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The Quagmire of Mortgage Short Sale Transactions Under Current Homeownership Tax Policy in a Time of Crisis

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THE QUAGMIRE OF MORTGAGE SHORT SALE TRANSACTIONS UNDER CURRENT HOMEOWNERSHIP TAX POLICY IN A TIME OF CRISIS

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"The most important point is, in a time of crisis, there is no way out but for the government to be bold and aggressive."

Mark Zandi[1]

I. INTRODUCTION

By now many homeowners have heard about the Mortgage Forgiveness Debt Relief Act that resulted from the 2007 financial crisis, which continues to loom over homeowners who own underwater properties.[2] On December 18, 2015, President Obama signed a bill that extended the Mortgage Forgiveness Debt Relief Act through December 31, 2016, providing an extension of the law and retroactive coverage for mortgage debt cancelled in 2015 so that homeowners do not have to pay taxes on forgiven debt from the sale of their principal residences.[3]

In March 2015, between 6 million and 9.7 million homes nationwide were underwater, meaning the loan balance was greater than the property value.[4] With an underwater property, also known as an upside-down

1. *See generally* MARK ZANDI, PAYING THE PRICE: ENDING THE GREAT RECESSION AND BEGINNING A NEW AMERICAN CENTURY (2013). Mark M. Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. *Mark Zandi*, MOODY'S ANALYTICS, https://www.economy.com/mark-zandi/index (last visited Apr. 8, 2016).

2. "Underwater" is a term of art coined after the 2007 financial crisis, which led to a catastrophic decline in residential property values for millions of homeowners whose significantly devalued property values were worth far less than the remaining mortgage balances. *See generally* PETER DEIER ET AL., UNDERWATER AMERICA 5 (Haas Inst. ed., 2014), http://diversity.berkeley.edu/underwater-america-report (last visited Dec. 11, 2014). *See also* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 495 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [hereinafter FCIC REPORT]; Christopher Matthews, *After 8 Years, The Real Estate Market is Finally Looking Normal Again*, FORTUNE (Mar. 31, 2014, 4:50 PM), http://finance.fortune.cnn.com/2014/03/31/after-8-years-the-real-estate-market-is-finally-looking-normal-again/.

3. Peter Thomas Ricci, *Mortgage Forgiveness Debt Act Extended to 2017*, BOSTON AGENT MAGAZINE (Dec. 21, 2015), https://bostonagentmagazine.com/2015/12/21/mortgage-forgiveness-debt-act-extended-to-2017/.

4. Florida, for example, has had in excess of 1 million of those properties. Drew Harwell,

property, homeowners who sold their property for less than they owed faced tax consequences. What owning underwater property means for homeowners is that the home's current market value is less than the mortgage balance, making it impossible to sell or refinance the home without the lender's cooperation. Many homeowners, who may be in financial distress and can no longer afford their homes because of national or personal financial crises,[5] cannot sell their underwater property[6] without their lender's agreement to accept less than the mortgage loan balance upon the sale of the property. Lender approval of this type of transaction is necessary for many current homeowners trying to sell their homes in the wake of the 2007 financial crisis, which has left many

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Expiration of Mortgage-Forgiveness Tax Break Triggers Fears for Distressed Homeowners, TAMPA BAY NEWS, http://www.tampabay.com/news/business/realestate/mortgage-forgiveness-tax-break-expires-triggering-new-worries-for/2160925 (last visited Jan. 19, 2015). *See also* Tory Barringer, *9.7 Million Homeowners Underwater*, DS NEWS, http://dsnews.com/news/05-20-2014/9-7-million-homeowners-underwater (last visited Jul. 25, 2014); *9.1 Million U.S. Residential Properties Seriously Underwater in First Quarter, Lowest Level in Two Years*, REALTYTRAC (Apr. 15, 2014), http://www.realtytrac.com/content/foreclosure-market-report/q1-2014-home-equity-and-underwater-report-8037 (reporting 17% of U.S. properties are seriously underwater, down from 26% a year ago); Erin Carlyle, *Study Finds 6.4 Million U.S. Homeowners Still Have Underwater Mortgages*, FORBES (Dec. 17, 2013, 8:00 AM), http://www.forbes.com/sites/erincarlyle/2013/12/17/6-4-million-still-have-underwater-mortgages-as-of-q3-2013-says-corelogic/ (noting that underwater properties are "often called 'upside down' or 'negative equity' properties, meaning that borrowers owe more on their mortgages than the homes are worth"); *8.1 Million U.S. Residential Properties Seriously Underwater in Third Quarter, Lowest Level in Two Years*, REALTYTRAC (Oct. 22, 2014), http://www.realtytrac.com/content/foreclosure-market-report/q3-2014-us-home-equity-and-underwater-report-8166 (stating that 8.1 million U.S. residential properties were seriously underwater, "representing 15 percent of all properties with a mortgage and an estimated $1.4 trillion in negative equity"). It appears from its website that CoreLogic began regularly publishing its Negative Equity Report for residential real estate around 2010, upon which the real estate and financial industries and media sources rely. *See generally* CORELOGIC, www.corelogic.com (last visited Apr. 13, 2016).

5. The distress of financial crisis left many Americans unemployed, underemployed, or forced to relocate to other communities/cities for work or better opportunities. The exodus in many communities forced homeowners to abandon homes they could no longer afford, causing historic foreclosure rates in both middle class and lower-income communities. Stanley Fischer, Vice Chairman, Board of Governors of the Federal Reserve System, Speech, At the "The Great Recession—Moving Ahead," a Conference Sponsored by the Swedish Ministry of Finance, Stockholm, Sweden (Aug. 11, 2014), http://www.federalreserve.gov/newsevents/speech/fischer20140811a.htm. For example, "job cuts at federal, state, and local governments have reduced payrolls by almost 3/4 of a million workers, resulting in a decline in total government civilian employment of 3-1/4 percent since its peak in early 2009." *Id*. Further strengthening of the economy will likely pull some of workers back into the labor market, although skills and networks may have depreciated some over the past years. *Id*. *See also* FCIC REPORT, *supra* note 2, at 203.

6. Current Market Value, as the author uses the concept, means what a willing third party buyer would pay for the property at the time of contracting with the homeowner, based on either current appraisal values or values of similar properties recently sold in the same area. *See generally Guide Note 11: Comparable Selection in a Declining Market*, APPRAISAL INSTITUTE, http://www.appraisalinstitute.org/assets/1/7/guide-note-11.pdf.

