

What Were the Tax Deductions Offered to Help Cure the Housing Crisis? Did They Work?

Teresa K. Lang
Auburn University Montgomery
Montgomery, Alabama USA
tlang@aum.edu

Rita C. Jones
Troy University
Phenix City, Alabama USA
ritajones@troy.edu

Abstract

The housing market crisis hit America in 2007, and in response, congress and other authorities responded with several stimulus measures. Two measures were implemented using the Internal Revenue Code: (1) the first-time homebuyer credit and (2) the mortgage forgiveness debt relief and debt cancellation act. This paper reviews home sales data to evaluate the effectiveness of these tax incentives. Based on the findings, this research indicates there was little or no effect on the housing market.

Introduction

The last decade in the United States has been marred by numerous financial challenges. Economists refer to the housing crisis in this period as the worst financial crisis since the Great Depression (Markels, 2008). From falling stock prices to high unemployment, the country has been on a downward economic spiral. In the past, the government has tried to help the economy by initiating tax credits and deductions to stimulate a particular area of the economy. The most recent downturn was no exception.

Many people claim they know the reasons causing the housing crisis, and like any other highly publicized financial topic, there were, and are, some farfetched ideas on how the country could overcome this particular crisis and rebuild the housing market. Politicians decided to use the Internal Revenue Code in their attempt to address the problem. Temporary tax deductions and tax credits were devised to encourage people to re-enter the housing market. Perhaps the most well-known tax provision is commonly referred to as the First-Time Homebuyer Credit (FTHBC). Other tax provisions dealt with debt forgiveness and also took the form of new taxpayer credits. These deductions applied to a wide segment of the population who were suffering due to the market downturn. This paper reviews some of the tax credit incentives along home sales data to determine how effective these inducements were in improving the housing situation.

Leading up to the Crisis

The housing crisis, also known as the sub-prime crisis, hit America full force in 2007; however, according to the Mortgage Bankers Association, the crisis began in 2005 to 2006, but became

more dramatic in 2007-2008 when mortgage rates began to rise and default rates jumped from 1.7 to 5.2 percent (Mayer, et.al., 2009). This preceded the largest financial crisis in decades. Economists have debated the origins of the U.S. mortgage crisis for years, but generally agree that inappropriate business practices, unrealistic optimism by borrowers and investors, and ineffective government regulations were contributing factors (Scanlon, Lunde, & Whitehead, 2011).

Historically, a home buyer needed to have money for a down payment, traditionally 20%, to purchase a home. They also had to prove their ability to pay off a mortgage, typically the remaining 80%, in order to purchase a house. Beyond providing proof of income, they had to have a good credit rating. However, in the years leading up to the housing meltdown, lending practices changed. Borrowers would be approved to take out two loans to purchase a house: one loan for 80% of the purchase price and a second loan to count toward the “down payment” portion of the purchase. In this way, borrowers could avoid paying the additional cost of mortgage insurance, and move into a home with little-to-nothing invested. These loans are referred to as piggy-back mortgages (Zandi, 2009). According to Standard and Poor’s, by 2004, approximately 66 percent of loans contained a piggyback mortgage. In addition, lenders did not consistently perform due diligence to verify either the borrowers’ income or their ability to repay the mortgage.

