer without consideration, the Supreme Court has held that the Tax Code requires specific intent on the part of the donee.[65] In *Commissioner v. Duberstein*, the Court held that for the purposes of the Tax Code, a gift "proceeds from a 'detached and disinterested generosity,' 'out of affection, respect, admiration, charity or like impulses.'"[66] At issue in *Duberstein* was whether the voluntary transfer of a Cadillac to the taxpayer from a business colleague, to whom the taxpayer had often passed useful information about customers, constituted an excludable gift or taxable income to the taxpayer.[67] There the Court opined that a fact-finder's determination of whether or not the specific donative intent required by the Tax Code was present in a particular case depended on the application of the fact-finder's "experience with the mainsprings of human conduct to the totality of the facts of each case."[68]

Applying the *Duberstein* test to the hypothetical loan forgiveness situation discussed above, mortgage forgiveness is not a gift and thus cannot be excluded from the taxpayer's income as such.[69] When a lender for-

61. *Id.* at 729.

62. *See id.* at 730.

63. "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance." I.R.C. § 102(a) (2008).

64. I.R.C. § 102(a).

65. Comm'r v. Duberstein, 363 U.S. 278, 285 (1960).

66. *Id.* at 285 (citations omitted).

67. *Id.* at 280–81.

68. *Id.* at 289.

69. Congress confirmed this in I.R.C. § 61(a)(12) (2008): "Gross income means income from whatever source derived, including . . . income from discharge of indebtedness."

gives part of a mortgagee's debt, the lender is not acting "out of affection, respect, admiration, charity or like impulses."[70] Rather, the lender is seeking to achieve the greatest return possible on what has turned out to be a faulty investment. Foreclosure proceedings can be lengthy and costly and, as such, are likely to eat away at the proceeds of a foreclosure sale. In addition, when a lender forecloses, it becomes responsible for the maintenance and upkeep of the residence in addition to losing whatever income it was receiving from the mortgagee's periodic payments. Thus lenders in this situation would likely consider renegotiation and loan forgiveness to be in their best long-term interests because it would ensure a continued income stream as opposed to a questionable return from a foreclosure sale. This is a case of sound business practices, not charity, and therefore not a gift for tax purposes.[71]

Thus, cancelled debt is still very much income to the taxpayer. As the Supreme Court famously stated, income consists of "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[72] The provisions of the Tax Code relating to cancellation of debt apply this reasoning: when a taxpayer's debt is forgiven, the taxpayer has an undeniable accession to wealth that is clearly realized and over which he has complete dominion.[73] The Supreme Court reinforced this general rule in *United States v. Centennial Savings Bank FSB* when it opined:

> Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates.[74]

There the Court acknowledged that "while the cancellation of the obligation to repay increases the taxpayer's assets, it does not necessarily generate cash with which the taxpayer can pay the resulting income tax."[75] This is precisely the issue that troubled Representatives on the floor of the House when they debated the MFDRA.[76]

70. *Duberstein*, 363 U.S. at 285.
71. *See id.* at 285.
72. Comm'r v. Glenshaw Glass Co. 348 U.S. 426, 431 (1955).
73. *See id.* at 431.
74. United States v. Centennial Sav. Bank FSB, 499 U.S. 573, 582 (1991).
75. *Id.* at 582.
76. For example, see statements of Rep. Lewis: "It is unfair to tax people on phantom income, particularly when they have suffered serious economic loss and had less ability to pay the tax." 153 CONG. REC. H11,290 (daily ed. Oct. 4, 2007) (statement of Rep. Lewis).

While discharge of indebtedness income may *seem* phantom to those who must pay taxes on it, it is income nonetheless. Indeed, such a discharge allows taxpayers to avoid incurring ordinary tax on income they earn in order to pay back the loan. Congress would do better to focus on the harshness of the result for "honest but unfortunate" homeowners rather than trying to ignore the very real income to the taxpayer from debt forgiveness.[77] One such attempt is discussed in Part I.B.3 below.