American homeowners unemployed, underemployed, or forced to relocate to other communities for better opportunities.[7]

Homeowners who are willing to sell their homes to relieve their financial distress need their lender's approval to accept a lesser amount than the existing mortgage balance in order to facilitate the real estate sales transaction at the deflated current market value. The mortgage lending and real estate sales industries refer to this type of real estate sales transaction as a "short sale," or for purposes of this Article, a "mortgage short sale transaction,"[8] or MSST, so as not to confuse the concept of a short sale as it is used in the securities market context.[9] To use the MSST, homeowners and lenders must come to an agreement about the reduced payoff amount of the mortgage in order for the homeowner to complete the real estate transaction with the purchaser.[10] The impact on lenders is that they more quickly receive a substantial amount of the mortgage balance versus allowing the property to go through the more costly foreclosure process. Lenders further incur a tax write-off for business loss on the forgiven loan balance.[11] More importantly, lenders do not take

7. The exodus in many communities forced homeowners to abandon homes they could no longer afford, causing historic foreclosure rates in both middle class and lower-income communities. Joshua Gardner, *Skeletons of the Great Recession: These American Cities Are Still Plagued by Homes Abandoned to Foreclosure*, DAILYMAIL (Jul. 14, 2014, 5:23 AM), http://www.dailymail.co.uk/news/article-2691092/Skeletons-Great-Recession-These-American-cities-plagued-homes-abandoned-foreclosure.html. *See generally The Housing Crisis and the Working Poor*, CASAS DEL PUEBLO COMMUNITY LAND TRUST (Oct. 2013), http://cltnetwork.org/wp-content/uploads/2013/12/2013-The-Housing-Crisis-and-Working-Poor.pdf.

8. *See* MADISON, ET AL., 2 LAW OF REAL ESTATE FINANCING § 12:10, Westlaw (database updated Dec. 2015) (detailing residential real estate short sale procedure context); s*ee also* 33A AM. JUR.2d *Federal Taxation* ¶ 10232, Westlaw (database updated Feb. 2016) (listing examples of how short sales are used including a short sale in the securities context where a contract for the sale of shares which the seller does not own or the certificates for which are not within his control so as to be available for delivery at the time when the delivery must be made). A full discussion of a securities short sale is beyond the scope of this Article and does not have the same meaning and application as an MSST discussed herein. *See also* KRISTY A. HERNANDEZ, EDUCATING UNDERWATER HOMEOWNERS ON THE OPTIONS FOR KEEPING OR LEAVING THEIR HOMES (Aspatore, Oct. 2012), 2012 WL 4364153.

9. Michael A. Valenza, *Digest of Selected Articles*, 38 REAL EST. L.J. 122, 122 (2009). Only a few years ago residential real estate mortgage "short sales were an unheard of occurrence in most markets." *Id*. *See also* Phil M. Fowler, *Legal Definition of a Short Sale*, SFGATE: HOME GUIDES, http://homeguides.sfgate.com/legal-definition-short-sale-7218.html (last visited Dec. 11, 2014); CORELOGIC, *supra* note 4.

10. "A Short Sale is where the lender or investor agrees to accept an amount less than is actually owed on the property." Alexander von Bryce, *Short Sale vs. Short Payoff—Advantages and Disadvantages of Each*, NEW HAMPSHIRE SHORT SALE CENTER (Feb. 14, 2011), http://nhshortsalecenter.com/2011/02/14/short-sale-vs-short-payoff-advantages-and-disadvantages-of-each/.

11. "Creditors often write off debts after a set period of time—for example, one, two, or three years after you default. The creditor stops its collection efforts, declares the debt uncollectible, and

ownership of, or liability for, the property. For homeowners, the results are not so positive. They are able to sell their underwater property, but, consequentially, they lose all their paid-in or market-incurred equity and incur tax liability from the lender's forgiveness of indebtedness of the mortgage balance. Thus, given these outcomes, the tax implication of MSSTs is inequitably balanced in lenders' favor, while, for homeowners, the transaction creates new financial distress because of the tax liability consequences.

In the current market, with almost ten million homes still underwater, MSSTs are often the only way for homeowners to sell their property.[12] For homeowners who do not fully understand, or are completely unknowledgeable about, the tax consequences of MSSTs, MSSTs seem like a win-win situation for themselves and lenders, especially with the government, lenders, and real estate sales professionals marketing MSSTs to homeowners. This win-win perception, however, is a fallacy. For homeowners, the perception is that they are now able to sell the property to relieve the financial stress of making mortgage payments, more freely relocate for work, and avoid the stress of foreclosure of their property. Emancipation from the mortgage allows them to pursue other life choices. This perception, however, does not follow the reality of MSSTs. Homeowners may find themselves in a worse financial situation with an MSST because of a tax liability, with accruing interest and penalties, that can plague homeowners up to seven years after entering into the MSST. Lenders, on the other hand, realize substantial benefits from MSSTs while ignoring the financial detriment to homeowners because any deference they give to homeowners' interests would be in direct conflict with their own profitable interests. Traditionally, profit motivation forces lenders not to make concessions or take actions that would affect their profitability. Foreclosure proceedings and assuming title to the property, it turns out, affect their bottom line more than MSSTs. Lenders' reality, not perception, is that they avoid greater losses through MSSTs of underwater property than lenders would through a judicial or non-judicial foreclosure or their own subsequent sale of the property to a third-party buyer.[13] Thus, the win-win scenario of an MSST is a fallacy.

reports it to the IRS as lost income to reduce its tax burden." *Tax Consequences When a Creditor Writes Off or Settles a Debt,* NOLO, http://www.nolo.com/legal-encyclopedia/tax-consequences-settled-forgiven-debt-29792.html (last visited Feb. 28, 2016).

12. *See* Carlyle, *supra* note 4. Underwater homes are commonly known as "'upside down' or 'negative equity' properties, meaning that borrowers owe more on their mortgages than the homes are worth." *Id*.

13. "It is also likely, given the current housing environment, that John's lender nets a greater return through a short sale of the property than the lender would have received, if it had taken back

Moreover, under the current industry practice, and to avoid the unauthorized practice of law, Realtors who engage in MSSTs, and logically lenders too, are under no legal obligation to disclose the financial disadvantages homeowners may face with an MSST or to suggest other less financially burdensome options of disposing of the property, such as foreclosure.[14] As far as lenders and real estate sales professionals are concerned, they walk away from MSSTs with a mortgage loan balance removed from liabilities on their balance sheet, no obligation to manage or sell a post-foreclosure property, or a commission check for their services.

The quagmire[15] of financial indebtedness created by current tax laws and policy related to MSSTs for homeowners, however, imposes an onerous burden on taxpayers selling underwater properties. The government and lenders, through various programs implemented to help distressed homeowners with underwater properties, have instilled a belief among homeowners that MSSTs are a positive vehicle for selling their underwater properties. This holds true especially because the government prioritized homeownership-related tax policy to promote homeownership beginning with Roosevelt's New Deal in 1933. But prior to 2007, MSSTs were virtually non-existent. There is very little literature about, or statistics on, MSSTs, likely because of the private nature of the transaction between homeowners and lenders. By forgiving the mortgage loan

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the property through nonjudicial foreclosure and subsequently sold it to a third party." SENATE BANKING AND FINANCE INSTITUTIONS COMMITTEE, BILL ANALYSIS OF S.B. 412, *as amended* MARCH 21, 2011, http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0401-0450/sb_412_cfa_20110405_150830_sen_comm.html [hereinafter BILL ANALYSIS, SB 412].