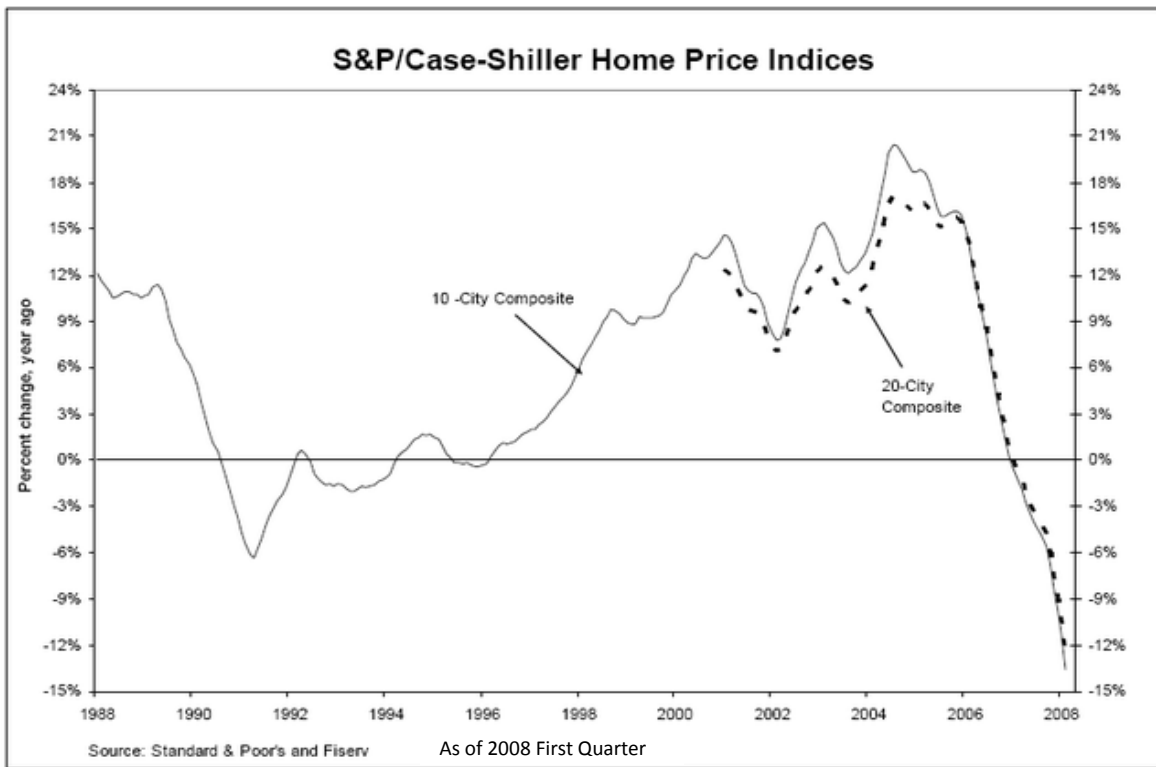
Between 1996 and 2006, according to Figure 1, which presents S&P’s/Case-Shiller Home Price Indices (2008), the national level of home prices grew at an average of about 6 percent per year, and this led to speculation. This long-term growth in the housing market led borrowers, lenders, and regulators to believe the price of houses would only go one way—up. Lenders wrote mortgages knowing the borrower more than likely could not repay. One rationale for this was that the property value would increase quickly enough that an interest only, or adjustable rate, mortgage would allow the borrower to hold the property long enough to resell it at a profit and repay the loan before the interest rate adjusted or the principal payments kicked in (Zandi, 2009).

Another issue involved the system lenders used to handle mortgages. Lenders earned commissions based on the mortgages written, without consideration for ultimate collection. Soon after the mortgages were written, they were sold to Federal agencies and investment institutions, transferring risk of foreclosure away from the loan originator. This practice of reward without ultimate risk, resulted in lenders lowering borrowing qualification standards in order to qualify more potential home buyers for home mortgages. As referred to earlier, piggy-back mortgages were used so that in many instances, borrowers did not put any money down to purchase a house. This meant that practically anyone in the United States was eligible to buy a house, even if they had poor credit scores. The low standards set by government regulations allowed people to purchase homes completely out of their capacity to pay (Jones, Beard, Langston, 2010).

These sub-prime mortgages were bought and sold similar to stocks, and when the housing bubble burst, many companies were left holding these mortgages that were now worth significantly less than the original purchase price. After all of the securities trading, it was hard to tell what some of the mortgages were worth because of deals made in bundling them. In the end, the consequences of this crisis were that many Americans lost their homes in foreclosure, because

after the bubble burst, many people were left holding mortgages with rates that adjusted upwards which caused staggering increases in monthly mortgage payments. Homeowners had the opportunity to refinance their mortgages for lower fixed rate mortgages, but by that time, lenders had become far more restrictive on approving loans, and many homeowners owed more on the home than it was worth.

Figure 1: S&P/Case-Shiller Home Price Indices



Tax Incentives

First-Time Homebuyer's Credit, 2008

In 2008, The Housing and Economic Recovery Act was the first act to establish the First-Time Homebuyer's Credit. The year 2008 had the strictest requirements, because the credit was required to be paid back in full over 15 equal, annual installments starting in 2010. The credit was thought of more as a zero interest loan and was limited to 10% of the mortgage on the home, up to a maximum of \$7500. The government was using a tax credit to encourage the US citizens to get back into the housing market. The problem is there were not enough checks and balances included in the FTHBC, and this led to negative issues down the road (IRS, First-Time Homebuyer Credit. 2013).

