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Before the Senate Committee on Finance

At a Hearing on "The Housing Decline: The Extent of the Problem and Potential Remedies"

Mr. Chairman and members of the Committee:

I am pleased to have the opportunity to discuss with you the tax consequences that arise on debt foreclosure or workout pertaining to a principal residence. I shall discuss the rules that apply to debt-discharge income generally, how those rules apply in the specific context of debt pertaining to a principal residence, and why I believe that the relief provided in The Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648), passed by the House of Representatives on October 4, 2007, is justifiable, except that I believe that—for conceptual reasons rather than revenue reasons—the relief should be temporary. Moreover, it would be conceptually defensible to dispense with the basis reduction required by H.R. 3648, though whether or not basis is reduced would likely have few real-world consequences. I explore each of these points below.

Sections 61(a)(12) and 108 of the Internal Revenue Code

Under our income tax, cash received is generally not includable in gross income so long as it is subject to an absolute and unconditional obligation to repay, which both parties acknowledge at the time of receipt.[1] This so-called borrowing exclusion does not mean that borrowed cash is not taxed at all. Rather, we usually tax borrowed cash upon *repayment* of the principal with nondeductible (*i.e.*, after-tax) dollars. That is to say, by denying deduction of the principal repayment, that repayment remains within the tax base for the year of repayment and is thus effectively taxed in that repayment year. If the repayment obligation disappears, however, the usual tax event (the act of repayment with

[1] *James v. Unites States*, 366 U.S. 213 (1961). In contrast, a cash receipt subject only to a conditional obligation to repay (rather than an absolute obligation to repay) is includable in the year of receipt. *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). If the condition ripens and repayment actually occurs, the taxpayer would then generally be entitled to a deduction in the year of repayment.

after-tax dollars) will never occur. Without a tax rule to account for this nonpayment, the borrower will have received *permanently* tax-free cash in the year of original receipt (because it was not included in gross income in that year *only* because it was subject to an absolute obligation to repay that we now know will never occur).

We could, in that event, require the taxpayer to file an amended return for the year of receipt because now we know, with the benefit of hindsight, that it was not actually going to be repaid and that the premise of the exclusion was thus not satisfied. But that would be impossible if the year of receipt was beyond the three-year statute of limitations. More important, the exclusion was *proper* in the year of receipt because, in that year, everyone truly expected repayment in the future. Under the annual accounting principle, we typically account for changed circumstances in the year our expectations about what would happen do not materialize. Thus, § 61(a)(12) of the Internal Revenue Code provides that the discharge of debt results in gross income in the year of discharge. In this way, § 61(a)(12) ensures that the originally borrowed cash is not made permanently tax-free if the repayment obligation upon which the original exclusion was premised disappears.[2]

For example, assume that Borrower borrows $400,000 at market-rate interest in Year 1, incurring an absolute obligation to repay the $400,000 in Year 5. Under the borrowing exclusion, Borrower does not include this $400,000 in his gross income in Year 1, regardless of whether he uses that $400,000 for business, investment, or personal purposes. If all goes as expected, Borrower repays that $400,000 principal in Year 5 and is not permitted to deduct that repayment from his gross income (again, regardless of the use to which he put that $400,000 in the interim). Because Borrower was denied a deduction for that repayment, the $400,000 used to make that repayment remains within his tax base for Year 5 and is thus effectively taxed to Borrower in Year 5. If, however, the creditor discharges Borrower's obligation to repay that $400,000 in Year 5 for some reason, Borrower will not repay with after-tax dollars (the usual method of taxing Borrower on that $400,000). Thus, Borrower realizes $400,000 of § 61(a)(12) debt-discharge income in Year 5 to ensure that the original $400,000 receipt is effectively taxed.