This mistaken analogy between sale and cancellation of debt transactions that pervades the Congressional Record exemplifies the modern American consumer's attitudes about debt. The trouble seems to lie in the concept of debt forgiveness as a clearly realized accession to wealth.[78] Over the last several decades, American society has become increasingly debt-ridden.[79] For the past eight years the federal budget changed from a surplus to a deficit to an even bigger deficit.[80] As a country, Americans have come to see acquired debt as a means to an end (i.e., the accoutrements of a "middle-class" lifestyle) rather than an obligation that must be repaid.[81] The deduction for mortgage insurance premiums, discussed in the next section, provides another example of this trend.

3. Mortgage Insurance Premiums

Floor comments about the extension of treating private mortgage insurance ("PMI") premiums as deductible interest for income tax purposes are couched in terms of "level[ing] the playing field" of access to homeownership.[82] Representative Levin described the provision in these terms: "What it does is to level the playing field among the products of mortgages."[83] In other words, more of the monthly payment for a mortgage that exceeds eighty percent of the purchase price of a taxpayer's principal resi-

77. Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

78. *See Glenshaw*, 348 U.S. at 431.

79. Steven Mercatante, *The Deregulation of Usury Ceilings, Rise of Easy Credit, and Increasing Consumer Debt*, 53 S.D. L. REV. 37, 37–38, 43–45 (2008).

80. In January 2009, the Congressional Budget Office estimated a federal budget deficit of $1.2 trillion for 2009. CONGRESS OF THE UNITED STATES, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2009 TO 2019, at 11 (2009).

81. In 2005 Congress amended the Bankruptcy Code to make it harder for individuals to file for liquidation of debts under chapter 7. The new "means test" under 11 U.S.C. § 707(b) and the requirement of credit counseling for all individual debtors under 11 U.S.C. § 109(h) suggest a belief that more stringent requirements were necessary to prevent Americans from seeking not only to get out of debts that they could pay but also to take on more debts than they could afford in the first place.

82. *See* Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. 110-142, § 3 (2007) (codified as amended in scattered sections of 26 U.S.C.); 153 CONG. REG. H11,290 (daily ed. Oct. 4, 2007) (statement of Rep. Levin).

83. 153 CONG. REG. H11,290 (daily ed. Oct. 4, 2007) (statement of Rep. Levin).

dence can be deducted from his income. This roughly equalizes the tax benefits accorded to mortgages for more than eighty percent of the purchase price with mortgages that cover eighty percent or less of the purchase price. Such a policy removes some of the incentive for taxpayers to use a high down-payment (at least twenty percent of the purchase price, the cutoff for mandatory private mortgage insurance) to create an equity cushion in their new residences—a cushion that would insulate lenders from fluctuations in the housing market that might decrease home values below the amount of the mortgage. In doing so, the provision encourages taxpayers to purchase more expensive residences than prudence might dictate since the cost of mortgage insurance is reduced through the deduction. While the Mortgage Bankers Association lauds such a deduction,[84] the approval of an industry group that benefits from taxpayers securing bigger mortgages is not a good indicator of healthy consumer behavior by taxpayers.[85]

While some in Congress supported the deduction because it increased homeownership opportunities among groups with high barriers to entry, other justifications for the deduction were less clear. Among those suggesting that the deduction is intended to lower the barrier to entry to homeownership, Rep. Lincoln Diaz-Balart (R – Fla.) commented: “This provision will be helpful, especially to young families purchasing their first home.”[86] In a similar vein, Rep. Cardoza (D – Cal.) argued:

> The deduction for PMI, as it is most commonly known, is critical to many low- and moderate-income families and first-time homebuyers who lack the traditional down payment. The PMI deduction allows them to purchase a home at lower cost while avoiding risky subprime or predatory second loans that would need to be made for them to make a down payment.[87]

However, there is some question about the efficacy of the PMI deduction since low- and moderate-income families may not be able to realize much benefit from the deduction. In 2007, the median U.S. household income was $50,233.[88] Assuming a family of four, taking only the allowed personal exemptions and the standard deduction, the median household adjusted gross income (AGI) is $25,333.[89] This AGI places the household

84. 153 CONG. REG. H11,256 (daily ed. Oct. 4, 2007) (statement of Rep. Cardoza).