In order to be eligible to receive this credit, the buyer could not have owned a home three years prior to purchasing the new house, and the purchased house had to be used as a main residence. This weeded out people from buying a second, or vacation, home on the program. Buying a

home from a relative also made someone ineligible. If the home was sold or stopped being used as a main home in the fifteen years following the purchase, the remainder of the credit was immediately due back in full. If a married couple claimed the credit on their joint return and a spouse died, the living spouse only had to pay their half of the credit back. This credit did entice taxpayers to enter the housing market, but it also created problems for the Internal Revenue Service (IRS) when it came to validating the credits. The succeeding credits provided even better opportunities to purchase new homes as well as confusion for tax payers due to the change in terms.

First-Time Homebuyer's Credit, 2009 and 2010

In 2009, a different act was passed with one major difference. The Worker, Homeownership and Business Assistance Act of 2009 did not require its recipients to pay back the credit as long as the home remained their main residence for at least three years. This act increased the maximum credit to \$8000. The credit could be claimed on the 2008 or 2009 tax returns for homes purchased in 2009, but it could not be claimed before the closing date. Under this act, long-time homeowners were eligible to claim this credit if they bought a house in 2010. The acts were established to motivate people to buy new homes, and they each had a phase-out stage based on income. This meant that some people would not qualify for the credit because their adjusted gross income was too high. The credit was extended to 2010 with no major changes. Problems arose because of the dramatic difference between this act and first credit act. The IRS increased the audit rate for these credits due to the confusion caused by the differences between the FTHBC of 2008 and 2009 (IRS, First-Time Homebuyer Credit, 2013).

Mortgage Forgiveness Debt Relief Act and Debt Cancellation

Congress tried to help out the families on whose houses were foreclosed during these turbulent times. The Mortgage Forgiveness Debt Relief Act of 2007 allowed taxpayers to exclude income from debt forgiveness if they had to dispose of their primary residence. This act was applicable in the calendar years 2007-2013. Normally, if a taxpayer has a debt such as a mortgage that is forgiven or decreased, releasing them from paying the full amount of the original liability, the amount of the decrease in the mortgage is taxable income. This act attempted to ease the hardship for people who were victims of the housing market crisis. Normally, if a taxpayer's home is foreclosed upon and a portion of the debt forgiven, or the loan is restructured and debt forgiven, they would have to record a taxable gain. This act made such debt forgiveness nontaxable if it related to the taxpayer's principal residence. If debt was forgiven, it still had to be reported on the taxpayer's tax return on Form 982 (IRS, The Mortgage Forgiveness Debt Relief Act and Debt Cancellation, 2013).

If a taxpayer underwent a foreclosure in one of the previously mentioned calendar years, the IRS would forgive the tax on up to two million dollars (one million if married filing separately) of that debt. The debt had to be directly related to buying, building, or substantially improving a primary residence and be secured by the home in question. Refinancing to a lower mortgage amount was also one of the qualifications. This act was meant to help people with debt related to only to homes (IRS, The Mortgage Forgiveness Debt Relief Act and Debt Cancellation, 2013).

Fraud Problems

The FTHBCs and debt forgiveness were helpful to a vast number of American citizens, but they resulted in compliance issues for the IRS. Inexperience with the 2008 credit followed by changes made to the credit the very next year, made it easy for taxpayers to claim the credit erroneously or to purposefully commit tax fraud. In testimony before the Senate on April 15, 2010, the drastic changes and different cut-off dates were cited as the cause of many people accidentally claiming this credit (Olson, 2010). The IRS even began a system of automatically flagging returns containing the credits in order to process them by hand, because the volume of problems was so large.

Due to the specific requirements that differ between the FTHBCs of 2008, 2009, and 2010, taxpayers seeking to claim this credit were required to submit all their information through paper filing, but they could e-file everything else and claim the credit on an amended paper return later. This was probably the more reasonable option for the taxpayer, but it costs the IRS more money and time per return. Further, because of the additional processing time, “many taxpayers were to wait five months (or more) to receive their FTHBC” (Olson, 2010).