Section 108(a)(1)(A) provides that § 61(a)(12) debt-discharge income may be excluded from gross income if the discharge is granted by a Bankruptcy Court or is

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[2] Instead of excluding borrowed principal on receipt and denying deduction on repayment (thus taxing borrowed money at the time of repayment), we could require inclusion of borrowed principal on receipt in every case (rather than only in those cases involving a conditional, rather than absolute, obligation to repay, as discussed in footnote 1) and then allow a deduction for principal repayments. In that case, we would not need § 61(a)(12) to ensure taxation of borrowed principal in the case of nonpayment. The taxpayer who fails to repay principal would simply lose the deduction that would otherwise attend the principal repayment. But, except with respect to receipts subject only to a conditional rather than absolute obligation to repay, such an approach has never been seriously considered in this or any other country employing an income tax. *See generally* Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should be Eliminated*, 26 VA. TAX REV. 245 (2006) (exploring, in part, whether a cash-flow approach to borrowing is conceptually superior).

pursuant to a plan approved by the court. This bankruptcy exclusion is not intended to be a complete forgiveness provision, however, but rather only a deferral provision. For every dollar of debt-discharge income excluded, the taxpayer must reduce valuable tax attributes listed in § 108(b), including net operating loss carryovers, capital loss carryovers, and basis in property owned by the taxpayer. The effect of these reductions should be that the taxpayer's gross income is higher in future years by an amount exactly equal to the amount excluded in Year 1. Because no interest is charged for the benefit of this deferral, however, the taxpayer is still better off because of the time value of money. Moreover, if the taxpayer possesses none of the tax attributes listed in § 108(b), the exclusion becomes, in effect, a complete forgiveness provision.

The bankruptcy exclusion is best understood as placing federal bankruptcy policy above a concern for the immediate collection of tax revenue. Absent this exclusion, the tax debt arising on the debt discharge in the bankruptcy proceeding itself would create a new creditor (the Internal Revenue Service), and under bankruptcy law this new creditor could jump ahead of other creditors in sharing in the bankruptcy estate. The exclusion prevents the creation of this new creditor so that other creditors take first. If, however, the taxpayer has any of the tax attributes listed in § 108(b), reduces them by the amount of the excluded debt-discharge income, and becomes profitable in the future, the government will nevertheless indirectly recover the tax due on the debt-discharge income realized in the earlier year.

If the debt is not discharged in a bankruptcy proceeding but the taxpayer can nevertheless show that he is "insolvent," he can exclude the debt-discharge income but only to the extent of his insolvency under § 108(a)(1)(B), (a)(3). Insolvency is measured immediately before the debt is discharged and is equal to the excess of the taxpayer's aggregate liabilities over the aggregate fair market value of his assets. For example, assume that Jacob owns assets worth $100,000 and has liabilities of $150,000 when a creditor cancels a $60,000 debt that Jacob owed him. If the cancellation occurs in a bankruptcy proceeding, Jacob's entire $60,000 of debt-discharge income is excluded from his gross income. If, however, Jacob is not in bankruptcy court when this happens, Jacob can exclude only $50,000 of the $60,000 debt-discharge income (*i.e.*, to the extent of his $50,000 insolvency measured before the debt discharge) and must immediately include the remaining $10,000. To the extent that Jacob has tax attributes listed in § 108(b), he must reduce them by the $50,000 that he excluded.

The insolvency exclusion is more difficult to rationalize. By definition, the taxpayer is not in bankruptcy court or the more generous bankruptcy exclusion would apply.[3] The

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[3] Moreover, no other type of gross income is excludable simply because the taxpayer is insolvent. Suppose, for example, that

> Hallie owed $20,000 to the local grocer by reason of buying subsistence food items on credit and had no assets. She had been taught that she is morally obligated to pay her debts. Consequently, she worked the graveyard shift at a deep coal mine, where the prevailing temperature was 115° F, until she earned $20,000 and paid her liabilities in full.

insolvency exception is likely no more than an historical artifact premised on Justice Holmes's early articulation of the reason why debt cancellation created debt-discharge income. In *United States v. Kirby Lumber*,[4] he reasoned that a debt discharge "frees up" assets previously subject to the cancelled liability, and it is this "freeing up" of assets that results in the realization of income. Subsequent courts early on concluded, based on this reasoning, that if assets weren't "freed up" upon the discharge of a debt because the taxpayer remained insolvent after the discharge, with all of his assets still effectively subject to liabilities, then no debt-discharge income was realized.

This "freeing up of assets" rationale for debt-discharge income no longer reflects current thinking.[5] The current rationale for debt-discharge income, as described above, is premised on the borrowing exclusion itself. Regardless of whether the taxpayer is insolvent, the taxpayer's original receipt of excluded cash would become permanently tax-free upon debt cancellation absent the realization of debt-discharge income. Congress has indicated its acceptance of this more modern thinking when it created current § 108 in 1980. The common-law insolvency exclusion that the statutory exclusion replaced was a complete forgiveness provision; the insolvent debtor was never deemed to realize debt-discharge income in the first place. As described above, however, the statutory insolvency exclusion under current § 108 is not usually a complete forgiveness provision but rather only a deferral provision. Debt-discharge income *is* deemed to be realized by the insolvent debtor, though taxation of this income is deferred through the mechanism of reducing the valuable tax attributes listed in § 108(b) by the excluded amount.

