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Recently Expired Housing Related Tax Provisions ("Tax Extenders"): In Brief

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Introduction

On December 18, 2015, a set of temporary tax provisions that are regularly extended and that are commonly known as "tax extenders" was retroactively extended by Division Q of P.L. 114-113—the Protecting Americans from Tax Hikes Act (or "PATH" Act). Some of the extensions are permanent; others are temporary. This report briefly summarizes and discusses the economic impact of the four housing related tax provisions included in P.L. 114-113. These provisions include (1) the tax exclusion for canceled mortgage debt; (2) the deduction for qualified mortgage insurance premiums; (3) the so-called 4% and 9% low-income housing tax credit (LIHTC) floors; and (4) the exclusion of military housing allowances for purposes of the LIHTC program. Prior to P.L. 114-113, the provisions discussed below were last extended through the end of 2014 by the Tax Increase Prevention Act of 2014 (P.L. 113-295).

Tax Exclusion for Canceled Mortgage Debt

Historically, when all or part of a taxpayer's mortgage debt has been forgiven, the amount canceled has been included in the taxpayer's gross income.[1] This income is typically referred to as canceled mortgage debt income. The borrower will realize ordinary income to the extent the canceled mortgage debt exceeds the value of any money or property given to the lender in exchange for cancelling the debt. Such exchanges are common in a "short sale," for example. Lenders report the canceled debt to the Internal Revenue Service (IRS) using Form 1099-C. A copy of the 1099-C is also sent to the borrower, who in general must include the amount listed in their gross income in the year of discharge.

It may be helpful to explain why forgiven debt is viewed as income. Income is a measure of the increase in one's purchasing power over a designated period of time. When an individual experiences a reduction in their debts, their purchasing power has increased (because they no longer have to make payments). Effectively, their disposable income has increased. From an economic standpoint, it is irrelevant whether a person's debt was reduced via a direct transfer of money to the borrower (e.g., wage income) that was then used to pay down the debt, or whether it was reduced because the lender forgave a portion of the outstanding balance. Both have the same effect, and thus both are subject to taxation.

The Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142), signed into law on December 20, 2007, temporarily excluded qualified canceled mortgage debt income that is associated with a primary residence from taxation. Thus, the act allowed taxpayers who did not qualify for one of several existing exceptions to exclude canceled mortgage debt from gross income. The provision was originally effective for debt discharged before January 1, 2010. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the exclusion of qualified mortgage debt for 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. Most recently, the PATH Act extended the exclusion through the end of 2016. The Act also allowed for debt discharged after 2016 to be excluded from income if the taxpayer had entered into a binding written agreement before January 1, 2017.

[1] Generally, any type of debt that has been canceled is to be included in a taxpayer's gross income. Several permanent exceptions to this general tax treatment of canceled debt exist. They are discussed in CRS Report RL34212, *Analysis of the Tax Exclusion for Canceled Mortgage Debt Income*, by Mark P. Keightley and Erika K. Lunder, Analysis of the Tax Exclusion for Canceled Mortgage Debt Income, by Mark P. Keightley and Erika K. Lunder.

The rationales for extending the exclusion are to minimize hardship for households in distress and lessen the risk that non-tax homeowner retention efforts are thwarted by tax policy. It may also be argued that extending the exclusion would continue to assist the recoveries of the housing market and overall economy. Opponents of the exclusion may argue that extending the provision would make debt forgiveness more attractive for homeowners, which could encourage homeowners to be less responsible about fulfilling debt obligations. The exclusion may also be viewed as unfair, as its benefits depend on whether or not a homeowner is able to negotiate a debt cancelation, the income tax bracket of the taxpayer, and whether or not the taxpayer retains ownership of the house following the debt cancellation.

The Joint Committee on Taxation (JCT) estimated the two-year extension included in the PATH Act would result in a 10-year revenue loss of $5.1 billion.[2]

Mortgage Insurance Premium Deductibility

Traditionally, homeowners have been able to deduct the interest paid on their mortgage, as well as any property taxes they pay as long as they itemize their tax deductions. Beginning in 2007, homeowners could also deduct qualifying mortgage insurance premiums as a result of the Tax Relief and Health Care Act of 2006 (P.L. 109-432). Specifically, homeowners could effectively treat qualifying mortgage insurance premiums as mortgage interest, thus making the premiums deductible if the homeowner itemized, and if the homeowner's adjusted gross income was below a certain threshold ($55,000 for single, and $110,000 for married filing jointly). Originally, the deduction was to only be available for 2007, but it was extended through 2010 by the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142). The deduction was extended again through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (P.L. 111-312), through the end of 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240), through the end of 2014 by the Tax Increase Prevention Act of 2014 (P.L. 113-295). Most recently, the PATH Act extended the deduction through the end of 2016.