14. *See generally* The *Short Sale Flow: What the Listing Agent Should Know to Successfully Negotiate a Short Sale, Risk Management*, THE NATIONAL ASSOCIATION OF REALTORS, http://www.realtor.org/law-and-ethics/risk-management/the-short-sale-workflow (last visited Feb. 28, 2016). The National Association of Realtors advises its Realtors not to provide legal or financial advice. It provides in almost all its disclosures the following language, or something similar:

> IT IS NOT INTENDED TO AND DOES NOT CONSTITUTE LEGAL, FINANCIAL OR TAX ADVICE, AND SHOULD NOT BE INTERPRETED AS POLICY OF THE NATIONAL ASSOCIATION. TO THE EXTENT LEGAL, FINANCIAL OR TAX ADVICE IS NEEDED BY A MEMBER OR A MEMBER'S CLIENT OR CUSTOMER, THOSE INDIVIDUALS SHOULD BE ENCOURAGED TO CONSULT WITH THEIR LAWYER OR ACCOUNTANT.

Id.

15. *Quagmire*, MERRIAM-WEBSTER'S DICTIONARY, http://www.merriam-webster.com/dictionary/quagmire?show=0&t=1418310421 (last visited Dec. 11, 2014) (defining quagmire as "a difficulty, precarious or entrapping position"); *Quagmire*, DICTONARY.COM, http://dictionary.reference.com/browse/quagmire?s=t (last visited Dec. 11, 2014) (defining quagmire as "a situation from which extrication is very difficult," such as a quagmire of financial indebtedness). For this Article, the federal tax liability one owes to the U.S. Internal Revenue Service is a quagmire of financial indebtedness.

balance, however, lenders expose homeowners to two situations. First, homeowners face exposure to possible deficiency judgments for the amounts of the forgiven loan balances, which some state laws address.[16] Second, homeowners incur potential, unavoidable tax liability[17] created by federal and state tax laws for the forgiven indebtedness, which is considered taxable income. It is the quagmire of the latter of these two situations facing middle-class homeowners with properties underwater that this Article addresses.

The discussion among scholars on the issues affecting homeowners engaging in MSSTs in the residential real estate market is very limited. This Article not only provides a critique of the government's tax and public policies, but also presents an analysis that exposes the contradictions of the transactional relationship between homeowners and lenders in MSSTs. Furthermore, the Article focuses on the laws regarding MSSTs that seem to provide a consumer protection focus, but, in reality,

16. Currently, several states have passed deficiency judgments legislation, or non-recourse statutes, which bar lenders from collecting a deficiency balance, specifically after a foreclosure but which may also cover MSSTs. *See* ALASKA STAT. § 09.45 (LEXIS, through the 2015 First Regular Session and the First, Second, and Third Special Sessions of the Twenty-Ninth State Legislature); ARIZ. REV. STAT. ANN. §§ 33-729.A, 814.G (LEXIS, through 2016 emergency legislation effective as of April 5, 2016); CAL. CIV. PROC. CODE § 580e (LEXIS, through Chapter 11 of the 2016 Regular Session and Chapter 3 of the 2015-16 2nd Extraordinary Session); FLA. STAT. § 702.06(2) (LEXIS, through Chapter 243 with the exception of Chapters 16, 40, 140, 160, 178, 220, 224, and 231), as amended by Fla. H.B. 35; IOWA CODE § 654.6 (LEXIS, through all legislation signed as of May 12, 2016 from the 2016 Second Regular Session of the 86th General Assembly); MINN. STAT. § 582.30 (LEXIS, through Act chapter 84 of the 2016 Regular Session); MONT. CODE ANN. § 71-1-232 (LEXIS, current through 2015 Legislative Session); N.C. GEN. STAT. §§ 45-21.36, 45-21.38 (LEXIS, through Session Laws 2016-3, 2016 2nd Extra Session, but not including corrections and changes made by the Revisor of Statutes); N.D. CENT. CODE § 32-19-03 (LEXIS, through all acts signed by the governor through the end of 2015 Regular Legislative Session including changes and corrections made by the North Dakota Code Revisor); OR. REV. STAT. § 88.103 (LEXIS, through all Acts of the 2016 Legislative Session (1-124) with the exception of ORS Chapters 163A, 181A, 350, 431A, 475B, and 743B); WIS. STAT. ANN. § 846.04 (LEXIS, current through 2015); WASH. REV. CODE § 61.12 (LEXIS, current through 2015 3rd Special Session and 2015 election (2016 c 1 and 2)). California has the broadest protection for borrowers among the statutes. *See also* Kathleen K. Wright, *Short Sales as Nonrecourse Mortgages*, TAX ANALYST 31 (Jan. 6, 2014), http://taxprof.typepad.com/files/71st0027.pdf. One-action statutes allow lenders a choice between an action of foreclosure or suing to collect the debt, but not both. *List of Non-Recourse Mortgage States and Statutes*, HELOCBASICS: A CONSUMER'S GUIDE TO HELOC LOANS, http://www.helocbasics.com/list-of-non-recourse-mortgage-states-and-anti-deficiency-statutes/ (last visited Dec. 13, 2014). The following states have some type of one-action statute: California, Idaho, Montana, Nevada, New York, and Utah. *Id.*

17. Tax burden here not only means the financial liability but the unchallengeable collection methods the IRS invokes for collection of the financial liability. *See* Tanina Rostain & Milton C. Regan Jr., *The IRS Under Siege*, GEORGETOWN LAW (2014), http://www.law.georgetown.edu/news/georgetown-law-magazine/upload/54-61_faculty-article_WEB.pdf.

provide incentives that do not benefit consumers, or in this case, homeowners. In this respect, one must acknowledge that MSSTs have created a hardship on consumers. In this vein, the government and lending industry roles in perpetuating MSSTs are an example of the failure of pragmatic lawmaking to address the needs of citizens in a time of crisis, particularly the 2007 financial crisis.