<u>Debt Foreclosures and Workouts Pertaining to a Personal Residence</u>

Suppose that Tom purchased a primary residence for $5,000 in cash plus $195,000 in debt in 2005, resulting in a $200,000 cost basis.[6] When the unpaid principal balance remains $195,000 on his interest-only loan, Tom discovers that the fair market value of his home has been reduced to $170,000 in 2007. He defaults on the debt, and the lender forecloses, taking title to the property.

In most instances, Tom's transaction is bifurcated into its two component parts for tax purposes. First, Tom is deemed to sell the property for its $170,000 current value, and then he is deemed to use the $170,000 proceeds to settle the $195,000 outstanding debt.[7]

Joseph M. Dodge, J. Clifton Fleming, Jr., & Deborah A. Geier, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, & POLICY 310 (3d ed. 2004). Even though she was insolvent throughout this period, her compensation income is not excludable from gross income. If, however, the grocer cancelled the debt, Hallie could exclude that particular kind of gross income because of her insolvency.

[4] 284 U.S. (1931).

[5] *See generally* Deborah A. Geier, *Tufts* and the Evolution of Debt-Discharge Theory, 1 FLA. TAX REV. 115 (1992).

[6] Under *Crane v. Commissioner*, 331 U.S. 1 (1947), debt used to acquire property is included in the cost basis of that property.

The deemed sale will result in a $30,000 loss under § 1001 ($170,000 amount realized *less* $200,000 basis). This loss would be nondeductible under § 165(c) because it arose from the sale of personal-use property. The deemed debt settlement will result in $25,000 of debt-discharge income if the lender discharges the shortfall ($195,000 debt *less* $170,000 repayment), which is excludable under current § 108 only if Tom is insolvent (or the discharge occurs in bankruptcy court).

Alternatively, assume the same facts except that the lender does not foreclose but rather reduces the outstanding $195,000 debt in a workout to $170,000 to reflect its current value. Because there is no property transfer, there is no § 1001 calculation (and no resulting nondeductible personal loss). But, as before, Tom nevertheless realizes $25,000 of debt-discharge income that would be excludable only if Tom is insolvent or in bankruptcy court.[8]

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[7] *See* Treas. Reg. § 1.1001-2(a)(2) and -2(c) Ex. 8; Rev. Rul. 90-16, 1990-1 C.B. 12.

[8] A different analysis would arise if the debt were considered "nonrecourse" rather than "recourse." A "nonrecourse" debt is one for which the taxpayer is not personally liable. The lender's only recourse on nonpayment is foreclosure on the property security. A "recourse" debt may also be secured by property, but the lender's recourse on nonpayment goes beyond taking possession of the property security and, depending on state law, can result in liens being placed on other property owned by the taxpayer or even wage garnishment.

With respect to a transfer of property subject to a nonrecourse debt, the "collapsed" approach adopted by the Supreme Court in *Commissioner v. Tufts*, 461 U.S. 300 (1983), and reflected in Treas. Reg. § 1.1001-2(a)(1) would apply instead of the "bifurcated" approach described in the text. Under the collapsed approach, Tom is not considered to first sell his property for its value (requiring computation of his sale gain or loss under § 1001) and then to settle the debt with the amount deemed realized on the sale (which would create debt-discharge income to the extent the debt exceeds the deemed sales proceeds). Rather, only a § 1001 calculation is done, and the debt relief is thrown into the taxpayer's "amount realized" under § 1001(b) from which basis is subtracted to create either a gain or loss. No debt-discharge income is deemed realized. Thus, in the text's hypothetical, Tom would be deemed to realize only a $5,000 nondeductible personal loss ($195,000 amount realized equal to the debt relief *less* $200,000 basis) and no debt-discharge income.