85. Mortgage brokers and lenders fees are directly proportional to the size of the loan: the larger the loan, the larger their commission.

86. 153 CONG. REG. H11,256 (daily ed. Oct. 4, 2007) (statement of Rep. Diaz-Balart).

87. 153 CONG. REG. H11,256 (daily ed. Oct. 4, 2007) (statement of Rep. Cardoza).

88. CARMEN DENAVAS-WALT, ET AL., INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE U.S.: 2007 6 (2008).

89. In 2008, the personal exemption was $3,500 and the standard deduction was $10,900. A family of four would subtract $14,000 ($3,500 x 4) and $10,900 to reach an AGI of $25,333.

squarely within the fifteen percent tax bracket[90] and would pay $2,997.45 in federal taxes for 2008[91]. In order for this household to realize a tax benefit from the PMI deduction, its itemized deductions must exceed the standard deduction of $10,900. Assuming that the household's only itemized deduction lies in its payment of mortgage interest, PMI premiums, and property tax; the sum of interest, premium, and tax payments must exceed $908.33 per month.[92]

For a household whose mortgage interest payments equal $908.33 per month, the PMI deduction provides a minimal tax benefit. Assuming that the household had purchased a primary residence for $150,000 with a mortgage securing greater than eighty percent of the purchase price, the PMI premium would be $82.50 per month.[93] Thus over the course of 2008, that household would have paid $990 in deductible PMI premiums.[94] Since the household falls within the fifteen percent tax bracket, the deduction of $990 in PMI premiums would produce a tax savings of $148.50, only a five percent reduction the household's 2008 federal tax burden, even if it itemized its deductions.[95]

Furthermore, Rep. Cardoza's statement suggests a misunderstanding of the lending process prior to purchasing a residence. Private mortgage insurance does not decrease the amount of money that must be available to purchase a residence; the purchase price must still be met. Instead, it insures the lender against the chance that the taxpayer will not be able to pay his mortgage payments over time, because the size of the down payment is a reasonable indicator of a borrower's ability to afford the loan. Thus, if a taxpayer must borrow more than eighty percent of the purchase price of the residence, the deduction does not help him avoid "risky subprime or predatory second loans" if that is all he qualifies for.[96] The deduction merely reduces the cost of the insurance he must purchase in addition to those possibly risky loans that cover the last twenty percent of the purchase price.

90. I.R.C. § 1(a) (2008).

91. The first $16,050 of taxable income is taxed at the 10 percent rate and produces $1,605 of tax. The next $9,283 of taxable income ($25,333 AGI minus $16,050 taxed at the 10 percent rate) is taxed at the 15 percent rate and produces $1392.45 of tax). The sum of $1,605 and $1392.45 provides the total amount of tax owed in 2008—$2,997.45.

92. $10,900 divided by twelve months equals $908.33.

93. This hypothetical assumes a PMI premium of $55 per $100,000 of the purchase price per month.

94. $82.50 per month times twelve months equals $990.

95. A deduction for a taxpayer in the fifteen percent tax bracket is only worth fifteen cents for every dollar claimed as a deduction. For this reason, households with higher tax brackets will find the PMI much more beneficial than households in lower tax brackets because the deduction will be worth up to thirty-five cents for every dollar claimed.

96. *See* 153 CONG. REG. H11,256 (daily ed. Oct. 4, 2007) (statement of Rep. Cardoza).

However, other comments, like those of Rep. Rangel, seem to completely misunderstand what PMI is and what the PMI deduction accomplishes.[97] According to Rep. Rangel, "we make it easier for people to extend their mortgage insurance, as well as those people who own condos, to be able to get relief from debts that they may have by getting long-term extension of private mortgage insurance on all of them."[98] An extension of private mortgage insurance will in no way reduce the debts of homeowner taxpayers. Rather, the premiums for private mortgage insurance increase the debt burden of these taxpayers because they eat up income that otherwise could have been used to pay down the principal on the loans. Perhaps Rep. Rangel was referring to relief from an extension of the *deductibility* of private mortgage insurance premiums, but the plain meaning of his words suggests confusion about the effects of the PMI deduction.