Thus, the scope of this Article is two-fold. First, this Article contextualizes the evolution of MSSTs as a lender's tool used to avoid owning underwater real property through the foreclosure process and to avoid the resulting liability exposures associated with properties owned by lenders, known as REOs, or Real Estate Owned by Lenders. In particular, it identifies how government and lender promotion of MSSTs as a solution to homeowners' financial burdens of owning or being unable to sell underwater property is only a cognitive perception. In reality, the true benefits are realized by lenders through minimized losses and by the government through potential tax revenues, which is contrary to decades of economic and public policy based on the need for public housing. Second, this Article criticizes the government for the lack of pragmatic current federal tax laws and policies to provide comprehensive relief for homeowners with underwater properties.[18] The Article does not stop with criticism of present policy. Instead, this Article provides a proposal for amending existing legislation that would permit use of MSSTs to provide the type of relief for homeowners that remains vital. The pragmatic tax relief proposed in this Article is needed to remedy the inadequacies of existing federal tax laws and the failure of newly created tax laws to take into account the evolutionary realities of the real estate markets since the 2007 financial crisis for homeowners with underwater properties, which still plague the current real estate market. The government should amend the Mortgage Forgiveness Debt Relief Act of 2007 to incorporate: the same exclusionary treatment for secondary homes as principal homes; the inclusion of a principal residence that changes status due to economic hardship but qualified as a principal residence any time after 2007; an exclusion from taxable income similar to the I.R.C. § 121, for either a principal residence to a secondary residence; and an extension of these

18. Mortgage Forgiveness Debt Relief Act of 2007 provisions apply to debt forgiven in calendar years 2007 through 2016. Pub. L. 110-142, H.R. 3648, was originally enacted in 2007 (for three years), renewed for three additional years through December 31, 2013, renewed in December 2014 to cover tax year 2014, renewed in December 2015 to cover tax year 2015 . *See* I.R.C. § 108(a)(1)(E) (LEXIS, through PL 114-115, approved 12/28/15). *See generally* INTERNAL REVENUE SERVICE, DEP'T OF THE TREAS., PUBLICATION 4681, CANCELLED DEBTS, FORECLOSURES, REPOSSESSIONS, AND ABANDONMENTS (FOR INDIVIDUALS) (2015) [hereinafter IRS PUBLICATION 4681].

provisions until the underwater property market is eliminated, or at a superficial volume. The lack of scholarship addressing these specific issues,[19] especially as it pertains to the potential tax liability for homeowners with underwater properties, makes this Article particularly pertinent to the scholarly discussion.

Part II contends that governmental public policy, particularly, social policy which reflects the social values or norms of its citizens, should be implemented to address the disparities that arise given the lender-consumer relational dynamics that typically result in more harm than benefit for consumers, specifically related to MSSTs discussed in this Article.

Part III provides a much-needed historical context for the introduction of MSSTs into the residential real estate finance market after the 2007 financial crisis. This section identifies the illusory advantages and tangible disadvantages to homeowners, primarily tax-related, when engaging in MSSTs. It contrasts these disadvantages with the low risk to lenders for approving MSSTs. (Part III also notes that the current tax policy underlying MSSTs is contrary to America's long standing public policy that emphasizes home ownership.)

Part IV of this Article analyzes existing tax treatment of MSST transactions and provides a critique of the solvency rules affecting middle-class taxpayers. It suggests that Congress's tax treatment of MSSTs, to date through the Mortgage Forgiveness Debt Relief Act, of 2007 has been insufficient in several ways and that Congress should apply a broader scope to existing, and any newly created, tax laws in order to provide meaningful tax relief to middle-class taxpayers with underwater principal and underwater secondary residences.

Part V proposes alternatives to MSSTs that homeowners can consider to avoid the onerous tax liabilities and suggests antidotes for policymakers to implement meaningful federal tax policy reform still needed to rescue middle-class homeowners from the potential tax burdens associated with MSSTs. Part V suggests that Congress should follow the pattern created in the special agreement in place for California, which is the only state to date that has secured a special agreement with the IRS to

19. Some debate has arisen that generally discusses the need to extend a tax exception that allows taxpayers to avoid liability for cancellation of indebtedness. *See* Dustin A. Zacks, *Avoid Insult to Injury: Extending and Expanding Cancellation of Indebtedness Income Tax Exemption for Homeowners*, 66 ARK. L. REV. 317 (2013); s*ee also* Bradford P. Anderson, *Robbing Peter To Pay for Paul's Residential Real Estate Speculation: The Injustice of Not Taxing Forgiven Mortgage Debt*, 36 SETON HALL LEGIS. J. 1, 10 (2011). These articles fail to discuss the various circumstances in which such exceptions would apply and the actual burdens placed on taxpayers if Congress does not take action, or to give any context for which the financial crisis contributed to this problem.

allow a residence to avoid tax liability from MSSTs regardless of solvency, relating to a principal residence. The Article also suggests that Congress should extend the scope of the Mortgage Forgiveness Debt Relief Act of 2007 (MFRDA); provide similar, favorable treatment for principal and secondary residences; exclude residences from taxable income; and take other government "paternalistic" actions to assist homeowners with underwater property. The financial crisis that led to the tremendous amount of underwater property was a catastrophic earthquake, the after-shocks of which will continue for many years to come, and the government must come to its citizens' aid in this time of crisis.

II. THE PUBLIC POLICY REASON FOR TAX RELIEF FOR MSSTS

The strength of American democracy lies in its social values.[20] Public policy reflects social values, and policy influences public choice.[21] The government's public policy is often revealed through the legislation it enacts to address social concerns and to protect the well-being of its citizens, e.g., when it passes new laws, or provides public services, to redress the current problems affecting its citizens.[22] The government's goal in implementing changes in the law, or offering services, is often to correct societal maladies that affect the economic welfare of the nation, and, ultimately, to improve the quality of life for its citizens.[23]

The federal government has long been committed to providing "a decent home and suitable living environment" for all its citizens.[24] Traditionally, the federal government has supported and initiated policy to promote homeownership through legislation aimed at benefiting its citizens, starting with the various New Deal laws enacted in the 1930s during the Roosevelt Administration[25] and continuing through the 1990s

20. *See* DEMOCRACY, SOCIAL VALUES AND PUBLIC POLICY ix (Milton M. Carrow, et al., eds. 1998).

21. *Id*.

22. *Id*.

23. William E. Forbath, *Social and Economic Rights in American Grain: Reclaiming Constitutional Political Economy*, *in* THE CONSTITUTION IN 2020, 59 (Jack M. Balkin & Reva B. Siegel eds., Oxford University Press 2009).