How do we know whether mortgage debt with respect to a personal residence is "recourse" or "nonrecourse"? Under current law, we do not have any guidance on how to make this determination. If we are limited to looking at the four corners of the loan documents, virtually all home loans are recourse. If, however, we are permitted to look beyond the loan documents to the effect of state statutes, apparently California law often prevents lenders from looking beyond the personal residence for repayment in most, if not all, cases. Does the effect of the state statute turn the loan, nominally recourse under the loan documents, into a nonrecourse loan? If we are permitted to look beyond the loan documents to state statutes, would it be permissible to look even further to the reality that most lenders making home loans—wherever located—look *only* to the value of the home for repayment, notwithstanding the nominally recourse label used in the documents? As I understand it, most lenders do not often pursue liens on other property owned by the home owner, wage garnishment, *etc.* If home loans were characterized under any of these theories as "nonrecourse," we need no change in statutory law in the transfer situation. *Tufts* comes to Tom's rescue already; he would realize no debt-discharge income.

However, *Tufts* would provide no relief in the workout situation where the debtor retains ownership of the home. A cancellation of nonrecourse debt *without* a transfer of the property security creates debt-discharge income equal to the amount cancelled. *See* Rev. Rul. 91-31, 1991-1 C.B. 19. This is one reason

Many taxpayers like Tom are not, in fact, legally insolvent because of retirement savings that cannot be accessed without stiff tax penalties. Though they may be functionally insolvent (with credit card and mortgage debt exceeding the reduced value of the home and other assets outside retirement accounts), they are not legally insolvent and thus gain no protection from the insolvency exclusion. These are the taxpayers that would be protected by H.R. 3648.

H.R. 3648

Under H.R. 3648, the solvent taxpayer would be permitted to exclude debt-discharge income realized on or after January 1, 2007, with respect to the taxpayer's primary residence to the extent of $2 million so long as the discharged debt satisfied the definition of "acquisition indebtedness" within the meaning of § 163(h)(3), pertaining to the deduction of qualified residence interest (other than the $1 million ceiling usually applicable to "acquisition indebtedness"). "Acquisition indebtedness" is debt that is secured by a personal residence and that was incurred to acquire, construct, or substantially improve the home (as well as debt that was used to refinance such debt). Thus, not only "first mortgages" can qualify. Second mortgages and home equity debt (in the non-tax sense of the term) can quality as "acquisition indebtedness" to the extent that the proceeds were used for one of the qualifying purposes. Home equity debt that is not used to acquire, construct, or substantially improve the home may produce deductible "qualified residence interest" under § 163(h)(3), but the discharge of such debt would result in debt-discharge income that could not be excluded under H.R. 3648 but rather could be excluded only to the extent that the taxpayer was in bankruptcy court or was insolvent.

H.R. 3648 provides that the amount excluded would reduce the basis of the personal residence only (and not any of the other tax attributes listed in § 108(b)), though it is not clear whether this basis reduction would occur in the year of the discharge or (under the

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why simply extending the *Tufts* approach to home mortgage debt foreclosures (even if the debt is recourse) would be incomplete relief.

Moreover, even in the transfer situation, *Tufts* is unwise law, in my view, because failing to bifurcate the transaction into its component parts can undermine Congress's rules for each separate leg. Moreover, having different rules in the transfer context for debt in excess of the value of the property, depending on whether the debt is styled "recourse" or "nonrecourse," and having different rules for nonrecourse debt itself, depending on whether the property security is transferred (no debt-discharge income but only a § 1001 calculation) or retained (debt-discharge income) works chiefly to encourage economically inefficient tax-motivated transactions whose sole aim is to opt into or out of these disparate rules, a phenomenon I describe more fully elsewhere. *See* Deborah A. Geier, *Another Take on the Home Mortgage Debt Relief Situation*, TAX NOTES (Oct. 22, 2007). These discontinuities would have never materialized if the government had adopted the bifurcated approach in the *Tufts* context, as well. Whether the debt is recourse or nonrecourse would not matter to the tax outcome. Whether the property were transferred, on the one hand, or retained with a negotiated partial debt cancellation on the other, would not matter to the tax outcome. Inefficient tax-motivated transactions would not occur. I think that would be a change for the better. For these reasons, I do not advocate an approach to the current home mortgage problem that would extend *Tufts* to home mortgage foreclosures. A narrowly tailored relief provision in § 108 is more appropriate, in my view.

usual rule in § 108) would occur at the beginning of the following taxable year. If the usual rule applied (the basis reduction occurs in the year following discharge), whether the basis reduction would have any effect would turn on whether the debt was discharged on a foreclosure transfer or in a workout, with the residence retained by the taxpayer. In the former, the basis reduction could have no effect, as the taxpayer no longer owns the residence. In the latter, where the taxpayer continues to own the residence, the basis reduction could produce a larger realized gain (or a reduced realized loss) on later sale. If sold at a gain, however, the gain might nevertheless be excluded under § 121, which generally allows exclusion of up to $250,000 of realized gain ($500,000 for married couples filing jointly) on home sale gain so long as the taxpayers owned and resided in the home for at least two of the previous five years.