While increasing homeownership among the American people is a laudable goal, an even more laudable one would be increasing responsible homeownership. As the housing crisis of 2007 and 2008 has demonstrated, when unhealthy lending practices combine with unhealthy purchasing practices by consumers, the fallout can be devastating.[99] Prior to the MFDRA, Congress had already passed a major piece of legislation that encouraged (if not required) risky lending by banks.[100] Prudence suggests that Congress consider the results of that effort closely before encouraging risky behavior by consumers as well.

II. THE HOUSING AND ECONOMIC RECOVERY ACT OF 2008

A. The Plain Language

The First-Time Homebuyer Credit found in § 3011 of the Housing and Economic Recovery Act also stands as an example of short-sighted legislation that would likely do more harm than good. Other housing provisions in the Housing and Economic Recovery Act of 2008 ("HERA") lie beyond the scope of this note.

97. 153 CONG. REG. H11,289 (daily ed. Oct. 4, 2007) (statement of Rep. Rangel).

98. *Id.*

99. *See* Razzi, *supra* note 40, at W12.

100. 12 U.S.C. §§ 2901–2906 (2008). The Community Reinvestment Act of 1977 required that "[i]n connection with its examination of a financial institution, the appropriate Federal financial supervisory agency shall—(1) assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution." 12 U.S.C. § 2903(a).

1. § 3011 – First-Time Homebuyer Credit

The first tax-related provision of the HERA provides a tax credit to first-time homebuyers.[101] The credit applies to first-time homebuyers who purchase a principal residence within the U.S. after April 9, 2008 and before July 1, 2009.[102] When those first-time homebuyers file their tax returns for the taxable year in which they purchased the principal residence, they can claim a credit for ten percent of the purchase price of the home.[103] For the purposes of this credit, the term "first-time homebuyer" refers to an individual who did not own a principal residence at the time of the purchase in question and, in addition, had no ownership interest in any principal residence for three years preceding the purchase in question.[104] If the taxpayer is married, the lack of ownership restrictions described above also apply to the taxpayer's spouse.[105] For purposes of this credit, the term "principal residence" has the same meaning as when used in I.R.C. § 121 to determine the exclusion of gain from sale of a principal residence.[106] Also for purposes of this section, adjusted gross income does not include exclusions made under §§ 911, 931, or 933 (exclusions for U.S. citizens or residents living abroad; income from sources within Guam, American Samoa, or the Northern Mariana Islands; and income from sources within Puerto Rico, respectively).[107]

This credit is subject to limitations on the amount of credit allowed and on the adjusted gross income of those taxpayers eligible to take the credit. First, the amount of the credit is capped at $7,500.[108] In other words, if a taxpayer purchases a principal residence with a purchase price up to and including $75,000, then the taxpayer can subtract ten percent of the purchase price from his taxes in that taxable year. Taxpayers who purchase a principal residence with a purchase price greater than $75,000 can only subtract $7,500, regardless of the purchase price. In addition, the credit is

101. I.R.C. § 36(a) (2008); Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3011 (2008).

102. I.R.C. § 36(a); Housing and Economic Recovery Act of 2008 §§ 3011(a), (c). "Allowance of Credit – In the case of an individual who is a first-time homebuyer of a principal residence in the United States during a taxable year, there shall be allowed as a credit against the tax imposed by this subtitle for such taxable year an amount equal to 10 percent of the purchase price of the residence."

103. I.R.C. § 36(a); Housing and Economic Recovery Act of 2008 § 3011.

104. I.R.C. § 36(c)(1); Housing and Economic Recovery Act of 2008 § 3011. "The term 'first-time homebuyer' means any individual if such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 3-year period ending on the date of the purchase of the principal residence to which this section applies."