24. Housing Act of 1949, ch. 338, 63 Stat. 413 (1949), codified as amended, 42 U.S.C.A. § 1441 (1949).

25. Tracie R. Porter, *Pawns for the Higher Greed: The Banking and Financial Services Industry's Capture of Federal Homeownership Policy and the Impact on Citizen Homeowners*, 37 HAMLINE L. REV. 139, 155-56 (2013) (discussing the homeownership policy integral to Roosevelt's plan for recovery of the national economy and for individual homeowners, through passage of several instrumental federal laws). The New Deal laws dealt with sweeping reforms to deal with a broad range of maladies that plagued citizens after the 1920's financial collapse, particularly in the real

during the George W. Bush administration.[26] Thus, the government's influence on and endorsement of its citizens becoming homeowners is well entrenched in the government's public policy platform.[27] The government's actions in redressing the current crisis in home ownership caused by the large quantity of underwater property should not be myopic because the legislation not only benefits its citizens, but it also strengthens the national economy. Therefore, in the current depressed real estate market, with millions of citizens who own homes that are underwater, Congress should enact new legislation or modify existing legislation to address the severe tax liability implications for homeowners. This legislation would promote home ownership, which has been a foundational principle of the American economy. This aid is especially necessary for homeowners who find that MSSTs are the best means by which to sell their homes.[28] The federal government, therefore, should promulgate a new and practical homeownership tax policy that does not create onerous tax liabilities for taxpayers, given that prior policies incentivized taxpayers to become homeowners. The tax savings benefits from homeownership relate to deductions that allow wealth-building because of the money homeowners save, as opposed to paying taxes when they lack the benefit of deductions or exclusions.[29]

The government has long prioritized homeownership-related tax policy. Subsequent to strong federal legislative reform in the 1930s, the government further substantiated the social good of homeownership by

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estate area with passage of the federal legislation and creation of federal agencies to implement the new laws to get the economy and citizens back in better financial positions. *Id.*

26. *Id*.

27. The severity of the Great Recession and its ongoing fallout, importantly including its influence on public opinion, has heightened the focus on the challenge of avoiding another such crisis. *See* Fischer, *supra* note 5.

28. For example, communities rebuild with homeowners who can afford the property, creating a stronger real estate tax base for local governments that the federal government has been aiding through funds delivered to depressed state governments. School districts, local safety services, and other local services have funding to support their communities. The social benefits of being in a stable community affect the morale of those who live in it. *See* Stephanie M. Stern, *Reassessing the Citizen Virtues of Ownership*, 111 COLUM. L. REV. 890, 891 n.4 (2011). The individual perceived benefits derived from homeownership pour over into the local economy, which could better thrive without federal government assistance. *Id*. In addition, homeownership provides a sense of social status and financial stability, from living in better neighborhoods with other homeowners and from steady inclines in property values that create equity wealth. *Id*.

29. *Understanding America's Homeownership Gaps: 2003 Fannie Mae National Housing Survey*, FANNIE MAE 5 (2004), http://www.fanniemae.com/resources/file/research/housingsurvey/pdf/survey2003.pdf (finding that 46% of the respondents to a survey perceived a tax benefit of homeownership, and 84% perceived that buying a home was a good investment). *See* Calvin Johnson, *The Taxation of the Really Big House*, 122 TAX NOTES 915 (2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1520767.

implementing social policy through tax law reform that allowed tax deductions or exclusions under the tax code to taxpayers who owned homes. First, the qualified residence interest deduction (QRID) lowered the adjusted gross income upon which tax liability is determined.[30] The QRID allows a yearly deduction for all mortgage interest taxpayers pay to lenders over the entirety of the mortgage term.[31] As the second largest tax deduction under the tax code, second only to the employer-provided health insurance premium deduction, the QRID substantially reduces citizens' tax obligations.[32] Second, mortgage insurance premiums (MIP) homeowners pay to lenders are allowable deductions so long as lenders charge MIP on the mortgage loan.[33] Third, real property taxes are also deductible each year of the mortgage.[34] Fourth, there is a deduction for first-time buyers for certain costs incurred at the time of purchase, but people may qualify as a first-time buyer several times over their lives and take the deductions.[35] Fifth, even more beneficial than the QRID and the three other deductions mentioned is the exclusion from taxable income for homeowners who sell their principal residences under § 121.

Under § 121, the gain from the sale of a principal residence is excluded from taxable income, so taxpayers pay no taxes at all and pocket the income, up to $250,000 or $500,000.[36] This exclusion is allowable

30. I.R.C. § 163(h)(3) (LEXIS, through PL 114-115, approved 12/28/15). *See* Roberta F. Mann, *Housing and the Mortgage Interest Deduction* (2012), www.ssrn.com/abstract=2189873.

31. Mann, *supra* note 30. Homeowners pay more in interest during the first half of the mortgage term than the latter, creating significant deductions. For example, a monthly payment on $100,000 mortgage with an interest rate of 5% over a 30-year term yields a monthly mortgage payment of $536.82, excluding any escrows for taxes and insurances. Of that monthly payment, about $416.67 is interest and $120.15 is applied to reduce the principal balance.

32. I.R.C. § 163(h)(3).

33. I.R.C. § 163(h)(3)(E). This section covers Mortgage Insurance Premiums. Lenders typically charge MIP if the loan to property value ratio is less than 80%.

34. I.R.C. § 164 (LEXIS, through PL 114-115, approved 12/28/15). In 2008 and 2009, even homeowners who did not itemize deductions could deduct real property taxes, by means of a special add-on to the standard deduction. I.R.C. § 63(c)(1) (LEXIS, through PL 114-152, approved 5/9/16) added Pub. L. No. 110-289, § 3012.

35. I.R.C. § 36 (LEXIS, through PL 114-115, approved 12/28/15). The credit evolved over time. First, the Housing and Economic Recovery Act of 2008 established a $7,500 credit that must be repaid in equal installments over 15 years. Second, the American Recovery and Reinvestment Act of 2009 established an $8,000 credit with no requirement of repayment unless the house was no longer the taxpayer's principal residence within the next three years. Pub. L. 111-5, 123 Stat. 115, I.R.C. §§ 1-5. The Worker, Homeownership and Business Assistance Act of 2009 continued the $8,000 credit through 2010. Pub. L. No. 111-2, 123 Stat. 2984, I.R.C. § 3304 (2012). The buyer need not be a true "first-time" homeowner, but, rather, the buyer must not have owned a home within the three-year period before the purchase. I.R.C. § 36(c). This provision was added by Pub.L. No. 110-289, Div. C, Title I, Subtitle B, § 3011(a), 122 Stat. 2888, and amended by Pub.L. No. 111-5, Div. B, Title I, Subtitle A, Part I, §§ 1006(a)–(c), (d)(2), (e), 123 Stat. 316, 317.

36. I.R.C. § 121 (LEXIS, through PL 114-115, approved 12/28/15). Since 1997, this law allows

every five years.[37] In essence, the government, through the tax code, allows a boondoggle, defined as "a project funded by the federal government out of political favoritism that is of no real value to the community or nation."[38] It is individual taxpayers who benefit from § 121, not the government or society. Thus, along with the public policy interest in helping homeowners recover from the financial crisis caused by government deregulation of the banking industry, § 121 allows the government the most reasonable justification for why homeowners with underwater properties should not be taxed at all for forgiven indebtedness resulting from MSSTs—it is shadow income at best, from which taxpayers see no tangible gain like under § 121.