“As of February 2010, the IRS reported that it was investigating 185 criminal schemes involving the FTHBC” (Olson, 2010). At the time, news shows, newspapers, and electronic media reported multiple cases of people who did not meet the requirements, but claimed the credit anyway. Multiple articles allege that people as young as four years old and linked to the mafia were claiming the credit. All of the illegal activity made it harder for honest people to actually claim their credit. While the act did encourage a great number of people to buy houses for the first time, the cost to the IRS was significant because the FTHBC was not well-thought-out in establishing a way to verify taxpayer qualifications.

The IRS eventually relied on third-party data to verify any prior home ownership. This led to additional mistakes and time lags, sometimes ending with deserving taxpayers having their credits denied while fraudsters successfully received credits. The fraud dealing with this credit is estimated to be the main issue with about 21% of the IRS’s communication audits during this period (Olson, 2010). Of course a system of checks and balances should have been implemented at the application stage before people could be accepted into the program for the FTHBC or debt forgiveness. The haste in enacting the laws without an implementation structure to monitor them led to huge repercussions.

What Happened

How Many and How Much

Homeownership rates represent the ratio of the number of renters to the number of homeowners. The peak of homeownership was in 2006, but every year since then, there has been a decrease across all age groups except seniors, ages 65 and over, which remained steady. In fact, the homeownership rate fell to 65.4 percent in the first quarter of 2012 which is the lowest level

since 1997. This is at the same time that mortgage rates dropped to their lowest level since 1971 (University, 2012).

Approximately one percent of the tax returns filed in 2008, 2009, and 2010 claimed the FTHBC, while less than one-half of one percent filed for waiver of tax on debt forgiveness (Table 1). So the credit was much more widely used, probably because a credit can result in a larger tax refund. Additionally there was a line item on the second page of the Form 1040, which would draw more attention to the credit. The tax on forgiveness of debt is less well known by taxpayers and the Form 982 is not common.

Table 1: FTHBC and Debt Forgiveness

	2008	% of Total	2009	% of Total	2010	% of Total	2011	% of Total
First-Time Home Buyer Credit	1,204,526	0.85%	1,469,407	1.05%	1,357,660	0.95%	202,437	0.14%
Form 982*	147,841	0.10%	310,474	0.22%	423,574	0.30%	464,425	0.32%
Total Tax Returns Filed	142,450,569	100%	140,494,127	100%	142,892,051	100%	145,370,240	100%

Table 1. Number of Tax Returns with These Tax Issues (in thousands)
 *Reduction of Tax Attributes Due to Discharge of Indebtedness. Table created from statistics available on (Service, 2014)

Taxpayers claimed FTHBCs totaling over \$6 trillion for the period the credit was available (Service, 2014). Tax credits are one of the more valuable tax incentives the tax code can offer. The FTHBC allows the taxpayer to report a percentage of the purchase price of the qualified home as if it were a payment to the IRS toward the taxpayer’s taxes. For example, if the taxpayer had \$2000 of federal tax withheld from their wages in 2009, they purchased a home that qualified for a \$4000 FTHBC, and their taxes due for the year was \$5,500, they would receive a \$500 refund. Without the benefit of the FTHBC, the taxpayer would owe additional taxes of \$3,500 with their tax return. So, although the number of returns involved appears small, the dollar value of the tax incentives, specifically the FTHBC, was significant.

The tax savings afforded taxpayers using the waiver of tax on debt forgiveness is not reported by the IRS. The number of returns as seen in Table 2 is available, but a dollar total cannot be correlated with the tax incentive. Further, this waiver relates to the foreclosure or loan restructuring agreement on a principal residence. So there would be little to no effect of this tax benefit on home sales. Therefore, the next section focuses on the FTHBC.

Home Sales

Per records maintained by the National Association of Realtors, existing home sales may have been slightly affected by the FTHBC. From 2003 to 2006, nationally existing home sales averaged 6,627,000 per year, but fell to 5,652,000 home sales in 2007 and 4,913,000 in 2008. In 2009 existing home sales bumped up to 5,156,000, but then decreased even further to 4,908,000 in 2010 (Figure 2). New home sales peaked in 2005 at 1,283,000, then fell sharply in 2007 to 776,000, and continued to fall through 2011. So at best, the \$6 trillion dollars in tax credits may

have influenced the 2009 boom in existing home sales, but seems to have had no effect on new home sales.