105. I.R.C. § 36(c)(1); Housing and Economic Recovery Act of 2008 § 3011.

106. I.R.C. § 36(c)(2); Housing and Economic Recovery Act of 2008 § 3011.

107. I.R.C. § 36(b)(2)(B); Housing and Economic Recovery Act of 2008 § 3011.

108. I.R.C. § 36(b)(1)(A); Housing and Economic Recovery Act of 2008 § 3011.

capped at $3,750 each for married individuals filing separately.[109] If two or more unmarried individuals purchase a residence together, the aggregate amount of the credits applied to each of their tax filings for the taxable year cannot exceed $7,500.[110]

The second major limitation to the credit consists of a phase-out for taxpayers with an adjusted gross income greater than $75,000 ($150,000 for married taxpayers filing jointly).[111] The phase-out works by reducing the credit for taxpayers whose adjusted gross income is between $75,000 and $95,000 ($150,000 and $170,000 for married taxpayers filing jointly) and thus does not apply to taxpayers whose adjusted gross income is less than or equal to $75,000 ($150,000 for married taxpayers filing jointly).[112]

To apply the phase-out, a taxpayer must first calculate his adjusted gross income for purposes of I.R.C. § 36. After determining the relevant adjusted gross income (AGI), the taxpayer must subtract from his AGI $75,000 in the case of an individual taxpayer or $150,000 in the case of married taxpayers filing jointly.[113] Next he must divide that excess amount by $20,000 to find the phase-out percentage.[114] Finally, he must multiply the $7,500 base credit amount by the phase-out percentage to find the amount of credit he can apply.[115]

Section 36 of the Tax Code also includes some predictable minor exceptions to the first-time homebuyer credit. The term "purchase" under § 36 does not include acquisitions of property from a relative[116] or inherited property.[117] However, it does include residences constructed by the taxpayer (i.e., new home purchases or constructions, as well as existing home purchases).[118] If a taxpayer or his spouse is eligible to take a § 1400C credit for first-time homebuyers in the District of Columbia, he cannot also take the § 36 credit.[119] A nonresident alien taxpayer does not qualify for the § 36 credit.[120] In addition, the credit is not applicable if the taxpayer either

109. I.R.C. § 36(b)(1)(B); Housing and Economic Recovery Act of 2008 § 3011.

110. I.R.C. § 36(b)(1)(C); Housing and Economic Recovery Act of 2008 § 3011. "If two or more individuals who are not married purchase a principal residence, the amount of credit allowed under subsection (a) shall be allocated among such individuals in such manner as the Secretary may prescribe, except that the total amount of the credits allowed to all such individuals shall not exceed $7,500."

111. I.R.C. § 36(b)(2); Housing and Economic Recovery Act of 2008 § 3011.

112. I.R.C. § 36(b)(2); Housing and Economic Recovery Act of 2008 § 3011.

113. I.R.C. § 36(b)(2)(A)(i); Housing and Economic Recovery Act of 2008 § 3011.

114. I.R.C. § 36(b)(2)(A)(i–ii); Housing and Economic Recovery Act of 2008 § 3011.

115. I.R.C. § 36(b)(2)(A)(i); Housing and Economic Recovery Act of 2008 § 3011.

116. I.R.C. § 36(c)(3)(A)(i); Housing and Economic Recovery Act of 2008 § 3011.

117. I.R.C. § 36(c)(3)(A)(ii); Housing and Economic Recovery Act of 2008 § 3011.

118. I.R.C. § 36(c)(3)(B); Housing and Economic Recovery Act of 2008 § 3011.

119. I.R.C. § 36(d)(1); Housing and Economic Recovery Act of 2008 § 3011.

120. I.R.C. § 36(d)(3); Housing and Economic Recovery Act of 2008 § 3011.

disposes of the residence or the residence becomes something other than the taxpayer's principal residence during the taxable year in which the residence was purchased.[121]