By enacting Mortgage Forgiveness Debt Relief Act and promoting programs[39] to aid distressed homeowners, the government created a societal perception[40] that new programs and homeownership tax laws would protect the welfare of its citizens in a time of crisis.[41] The aftermath of the 2007 financial crisis will continue for many years to come, devastating the long-recognized social benefits of homeownership. MSSTs, as thus far permitted, jeopardize any wealth-building many taxpayers could realize or derive from homeownership-related tax deductions because the new tax liability MSSTs create jeopardizes their financial stability and impedes recovery. The government, therefore, must expand MFDRA coverage as a matter of public policy to provide a mechanism to protect the financial well-being of its citizens from the societal malady caused by the 2007 financial crisis, and, arguably, caused in part by the government's action of misleading its citizens into homeownership.[42]

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one who sells a principal residence to exclude up to $500,000 (if married) and $250,000 (for individuals) of gain from their taxable income.

37. *Id*.

38. *Boondongle*, DICTIONARY.COM, http://www.dictionary.com/browse/boondoggle (last visited Apr. 15, 2016).

39. *See Home Affordable Foreclosure Alternative Program: Overview*, MAKING HOME AFFORDABLE, https://www.hmpadmin.com/portal/programs/foreclosure_alternatives.jsp (last visited Apr. 15, 2016) [hereinafter HAFA].

40. In the early 2000s, the perception the federal government and lenders created was that homeownership provides useful societal benefits, such as creating a "secure America." Mann, *supra* note 30, at 3, n. 1 (citing George W. Bush, President Calls for Expanding Opportunities for Home Ownership, Remarks by the President on Home Ownership, St. Paul A.M.E. Church, Atlanta, Georgia (June 17, 2002, 11:10 AM), http://georgewbush-whitehouse.archives.gov/news/releases/2002/06/20020617-2.html).

41. Mann, *supra* note 30. *See also* Stern, *supra* note 28, at 891. With homeownership, one could build wealth, improve educational outcomes for children, and participate in local government through voting and paying taxes. *Id*.

42. *See* FCIC REPORT, *supra* note 2, at 495.

Some researchers argue that a change in the tax code is particularly salient because they discredit prevailing notions of societal and personal benefit of homeownership.[43] Some state that homeownership hinders employment mobility[44] or creates financial hardship on those who cannot afford associated maintenance costs.[45] If the government, therefore, was complicit in promoting homeownership, which has now caused detriment to its citizens, then the government should arguably do all it can to remedy the ill it has helped create.

The practicality is that the impact of the 2007 financial crisis continues to impede homeowners severely.[46] While Congress may be unable to fix all the consequences resulting from homeownership and this financial crisis, such as the underwater property market or the impact on local and state government, it can take action through homeownership tax law reform to remedy the adverse consequences the tax code places on homeowners in today's real estate market.

It is fundamentally unfair, given the current condition of the real estate market,[47] for the government to burden its citizens with tax liability through MSSTs.[48] The government's obligation is to provide an equitable means to allow homeowners who have not been able to recover from the

43. *See generally* Andrew J. Oswald, *The Housing Market and Unemployment: A Non-Technical Paper* (1999), http://www.andrewoswald.com/docs/homesnt.pdf.

44. *Id*. *See* Daniel N. Shaviro, *The 2008 Financial Crisis: Implications for Income Tax Reform* 22, http://ssrn.com/abstract=1442089 (last visited Dec. 8, 2014) (noting it is more costly to move as a homeowner than a renter, possibly slowing economic adjustment when jobs disappear in one area and arise in another area); s*ee also* Richard Florida, *How the Crash will Reshape America*, THE ATLANTIC (Mar. 2009), http://www.theatlantic.com/magazine/archive/2009/03/how-the-crash-will-reshape-america/7293/6 (Noting homeownership makes the individual, and ultimately the society, less nimble, especially when labor markets are shifting within regions, and also creates a stagnant economy). Employment mobility is hindered because the need to sell an underwater home, or any home, makes it difficult to take jobs in other locations, fostering a mismatch between workers' skills and available jobs when the local employment market tightens. Oswald, *supra* note 43.

45. In addition to the monthly mortgage payment that could increase, homeowners facing financial hardship also must pay the rising costs of municipal taxes, such as real estate taxes, and maintenance of the property. *See generally* Fischer, *supra* note 5 (stating the main goals in the United States are those of the dual mandate: maximum employment and stable prices). For those homeowners who had just enough financial ability to pay the increased mortgage payment, they were left with little funds or no funds for other home-related costs, such as upkeep of the property or increases in local real estate taxes. *See* Oswald, *supra* note 43.

46. Robert R. Callis & Melissa Kresin, *Residential Vacancies and Homeownership in the Third Quarter 2014*, U.S. CENSUS BUREAU NEWS (Jan. 28, 2014), http://www.census.gov/housing/hvs/files/currenthvspress.pdf.

47. Financial crisis, and ultimately the real estate market collapse, was birthed from the government's lack of regulation of mortgage lending practices. *See* FCIC REPORT, *supra* note 2.

48. Mortgage lenders failed to restrain themselves from introducing toxic mortgage products into the market, for which they were profit motivated, that ultimately stripped equity wealth from a vast number of citizens. *See id.*

continuing financial crisis to eliminate tax liability resulting from MSSTs by modifying the tax code. The government "owes to everyone an avenue to possess himself a portion of the [nation's wealth] sufficient for his needs, through his own work . . . ," and taxation of MSSTs denies that avenue to too many current homeowners.[49] The equity wealth that millions of citizens lost, and continue to lose, resulted from the conduct, or lack thereof, of both the government regulators and self-regulating mortgage lenders.[50] Homeowners should not suffer even more financial loss by virtue of an antiquated tax code when the drafters of MFDRA failed to foresee resulting consequences to homeowners who would be further crippled economically by selling underwater properties.[51] MSSTs are likely to remain a permanent, necessary feature of the marketplace in many cities for quite some time into the future, especially given the millions of underwater properties that exist nine years after the 2007 financial collapse. The government, therefore, must implement a long-term solution to avoid disproportionally burdening lower and middle-class taxpayers with further financial hardship caused by tax liability to the government.

III. THE RISE OF MORTGAGE SHORT SALE TRANSACTIONS

The concept of MSSTs evolved in the residential real estate market in the aftermath of the 2007 financial crisis, which caused home values to plummet. Prior to that time, American homeowners were scarcely aware of the existence of MSSTs because the housing market generally maintained its values over the previous decades or saw less volatile declines than were seen during the Great Recession. Housing values that are underwater, or upside down, are also referred to as having negative equity value, a concept used to refer to assets that are worth less than the liability secured against the property.[52] Some data exists regarding

49. FORBATH, *supra* note 23, at 29 (citing Franklin D. Roosevelt, Acceptance of the Renomination for the Presidency, Philadelphia, Pennsylvania (June 27, 1936), *in* 5 PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 234 (Samuel I. Rosenman, ed., 1938)).