Figure 2: Home Sales

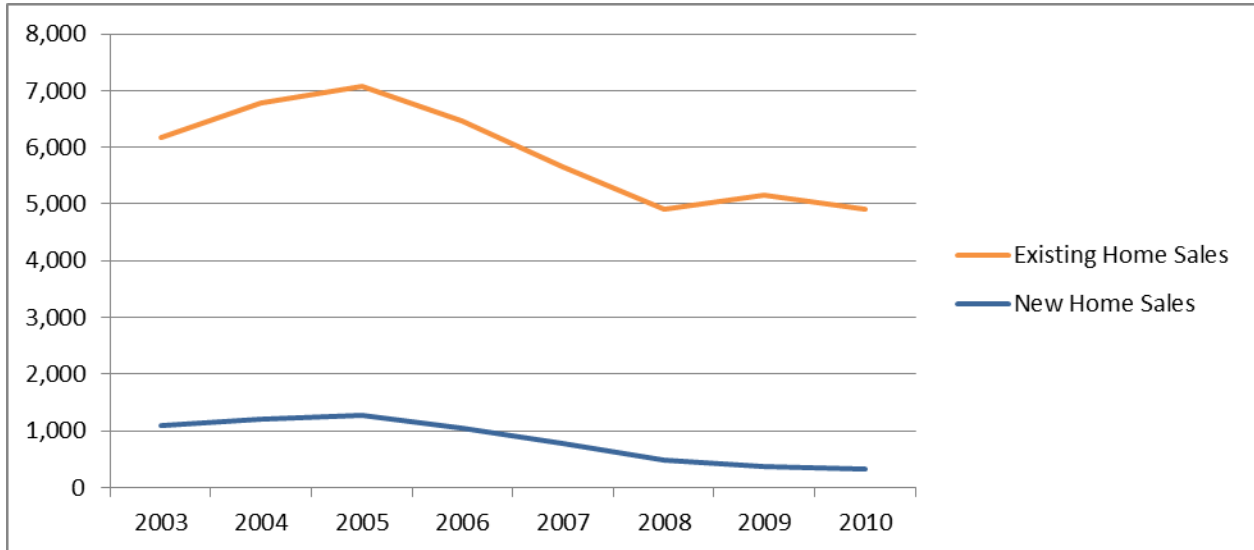


Figure 2. Home Sales in thousands. Adapted from National Association of Realtors data. (2010).

A review of existing home sales by state reveals that Florida, California, and to a slight extent, New York and Michigan may have been influenced by the credit. The drastic drop in home sales was highly publicized during the crisis period for the above mentioned states. Figure 3 makes it easy to see the large decreases in home sales experienced in Florida and California. New York, Michigan, and North Carolina also had decreases in home sales, but not as severe as the other two. North Carolina home sales appear unaffected by the credit.