However, the § 36 credit contains one last limitation, one that eliminates much of the benefit to taxpayers who use the credit: recapture.[122] For the next fifteen taxable years after the taxpayer uses the § 36 credit, 6.67 percent of the amount of the credit shall be imposed as a tax on the taxpayer.[123] In other words, the taxpayer must pay back the § 36 credit over fifteen years. Thus § 36 generally provides an interest-free loan, not a permanent credit.[124] If the taxpayer sells the residence prior to the end of the fifteen-year recapture period, he must repay the remainder of the credit in the tax year of the sale.[125] However, should the taxpayer's gain on the sale not exceed the amount of the § 36 credit that must be repaid, the taxpayer need only repay the amount of his gain.[126] Moreover, the taxpayer does not have to repay the credit in the case of (1) his death,[127] (2) involuntary conversions,[128] or (3) a transfer to his spouse as part of a division of property in a divorce proceeding[129]. In the case of a transfer incident to a divorce, the taxpayer's spouse becomes responsible for repayment of the remainder of the credit.[130]

2. Other Provisions

Two other provisions of the HERA target taxpayers in an attempt to alleviate the housing crisis: § 3012 – Additional Standard Deduction for Real Property Taxes for Nonitemizers and § 3092 – Gain from Sale of Principal Residence Allocated to Nonqualified Use Not Excluded from Income. These provisions lie beyond the scope of this note.

B. Congressional Policy Behind the Language

Whereas the comments in the Congressional Record relating to the

121. I.R.C. § 36(d)(4); Housing and Economic Recovery Act of 2008 § 3011.

122. I.R.C. § 36(f); Housing and Economic Recovery Act of 2008 § 3011.

123. I.R.C. § 36(f)(1), (7); Housing and Economic Recovery Act of 2008 § 3011.

124. Taxpayers in 2009 may find the recapture component of the first-time homebuyer credit an unwelcome surprise. As late as November 2008 the draft Form 5405 for use with this credit available on the IRS website made no mention of repayment. Sheldon R. Smith, *The First-Time Home Buyer Credit: Technical Correction Needed*, TAX NOTES 405, 407 (Jan. 19, 2009).

125. I.R.C. § 36(f)(2); Housing and Economic Recovery Act of 2008 § 3011.

126. I.R.C. § 36(f)(3); Housing and Economic Recovery Act of 2008 § 3011.

127. I.R.C. § 36(f)(4)(A); Housing and Economic Recovery Act of 2008 § 3011.

128. I.R.C. § 36(f)(4)(B); Housing and Economic Recovery Act of 2008 § 3011.

129. I.R.C. § 36(f)(4)(C); Housing and Economic Recovery Act of 2008 § 3011.

130. I.R.C. § 36(f)(4)(C)(ii); Housing and Economic Recovery Act of 2008 § 3011.

MFDRA suggested a wide-ranging series of approaches attempted by Congress to halt the housing crisis in late 2007, the Congressional Record discussions of the HERA indicate a more targeted approach by Congress in the face of a more entrenched economic slump. By the summer of 2008, "the dream of homeownership ha[d] become a nightmare for too many people in our country."[131] Discussion among House and Senate members prior to the passage of the HERA highlighted two main purposes behind the first-time homebuyer tax credit. First, members predicted that the credit would serve as an incentive to home purchasing for first-time homebuyers.[132] Second, members also spoke of the credit as a tool with which Congress could reduce the glut of foreclosed homes available in the real estate market.[133] By naming these two underlying purposes, Congress demonstrated its intent to use tax law to spur desired taxpayer behavior. While several members praised the short-term nature of the first-time homebuyer credit, the comments in the Congressional Record indicate a lack of consideration of the long-term effects of employing a refundable tax credit to spur home purchases.[134]

1. "Jump Start the Market"

While Rep. Ron Klein (D – Fla.) offered one of the more pithy explanations of a major purpose behind the first-time homebuyer credit—"jump start the residential real estate market"—members echoed his sentiment on both sides of the aisle.[135] As Sen. Cardin (D – Md.) explained, "[w]e know that 40 percent of home buyers are first-time home buyers, and by helping first-time home buyers, we help the housing market and we help the economy. I think the provision in this bill that will provide a $7,500 credit or an interest-free loan will help."[136] On the Republican side, Sen. Isakson (R – Ga.) likened the 2008 credit to a similar credit passed by "[a] Democratic Congress and the Republican President, Gerald Ford."[137] As Sen. Isakson explained, "[t]hat incentive brought Americans off the sidelines and into

131. 154 CONG. REC. E1,564 (daily ed. July 25, 2008) (statement of Rep. McCollum).