50. *See* FCIC REPORT, *supra* note 2.

51. *See infra* notes 80-92, and accompanying text.

52. As the leading global property information, analytics and data-enabled solutions provider, CoreLogic delivers unique property-level insights that power the global real estate economy company. *See generally* CORELOGIC, *Negative Equity Report*, http://www.corelogic.com/about-us/researchtrends/equity-report.aspx#.VIxsLMJ0xOw (last visited Dec. 13, 2014). It produces a Negative Equity Report every quarter but appears not to have started doing so until after the financial crisis. *Id*. This report evidences the practical need to capture regularly these losses due to the significant devaluation of property after the 2007 financial crisis. *Id*. The Equity Report provides a quarterly overview of the distribution of equity across all U.S. single-family residential properties

negative equity real property values that lenders rely on to negotiate the terms upon which homeowners can sell their underwater homes through MSSTs.

In the residential real estate mortgage context, the concept of the "short sale," referred to here as MSST, does not have clear origins in scholastic literature, legal treatises, or tax laws prior to the 2007 financial crisis.[53] According to at least one treatise, MSSTs are (private) two-party contractual transactions between lenders and their borrowers in which lenders allow borrowers[54] to pay a reduced mortgage balance, typically based upon the current market value of the real property and what third-party buyers are willing to pay to buy the property.[55] For MSSTs, the property values are always worth less than the existing mortgage balances owed to lenders at the time the real estate sale transaction closes.[56] Lenders and homeowners negotiate MSSTs as arms-length transactions, but lenders are in the superior bargaining position[57] because homeowners' ability to sell underwater properties is subject to lenders' sole discretion to accept reduced payoffs of mortgages. Thus, when lenders accept the reduced mortgage payoff, they agree to release their mortgage lien so that homeowners can sell the property free and clear to buyers.

Under the MSST agreement, homeowners sell the underwater

with a mortgage. *Id*. In addition to the comprehensive national snapshot, the report includes details for all states and the 25 largest metropolitan areas. *Id*. It is relied on by reputable financial and wealth medias, such as Forbes. *See* Carlyle, *supra* note 4.

53. *See* MADISON, ET AL., *supra* note 8.

54. Buyers of the property are not a part of MSSTs agreement—only the real estate transaction between homeowners/sellers of the property. Buyers typically enter into the real estate sale contract on the condition that the deal will only be consummated if sellers can successfully obtain lenders' approval for MSSTs. *See generally* Stacey Vernallis, *Short Sales: Full Disclosure Needed*, REALTORMAG (Mar. 2010), http://realtormag.realtor.org/law-and-ethics/law/article/2010/03/short-sales-full-disclosure-needed; *see* California Association of Realtors, *Short Sale Addendum* (Nov. 2010), http://www.car.org/media/pdf/legal/standard-forms/478214/.

55. In the author's experience, the MSST agreements with lenders release borrowers from any further payment obligation in some cases, but in other instances, lenders may ask borrowers to agree to an unsecured loan by signing a promissory note for all or a portion of the loan balance that cannot be satisfied from the sales of the property.

56. MSSTs are governed by contract law and state legislation. *See generally* MICHELLE KIRBY, OLR RESEARCH REPORT, 2013-R-0400, SHORT SALES (2013), http://www.cga.ct.gov/2013/rpt/2013-R-0400.htm (last visited Dec. 13, 2014) (discussing various states that are considering legislation regulating [residential] short sales transactions). The federal government has only provided guidelines for MSSTs under various loan modification programs. *Id*. *See also* HAFA, *supra* note 39.

57**.** Typically, homeowners pay off their mortgages upon the sale of their homes through the proceeds at closing. At that time, lenders release the mortgage lien against the property, and the new buyer has clear title. When the sales proceeds are insufficient to pay off the mortgage balance, the risk is that the lender will not release the lien and no buyers or their purchase money mortgage lenders will want to take title to the property subject to a superior lien position. *See generally* Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253, 253 (2009).

properties at the deflated current values that buyers in the market are willing to pay for the property. At the closing, homeowners use the sales proceeds from the real estate sales transaction to pay off the mortgage balance. Lenders specifically instruct the escrow company as to the conditions of the mortgage payoff, through instructions delivered to the escrow company, so that lenders also release the mortgage lien on the property upon payoff of the mortgage. If lenders do not agree to MSSTs, the real estate sales transactions cannot occur unless homeowners can afford to pay lenders the difference between the outstanding mortgage balance and the sales proceeds at the time of closing of the real estate transaction, which is a highly unlikely situation for financially distressed homeowners with underwater property. But once the closing concludes, the lender releases the mortgage lien and the homeowner is emancipated from mortgage and associated costs of homeownership.

MSSTs are, arguably, beneficial to both lenders and borrowers. Some of the benefits of MSSTs for lenders and homeowners are tangible. For lenders, MSSTs aid them in receiving a substantial amount of the mortgage balance that they might not otherwise receive if homeowners default on their mortgages by not making monthly payments.[58] Homeowners benefit from being able to sell their underwater property in times of financial distress. However, the financial benefit of MSSTs is actual for lenders but illusory for homeowners because homeowners may end up substituting the payment of a tax liability for the mortgage payment. Given the federal tax consequences of the MSST that exists under current tax laws, the mortgage balance lenders forgive to allow MSSTs is treated by the Internal Revenue Service (IRS), under the tax code, as taxable income to homeowners.

Homeowners with underwater properties are at a disadvantage because they do not know all of the alternatives to MSSTs and, thus, cannot weigh the benefits and disadvantages of each scenario as applied to their specific financial situation. In particular, they do not know that the existing tax law may not be favorable to them when selecting MSSTs. Although Congress twice renewed MFDRA, broadening the scope of its coverage would help millions of homeowners with underwater properties to receive relief the government promised and would eliminate the onerous tax consequences of the existing law, an inequity that the government must remedy.

Subpart A analyzes the perceived, but illusory, benefits of MSSTs for homeowners, and contrasts the perceived benefits with the actual

58. *See* MADISON, ET AL., *supra* note 8.

pitfalls of MSSTs, while discussing the tangible monetary benefits of MSSTs for Realtors and lenders. Subpart B highlights the disadvantages to homeowners when dealing with Realtors and lenders who are knowledgeable about the intricacies of MSSTs. Subpart C demonstrates the harsh implications of MSSTs for homeowners and suggests the alternatives of bankruptcy and foreclosure actions. Subpart D discusses the alternatives available to homeowners, specifically bankruptcy and foreclosure. Subpart E advocates that finding a solution to the MSST problem would boost the national economy.