Figure 3: Home Sales in Select States

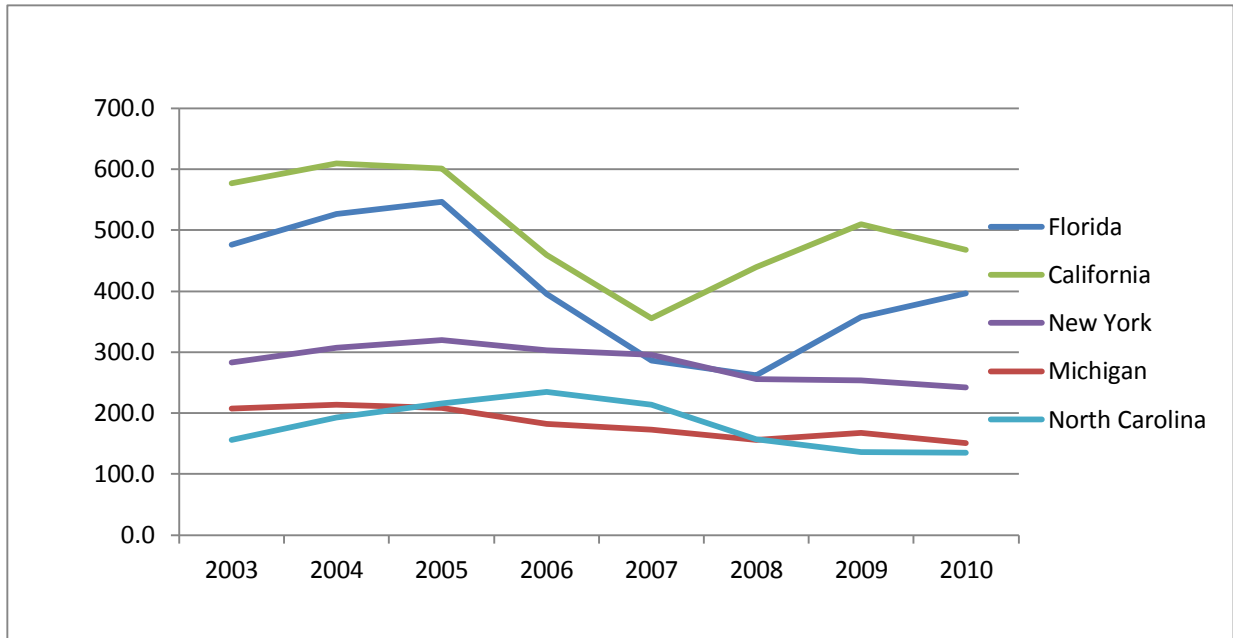


Figure 3. Existing Homes Sales by state. Adapted from National Association of Realtors data. (2010).

Based on the statistics reported by the National Association of Realtors, the tax credit may have had some effect on existing home sales, particularly in some areas of the country. Whether or not the credit was the reason for some support in certain housing markets at that time cannot be determined definitively, but the results indicate it is possible.

Foreclosures and Exploitations

As early as February 2012, some of the deceitful acts of banks came to light. They were forced to make reparations for the damages they caused; however, even with 49 of the 50 states involved in the settlement, few of the individual borrowers received compensation amounts that they considered meaningful when considering the financial suffering they endured. Oklahoma was the first state to individually reach a settlement with the banks.

Many banks and mortgage companies were knowingly signing off on mortgage foreclosure notices without doing any research into the situation. This was happening in every state in the United States, and the attorney generals for each state looked into these matters. Eventually those investigations led to the 2012 settlement. “In December 2009, a GMAC employee said in a deposition in a foreclosure case filed in West Palm Beach, Florida, that his team of 13 people signed about 10,000 documents a month without verifying their accuracy” (McLaughlin & Woellert, 2012).

Economic Ramifications

Lessons Learned and Moving On

There were many mistakes all around leading to the housing crisis. Perhaps educating the public and restricting the financial institutions is a way to help prevent this from occurring again. Democrats thought that the Dodd-Frank laws would pull the United States out of the crisis, because these laws made it harder for people to get loans by putting more regulations on the institutions providing them. They have been in effect for some time now, and the effect on the economy is debatable (Klein & Dionne, 2010).

It has been several years since the housing bubble burst, and Americans are still affected by the crisis. Lessons were learned after the Great Depression, and this more recent crisis has its share of lessons for the American people. The biggest lesson that many Americans learned is that they should only buy what they can afford. The trend of buying very large homes changed somewhat after the downturn, and people started buying smaller homes, focusing more on what they could afford. “In the short run, this is depressing home sales, but in the long run it will create a more stable housing market” (Aharoni, 2012).

The housing market crash was highly publicized in all forms of media. The government’s attempts to alleviate the pressures of the housing crisis were highly publicized as well. Americans have learned that saving needs to be a way of life and that their credit scores can either help or hurt them. According to Aharoni, “the savings rate is the highest it has been since December 1993” (2012), and banks and financial institutions have reverted to the old ways of giving out loans. Through self-education, people are now seeing that the adjustable rate mortgages (ARM’s) had the possibility of severely hurting them, and they are gravitating more towards fixed rate loans. They are also planning for bills and maintenance instead of just trying to react and pay them when they occur. Americans better understand that buying a house is a long term commitment.