If, contrary to the current § 108 approach, the basis reduction is deemed to occur in the same year as the property transfer, the basis reduction would have the same result in the workout situation. In the transfer situation, the basis reduction would typically reduce the amount of nondeductible loss realized by the taxpayer. In our hypothetical, Tom—who would be permitted to exclude the $25,000 of debt-discharge income under H.R. 3648 even if he is solvent—would reduce his $200,000 basis to $175,000. Because, in the first step of his bifurcated analysis, he is deemed to sell the property for its $170,000 value, his nondeductible loss would be reduced from $30,000 to only $5,000. Because the loss is nondeductible, however, the basis reduction has no real effect.

Analysis and Recommendations

Because H.R. 3648 effectively applies only to solvent taxpayers, the central question is whether the solvent taxpayer is deserving of any exclusion here. The key to understanding this analysis, in turn, is the treatment of the loss on the deemed sale of the residence in the first step of the bifurcated treatment. Recall that, in our hypothetical, Tom's transfer in foreclosure results in a $30,000 nondeductible personal loss (the difference between the home's $170,000 value at the time of the transfer in foreclosure and Tom's $200,000 original purchase price) and $25,000 of debt-discharge income (the difference between the $195,000 debt owed and the $170,000 value of the house transferred to settle the debt). The problem arises here chiefly because personal residences are categorized for tax purposes entirely as personal-use assets providing personal consumption. Wealth used in consumption should not reduce the tax base under income tax principles. Thus, personal residences are not depreciable (as are business and investment real estate), and losses on sale are not deductible.[9] In contrast, if Tom had

[9] For non-tax purposes, personal residences are viewed by most people as mixed-use property. That is to say, a home provides shelter (personal consumption), but it also provides the chance for value appreciation (investment). Indeed, most middle class taxpayers see their home as their primary investment vehicle. Most indivisible mixed-use outlays that contain both personal and income-producing components are nevertheless categorized in an all-or-nothing manner for tax purposes as either wholly personal or wholly business/investment. The one exception is a business meal or business entertainment. Section 274(n)(1) provides that 50% should be allocated to personal consumption (not deductible) while 50% can be allocated to income production (deductible).

bought stock instead of a personal residence with the debt, his $30,000 loss would be deductible.

In a more normal market for personal residences, this categorization of personal residences as personal-use assets that cannot produce deductible losses is generally a good rule. If a home loses value in such a market (when most homes at least maintain nominal value, if not appreciate), the reason is usually because the owner failed to maintain the home or made idiosyncratic changes that she liked but which the market abhorred. That is to say, the value loss is usually due to personal consumption of the taxpayer, just as use of a personal-use car, which reduces its value, reflects personal consumption of the driver. In that case, the value loss reflects personal consumption and thus should remain in the taxpayer's tax base. Application of the usual rule results in this treatment: the loss is nondeductible and the debt, which effectively paid for this personal consumption, results in includable gross income if the debt is discharged.

But in the current unusual market conditions, the value loss of the personal residence does *not* likely reflect personal consumption of the taxpayer. The loss in value wasn't consumed by Tom but rather was an artifact of this unusual market. Tom still cannot deduct the loss, however.