132. *See, e.g.*, 154 CONG. REC. S7,460 (daily ed. July 25, 2008) (statement of Sen. Isakson).

133. *See, e.g.*, 154 CONG. REC. S6,271 (daily ed. June 26, 2008) (statement of Sen. Dodd).

134. *See, e.g.*, 154 CONG. REC. S7,496 (daily ed. July 26, 2008) (statement of Sen. Cardin) and 154 CONG. REC. S7,501–02 (daily ed. July 26, 2008) (statement of Sen. Baucus).
In contrast, Rep. Ron Paul (R – Tex.) highlighted a primary concern with legislation aimed at creating a short-term solution to a long-term problem: "Massive bills passed in knee-jerk reaction to crisis events will always be poorly written, burdensome and expensive to taxpayers, and destructive of liberty." 154 CONG. REC. E1,563, (daily ed. July 23, 2008) (statement of Rep. Paul).

135. 154 CONG. REC. H7,002 (daily ed. July 23, 2008) (statement of Rep. Klien).

136. 154 CONG. REC. S7,496 (daily ed. July 26, 2008) (statement of Sen. Cardin).

137. 154 CONG. REC. S7,460 (daily ed. July 25, 2008) (statement of Sen. Isakson).

the marketplace, and we absorbed a tremendous amount of the standing inventory [of unsold homes]. Values came back in the United States and the housing market responded."[138] Sen. Shelby's (R – Ala.) hopes for the tax credit echoed sentiments that pervade the Congressional Record: "I believe this should serve as an additional incentive to potential first-time buyers who may be waiting to purchase a home. The tax credit, combined with the greater availability of sustainable mortgages, should encourage buyers and help invigorate the housing market."[139]

However, Sen. Shelby's hope that a tax credit will catalyze new homebuyers to enter the market seems to assume that a surfeit of buyers with savings for a down payment exists and will come in and scoop up unsold homes. Rep. Capps's (D – Cal.) comment that the credit will "help young families . . . better afford the costs of buying a new home" might better describe the type of taxpayer who would seek to take advantage of the credit: those who do not have sufficient savings to cover the down payment on a new home purchase.[140] As Rep. Mitchell (D – Ariz.) predicted, the credit "will ensure that homebuyers without the traditional down payment capital are able to purchase their first home."[141] Thus one potential effect of the tax credit would result in an influx of undercapitalized homebuyers into the market—one of the causes of the housing crisis and subsequent slump that Congress is attempting to remedy. Another potential pitfall suggested by Rep. Mitchell's comment lies in the very nature of a tax credit. Any taxpayers who elect to take the $7,500 credit will not be able to apply that money to the down payment on a new home purchase because the credit will only become available when the taxpayers file their 2008 or 2009 tax returns, possibly months after the closing of the home purchase. Even if taxpayers reduced their wage withholding in the meantime, those taxpayers, for whom the $7,500 credit promises an influx of cash flow sorely needed to justify a home purchase, are likely not the sort of strongly capitalized, responsible homebuyers that the current economy needs.

In addition, several members highlighted the temporary existence of the first-time homebuyer credit. According to Sen. Baucus (D – Mont.), "[t]he short-term nature of this credit is also critical because it would avoid over-subsidizing the housing industry in the long run."[142] As Sen. Isakson

138. *Id.*

139. 154 CONG. REC. S7,499 (daily ed. July, 26, 2008) (statement of Sen. Shelby). *See also*, 154 CONG. REC. S7,457 (daily ed. July 25, 2008) (statement of Sen. Salazar).

140. 154 CONG. REC. E1,555 (daily ed. July 25, 2008) (statement of Rep. Capps).

141. 154 CONG. REC. H7,008 (daily ed. July 23, 2008) (statement of Rep. Mitchell).