Two justifications for allowing the deduction of mortgage insurance premiums are the promotion of homeownership, and, relatedly, the recovery of the housing market. Homeownership is often argued to bestow certain benefits to society as a whole, such as higher property values, lower crime, and higher civic participation, among others. Homeownership may also promote a more even distribution of income and wealth, as well as establish greater individual financial security. Last, homeownership may have a positive effect on living conditions, which can lead to a healthier population.

With regard to the first justification, it is not clear that the deduction for mortgage insurance premiums has an effect on the homeownership rate. Economists have identified the high transaction costs associated with a home purchase—mostly resulting from the downpayment requirement, but also closing costs—as the primary barrier to homeownership.[3] The ability to deduct insurance premiums does not lower this barrier—most lenders will require mortgage

[2] All revenue estimates in this report come from U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Budget Effects Of Division Q Of Amendment #2 To The Senate Amendment To H.R. 2029 (Rules Committee Print 114-40), The "Protecting Americans From Tax Hikes Act of 2015,"* 114th Cong., 1st sess., December 16, 2015, JCX-143-15.

[3] See for example, Peter D. Linneman and Susan M. Wachter, "The Impacts of Borrowing Constraints," *Journal of the American Real Estate and Urban Economics Association*, vol. 17, no. 4 (Winter 1989), pp. 389-402; Donald R. Haurin, Patrick H. Hendershott, and Susan M. Wachter, "Borrowing Constraints and the Tenure Choice of Young Households," *Journal of Housing Research*, vol. 8, no. 2 (1997), pp. 137-154; and Mathew Chambers, Carlos Garriga, and Donald Schlagenhauf, "Accounting for Changes in the Homeownership Rate," *International Economic Review*, vol. 50, no. 3 (August 2009), pp. 677-726.

insurance if the borrower's downpayment is less than 20% regardless of whether the premiums are deductible. The deduction may allow a buyer to borrow more, however, because they can deduct the higher associated premiums and therefore afford a higher housing payment.

Concerning the second justification, it is also not clear that the deduction for mortgage insurance premiums is still needed to assist in the recovery of the housing market. Based on the S&P Case-Shiller National Composite Index, home prices have increased consistently since the first quarter of 2012, which suggests that the market as a whole is stronger than when the provision was enacted. Extending the deduction may, however, assist some individuals who are in financial distress because of burdensome housing payments.

Last, economists have noted that owner-occupied housing is already heavily subsidized via tax and non-tax programs. To the degree that owner-occupied housing is over subsidized, extending the deduction for mortgage insurance premiums would lead to a greater misallocation of resources that are directed toward the housing industry.

The Joint Committee on Taxation (JCT) estimated the two-year extension included in the PATH Act would result in a 10-year revenue loss of $2.3 billion.

Low-Income Housing Tax Credit: The 9% Floor

The low-income housing tax credit (LIHTC) was created by the Tax Reform Act of 1986 (P.L. 99-514) to provide an incentive for the development and rehabilitation of affordable rental housing. Two types of LIHTCs are available depending on the nature of the rental housing construction: the so-called 9% credit for new construction, and the so-called 4% credit for rehabilitated housing and new construction that is financed with tax-exempt bonds. The credits are claimed annually over 10 years. The credit percentages do not actually equal 9% or 4%. Instead, the credit percentages are determined by a formula that is intended to ensure that the present value of the 10-year stream of credits equals 70% (new construction) and 30% (rehabilitated construction) of qualified construction costs. The formula depends in part on interest rates that fluctuate over time, implying that LIHTC rates fluctuate as well.

The Housing and Economic Recovery Act of 2008 (P.L. 110-289) temporarily changed the credit rate formula used for new construction. The act effectively placed a floor equal to 9% on the new construction tax credit rate. The 9% credit rate floor originally only applied to new construction placed in service before December 31, 2013. The 4% tax credit rate that is applied to rehabilitation construction or new construction jointly financed with tax-exempt bonds remained unaltered by the act. The American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the 9% floor for credit allocations made before January 1, 2014 and the Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the 9% floor through the end of 2014. Most recently, The PATH Act permanently extended the 9% floor, but left the 4% credit unchanged.

Historically, relatively low interest rates have resulted in the LIHTC rates being below the 4% and 9% thresholds. Because low interest rates persist, the floors would result in subsidies in excess of 30% and 70%. Specifically, the 4% floor would have resulted in a 37% subsidy and the 9% floor would have resulted in an 84% subsidy had they been in place as of the time of this writing (December 2015).