In other words, the problem arises here chiefly because the Internal Revenue Code, in effect, *assumes* that any loss in value of a personal residence is due to personal consumption rather than market forces unrelated to the taxpayer's consumption. That is usually true and thus a good rule. Historically, most well-maintained homes at least retain nominal value over time. But today the unusual market conditions mean that in many cases the loss in value is due to market conditions (as occurs with investment property like stocks and bonds) and *not* to any personal consumption of the taxpayer. Thus, the only way to properly measure this taxpayer's wealth is to conclude that the debt-discharge income should not be taxed.[10]

In an ideal world, we would identify those value losses resulting from consumption by the taxpayer and those resulting from market forces unrelated to consumption by the taxpayer. Those debt discharges resulting from the former would result in includable income by the solvent taxpayer, whereas those debt discharges resulting from the latter would not. Because I do not think it would administratively feasible to make such identifications, however, I believe that the H.R. 3648 should be made temporary. The current market conditions are unusual. Because most home value losses today are more likely due to these market conditions rather than due to personal consumption, it might be

[10] Temporarily making deductible a realized loss on a foreclosure transfer of a personal residence (because not representing personal consumption in this unusual market) combined with inclusion of the debt-discharge income by solvent taxpayers would not be an adequate remedy, as it would do nothing for the owner who remains in his home after a debt workout with his lender. The loss in home value, which convinces the lender to reduce the debt, is not "realized" absent a transfer of the home, and thus the loss could not be deducted in any event. Amendment to § 108 would, in contrast, provide appropriate relief to both taxpayers who transfer in foreclosure and taxpayers who have their debt reduced in a workout but who retain their home.

administrable “rough justice” to allow *all* such debt-discharge income to be excluded without a specific showing that the home’s loss in value was due solely to market conditions rather than personal consumption. But that will not be true forever; the home market will eventually revert to the historical norm where most well-maintained homes at least hold their nominal value (if not actually appreciate over time). When that happens, most value loss, if it occurs, will be due to personal consumption and thus any resulting realized debt-discharge income should be includable by the solvent taxpayer.

How long such a temporary measure should last depends on how long it is anticipated that the market will continue to experience across-the-board value reductions that do not represent personal consumption by owners. This is a non-tax empirical prediction outside my expertise.

I also argue that the pending bill is correct to allow exclusion only for discharged acquisition indebtedness (including second mortgages and home equity debt, in the non-tax sense of the word, to the extent that it was used to substantially improve the home). It would not allow exclusion of discharged home equity debt used to fund personal consumption. I believe that treatment is correct, as such debt is tantamount to credit card debt that just happens to be secured by the home. If such debt is cancelled, the justification for exclusion described above (that the debt relief does not likely reflect personal consumption by the taxpayer) disappears.

I also see no reason (from a conceptual point of view) to limit the exclusion to $2 million of debt relief. If the loss in home value truly does not reflect personal consumption by the taxpayer, it should not be taxed (at least as a conceptual matter), as only “income” is intended to be captured under the income tax. If after careful consideration we choose to tax apples instead of oranges, a person with oranges should not be taxed, even if he could afford to pay the tax. The underlying conceptual analysis described here is not affected by the degree of debt relief.

Next, because the underlying conceptual analysis is premised on the assumption that the home value reduction in today’s market does not represent personal consumption by the taxpayer, I see no reason to require a basis reduction in the personal residence, which is usually intended under § 108 to result only in deferral rather than forgiveness. For the reasons described earlier, Congress has made the decision to defer the tax due on debt-discharge income realized by the bankrupt or insolvent taxpayer but not to forgive it. That approach, however, assumes that the debt discharge, as a conceptual matter, properly produces “income,” even though the taxation of that income should be deferred for policy reasons. In contrast, the debt discharges in the current home mortgage market are due to unusual reductions in home values that do not truly represent personal consumption by the taxpayer and thus should not be taxed in the year of discharge or any other year.

I believe that the basis-reduction rule in H.R. 3648 was inserted, without reflection, simply because we see such deferral (rather than forgiveness) in connection with the bankruptcy and insolvency exclusions in general. Because H.R. 3648 is premised on far

different underlying conceptual grounds, the usual approach need not necessarily apply. If the Committee decides to keep it simply for the sake of formal consistency, however, in most instances the basis reduction would not result in any real-world consequences. It would either increase the amount of nondeductible loss or produce gain that is likely excludable under § 121.

Finally, whether the proposed January 1, 2007, effective date of H.R. 3648 is adequate to capture the debt discharges arising because of falling home prices is an empirical question beyond my expertise. If there is substantial evidence that these foreclosure transfers (or debt workouts) due solely to market value reductions began before 2007, then the provision should be made retroactive to the date when they began. If the debt discharge does not properly reflect "income" as a conceptual matter (because not reflecting personal consumption of the home by the taxpayer), then it should not matter when it arises; it should not be taxed.