142. 154 CONG. REC. S7,502 (daily ed. July, 26, 2008) (statement of Sen. Baucus).

explained:

> It doesn't bail anybody out; it incentivizes [sic] a market to come back. When that happens, the problems go away. We cannot regulate ourselves, as a nation, into a strong economy. But we can incentivize [sic] people and get confidence to the financial markets and restore what is a very shaky economy.[143]

Thus by focusing on short-term incentives Congress appears to have ignored, at least in part, incentives to spur responsible taxpayer behavior in the current housing climate.

2. Reduce the Number of Foreclosed Properties

The second Congressional purpose underlying the first-time homebuyer tax credit views the credit as a tool with which Congress can reduce the number of foreclosed homes available on the market. As Sen. Dodd (D – Conn.) described the credit, it "would allow [first-time home buyers] to purchase foreclosed properties" with government money.[144] Earlier in June, Sen. Grassley (R – Iowa) had elaborated on a desired effect of the credit: "There is a glut of homes on the market. The glut is depressing home values. It is important that this excess inventory is moved so that we can help retain home values of others who are not in foreclosure or have been foreclosed on."[145] Thus not only would new homebuyers buy up some of the excess supply on the market but those purchases would also halt the slide of home values because of distressed neighborhoods.[146]

Because the $7,500 credit will not be available to homebuyers until after they have completed the sale transaction, the second Congressional purpose stands a good chance of turning into action. The often-distressed condition of foreclosed homes causes the homes' new purchasers to incur substantial costs shortly after purchase in order to bring the property back into working order.[147] Since first-time homebuyers cannot apply the first-time homebuyer credit to their down payments on the purchase of a foreclosed home,[148] they could instead use the $7,500 towards the repair costs of the foreclosed home. This scenario illustrates a possible effective and

143. 154 CONG. REC. S7,460 (daily ed. July 25, 2008) (statement of Sen. Isakson).

144. 154 CONG. REC. S6,271 (daily ed. June 26, 2008) (statement of Sen. Dodd).

145. 154 CONG. REC. S5,784 (daily ed. June 19, 2008) (statement of Sen. Grassley). *See also* the comments of Sen. Baucus: "This bill would help to reduce the excess supply in the housing market due to declining home values and rising foreclosures." 154 CONG. REC. S7,501 (daily ed. July 26, 2008) (statement of Sen. Baucus).

146. *See, e.g.*, Bob Tedeschi, *Mortgages; Foreclosures Hurt Neighbors, Too*, N.Y. TIMES, Dec. 2, 2007, § 11, at 10.

147. For the condition of foreclosed homes, see *id.*

148. S*ee* discussion *supra* Part II.B.1.

beneficial use of the first-time homebuyer tax credit.

3. Long-term Consequence

The largest, and yet most ignored,[149] consequence of the first-time homebuyer tax credit lies in the repayment provision.[150] Every year for fifteen years after receiving the credit, taxpayers will have to pay up to an addition $500 in federal income taxes.[151] For the median taxpayers from the example in section I.B.3 above, that additional $500 per year represents a seventeen percent increase in the total amount of federal income tax owed each year. For taxpayers who will not have that additional $500 withheld from their pay during the year by their employers, the extra $500 owed at tax time may likely pose a significant hardship if the taxpayers do not have other credits or deductions to help offset the cost.

CONCLUSION

Did Congress fail in its attempts to address the housing crisis and subsequent economic recession? The former homeowner, who will save taxes when the house on which her lender foreclosed was worth less than its mortgage, will likely say no. Yet she nonetheless got something for nothing. She got to use and enjoy a house worth more than she can afford. The taxpayers who will foot the bill for these provisions will likely say yes. At this point in time, the Congressional approach to the housing crisis was too short-sighted and failed to encourage the sort of responsible long-term behavior that the U.S. economy desperately needs.

149. Only two members of Congress, out of sixteen who spoke about the first-time homebuyer tax credit in the Congressional Record, mentioned that recipients must repay the credit.

150. I.R.C. § 36(f) (2008); Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3011 (2007).

151. $7,500 divided by the 15-year repayment period.