Summary and Conclusions

The crash of the housing market was part of a debilitating time in the United States, marked with turbulent times for the people involved. Congress attempted to make it easier on the American citizens, and a little less painful to deal with, by offering different tax credits and debt forgiveness options during those years. They were hoping these acts would stimulate the housing market. While these tax incentives may have been somewhat successful, the biggest take-aways may be the discovery of some of the unscrupulous business tactics employed by the financial industry. In addition, borrowers need to exercise caution when taking out a loan, by knowing to what they are obligating themselves.

The FTHBC ended with the 2010 extension of the 2009 Act, so the data in this paper is limited to new home sales ending in 2010. It could be that increased new home sales took place after the expiration of the FTHBC; however, that would be a topic for additional research.

The IRS needs to establish a better system for implementing legislation passed by Congress’s. However well-intended, legislation that is not properly administered can create as many problems as it solves. The potential for fraud should always be among the considerations. If the IRS is to implement congressional laws in situations like this, adequate monitoring systems need to be developed and put in place to avoid repeating the same mistakes as were made in the past.

References

- Aharoni, G. B. (2012, January 4). *7 Lessons from the U.S. Housing Crisis*. Retrieved May 14, 2014, from Newsday: <http://www.newsday.com>.
- Case, Karl E., & Shiller, Robert J. (2004). *Is there a bubble in the housing market?* Connecticut: Yale University. <http://www.econ.yale.edu/~shiller/pubs/p1089.pdf> (accessed September 28, 2008).
- IRS. (2013, Dec 5). *First-Time Homebuyer Credit*. Retrieved May 14, 2014, from IRS: <http://www.irs.gov/uac/First-Time-Homebuyer-Credit-1>.
- IRS. (2013, Sep 12). *The Mortgage Forgiveness Debt Relief Act and Debt Cancellation*. Retrieved May 14, 2014, from IRS: <http://www.irs.gov/Individuals/The-Mortgage-Forgiveness-Debt-Relief-Act-and-Debt-Cancellation>.
- Klein, C. H., & Dionne, L. E. (2010, August 2). *An Executive Summary of the Dodd-Frank Financial Reform Act*. Retrieved May 14, 2014, from Jenner & Block Corporate Finance and Financial Services Advisory: http://jenner.com/system/assets/publications/273/original/Dodd_Frank_Financial_Reform_Act_8.2.2010.pdf?1319809629.
- Jones, Rita C., Beard, Jason, & Langston, Vicky (2010). *The Blame Game—Who's at Fault in the Mortgage Crisis?* Academy of Business Disciplines Journal. (Vol. 2, 2010).
- Markels, Alex. (12 October 2008). Comparing today's housing crisis with the 1930s." February 28, 2008. <http://www.usnews.com/articles/business/real-estate/2008/02/28/comparing-todays-housing-crisis-with-the-1930s.html> (accessed Oct. 12, 2008).
- Mayer, Christopher, Pence, K., & Sherlund, Shane M. (Winter 2009). The rise in mortgage defaults. *Journal of Economic Perspectives*. 23:1, 27-50.
- McLaughlin, L., & Woellert, D. (2012, February 14). *Mortgage Servicers Agree to \$26 Billion Foreclosure Settlement*. Retrieved May 14, 2014, from Business Week: <http://www.businessweek.com>.
- Olson, N. E. (2010, April 15). Tax Filing Season Update: Current IRS Issues. *National Taxpayer Advocate*. Committee on Finance U.S. Senate.
- National Association of Realtors. (2010). *Real Estate Outlook; Market Trends & Insights*. (Retrieved May 12, 2014), from National Association of Realtors: <http://www.realtor.org/research-and-statistics>.
- Scanlon, K., Lunde, J., & Whitehead, C. (2011). Responding to the Housing and Financial Crises: Mortgage Lending, Mortgage Products and Government Policies. *International Journal of Housing Policy*, 23-49.
- Service, I. R. (2014, February 7). *SOI Tax Stats - Individual Income Tax Return (Form 1040) Statistics*. Retrieved May 10, 2014, from IRS: <http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Return-Form-1040-Statistics>.
- University, J. C. (2012). *The State of the Nation's Housing 2012*. Cambridge, MA: Harvard University.

Zandi, Mark M. (2009). *Financial Shock: A 360° Look at the Subprime Mortgage Implosion*.
Upper Saddle River: Pearson Education.