The floors on the credit rates address a concern among some LIHTC participants—that the variable rate method for determining the LIHTC rates discourages some investment because of the uncertainty it introduces over what the final credit rate for a particular project will be. The floors also indirectly address a potential problem in the original formula used for determining the variable credit rates. The original formula was designed to ensure that when the 10-year stream of

tax credits is discounted, the present value subsidies of 30% or 70% are achieved. However, the interest rate used to discount the tax credit streams is based on U.S. Treasury yields, which are generally viewed as risk-free. Investing in LIHTCs is not risk-free, which suggests that the interest rate used to compute the subsidy levels should be higher than the yield on U.S. Treasuries. Using a higher discount rate would result in higher LIHTC rates to achieve the 30% and 70% subsidies. The floors may result in credit rates that are closer to what using a higher discount rate would achieve.

At the same time, the floors may lead to fewer projects receiving funding. A fixed number of credits are made available each year on a per capita basis, or in the case of the 4% credit are limited by a state's tax-exempt bond capacity. If the total number of credits available does not change, but the number of credits each particular project receives is higher because of the floors, then fewer projects may get financing. Additionally, there may be better options for addressing issues about the LIHTC program. Specifically, the target subsidy levels of 30% and 70% could be increased, while still requiring that the variable rate formula for determining credits be used. This could be combined with a requirement that the discount rate used in the formula more accurately reflects the risk of investing in LIHTC.

The Joint Committee on Taxation (JCT) estimated the permanent extension included in the PATH Act would result in a 10-year revenue loss of $19 million.

For more information on the LIHTC program, see CRS Report RS22389, An Introduction to the Low-Income Housing Tax Credit, by Mark P. Keightley and Jeffrey M. Stupak; and CRS Report RS22917, The Low-Income Housing Tax Credit Program: The Fixed Subsidy and Variable Rate, by Mark P. Keightley and Jeffrey M. Stupak.

Low-Income Housing Tax Credit: Treatment of Military Housing Allowance

Tenants must have an income below a particular threshold to live in a LIHTC unit.[4] Specifically, a tenant must have an income of either 50% or less of the area's median income, or 60% or less of the area's median income. Which threshold applies depends on an election made by the developer that determines the targeted low-income population. Civilians as well as servicemembers are potentially eligible to live in LIHTC units. However, when calculating a servicemember's income for purposes of determining their eligibility, their annual pay *and* basic allowance for housing (BAH) must be included. The BAH is a tax-exempt form of compensation that is based on a servicemember's pay grade, location, and number of dependents.

The Housing and Economic Recovery Act of 2008 (P.L. 110-289) temporarily excluded military housing allowances from the LIHTC income calculations for properties near rapidly growing military bases. This, in turn, should make more servicemembers eligible to live in LIHTC housing. The exclusion applies to LIHTC properties in a county with a military base that experienced military personnel growth of 20% or more between December 31, 2005, and June 1, 2008, or that are located in an adjacent county. The HERA change was originally set to expire on December 31, 2011, but it was subsequently extended through the end of 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240). The Tax Increase Prevention Act of 2014 (P.L. 113-

[4] A LIHTC property may be composed of both affordable rental units and market-rate rental units. However, only the costs associated with the affordable rental units may be offset with tax credits.

295) extended the exclusion through the end of 2014. Most recently, the PATH Act permanently extended the exclusion.

The exclusion may help address a concern, held by some, that there is a lack of affordable housing near particular military bases. The exclusion increases the incentive for the development of affordable rental housing available to military families in these locations, and, as a result, may alleviate rising rents near particular military bases. A 2005 Government Accountability Office report, however, suggests that the exclusion may have limited effect for several reasons.[5] First, junior enlisted servicemembers and those without dependents typically live in barracks. Second, housing allowances are already intended to cover the area median cost of living, and are adjusted for changes in area rents. Third, Department of Defense officials can increase housing allowances if warranted. In addition, the exclusion could have the unintended consequence of displacing the construction of LIHTC properties for civilians.

The Joint Committee on Taxation (JCT) estimated the permanent extension included in the PATH Act would result in a 10-year revenue loss of $83 million.

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[5] U.S. Government Accountability Office, Rental Housing Programs: Excluding Servicemembers' Housing Allowance from Income Determinations Would Increase Eligibility, but Other Factors May Limit Program Use, GAO-06-784, July 2006, http://www.gao.gov/assets/260/250986.pdf.