A. Tangible Benefits of MSSTs for Realtors and Lenders Versus Illusory Benefits for Homeowners

The post-2007 financial crisis has forced lenders and Realtors to find ways to minimize their respective profit and losses in the sea of underwater properties that has surged into the residential real estate market. As a mechanism to aid the real estate sales market recovery and to mitigate losses to lenders, MSSTs solved the problem of selling devalued properties after the 2007 financial collapse. Lenders and Realtors cooperated to assist homeowners in selling underwater properties they could no longer afford through the use of MSSTs, and this seemed like the ultimate solution for lenders, Realtors, and homeowners. The motivations of the lenders and Realtors, however, were adverse to those of homeowners who could have sought other alternatives to MSSTs such as bankruptcy or foreclosure.

For Realtors, using MSSTs presented a solution to the problem of a stagnant housing market with volumes of underwater properties, making it easier for homeowners to sell, and Realtors to maintain revenue streams through commissions. Lenders used MSSTs to avoid the costs and liabilities of the foreclosure process and subsequent ownership of properties.[59] Lenders are not in the business of owning property,

59. Lenders used short sales to trade a slow moving or greatly depreciated asset, in this case a mortgage loan, for liquidity. Nelse Thompson Miller, *Short Sales Overview with an Emphasis on Broker Issues Until the Market Improves, More Property Owners Will Cut Their Losses and Move On*, PRACT. REAL EST. LAW 9 (2010). Lenders do not want to carry too many properties on their REO (real estate-owned) books because they are not income-producing without monthly mortgage payments. *Short Sale*, REALTYTRAC, http://www.realtytrac.com/real-estate-guides/foreclosure-prevention/short-sale-to-stop-foreclosure/ (last visited Dec. 13, 2014). *See generally REO and Bank-Owned Properties: What You Need to Know*, MY HOME BY FREDDIE MAC, http://www.freddiemac.com/homeownership/rent_or_buy/reo_bank_owned.html (last visited Dec. 13, 2014). Real Estate Owned by Lenders is also referred to as REO Property. *Id*. Now the bank is the owner, and it has a different liability than it ever did as a lender. *See generally* Roberto Ceniceros, *Foreclosures Create New Risks for Banks*, BUSINESS INSURANCE (May 31, 2009),

especially underwater property that creates more liability risk than profit potential.[60] Homeowners who sought to avoid default or relocate to other areas due to their personal financial crisis, such as income reduction or job loss, needed MSSTs to sell their homes to cut their financial losses.[61] While at first glance, the use of MSSTs seemed mutually beneficial to lenders, Realtors, homeowners, and, ultimately, the national economy that was in desperate need of recovery, homeowners received the least beneficial impact from MSSTs due to the federal tax liability created by MSSTs that neither lenders nor Realtors experienced.

Lenders led the way to the real estate sales market recovery by approving MSSTs, which Realtors used to move the unprecedented number of underwater properties off the market. Motivated Realtors and lenders worked in tandem to sell underwater properties. In promoting the use of MSSTs to homeowners as a less detrimental option than foreclosure, lenders and Realtors disregarded the detrimental tax and consequential financial implications that homeowners face by entering into MSSTs. In addition to the potential tax liability, homeowners face the following: (a) negative credit reports; (b) the financial burden of upfront fees some lenders require before they approve MSSTs; (c) the costs of necessary repairs homeowners cannot afford to pay (either required by buyers or municipalities before the sale of the property); (d) significant loss of equity; and (e) potential other burdensome financial consequences.

The real estate sales industry's consequences for engaging in MSSTs were not grave at all by comparison to homeowners. Realtors were not parties to the actual MSSTs, although necessary for its success, because some lenders required homeowners to first attempt to sell the underwater property through a Realtor for a specified period, such as three to six months, before lenders would even consider MSSTs. Lenders agreed to pay Realtors their commissions once the real estate sales transaction closed. Thus, by listing the property, Realtors were able to provide market value comparisons, or "comps," of the property compared to other sales in the market that lenders relied on when setting MSST mortgage payoff amounts. After the period for listing the property expired and by the time

http://www.businessinsurance.com/article/20090531/ISSUE01/305319984; s*ee also* Patrick Barnard, *Property Preservation, Longer Foreclosure Timelines Drive Demand for REO Insurance*, SERVICING MANAGEMENT (Dec. 2013), http://www.mortgageorb.com/issues/SVM1312/FEAT_05_Longer-Foreclosure-Timelines-Driving-Demand-For-REO-Insurance.html.

60. *See* Miller, *supra* note 59.

61. *See generally* Michael Babbitt, Erik Gerth & Mary McGrane, *Workout of Home Mortgage Default*, *in* 1 LAW OF DISTRESSED REAL ESTATE § 3B:8 (Thompson Reuters 2014). From the perspective of homeowners, MSSTs avoid foreclosures and deficiency judgments, allowing them a fresh start without any continuing obligation to repay the loan under the note and mortgage. *Id*.

homeowners had missed several payments,[62] lenders either began negotiations of MSST payoff amounts based on the existing value of the property, or waited until the homeowners actually entered into a real estate sales contract with a buyer, with the contract closing being conditioned on lender approval of an MSST. Homeowners and buyers then waited until lenders processed the homeowner's information for the MSST, including income, financial statements, the real estate contract, Realtor comps, and any other information lenders deemed necessary in their assessment as to whether an MSST was in the lender's best interest. Remember that Realtors and buyers are not involved in the actual MSSTs negotiations, only homeowners and lenders. Thus, if the real estate deal falls through because lenders do not approve MSSTs, buyers do not suffer any damages because of the conditional contract and Realtors do not have any loss except the potential commissions (typically, commissions are not guaranteed payments under the real estate sales contract by either sellers or buyers until all contract conditions are met allowing the transaction to close). Homeowners, however, face adverse consequences if their need to sell the property is necessary for their financial viability.

Realtors' motivations to make a commission would have outweighed the need for homeowners to consider other viable alternatives, including bankruptcy or foreclosure—possible acceptable options that might have been more beneficial for homeowners to consider in lieu of an MSST.[63] Either foreclosure or bankruptcy might have had a less detrimental financial impact than the federal tax liability created by an MSST. Another possible benefit for homeowners choosing to allow foreclosure on the property would be anti-deficiency judgment statutes in a minority of states. Anti-deficiency judgment statutes forbid lenders from collecting deficiency judgments against homeowners in the event of foreclosure without tax consequences. For states without anti-deficiency judgment statutes, when foreclosures are coupled with bankruptcy, homeowners in bankruptcy avoid deficiency judgments because once the foreclosure court enters the deficiency judgment, the lender becomes an unsecured creditor, and that unsecured debt is dischargeable in bankruptcy court.[64] Under these circumstances, homeowners would still have negative credit ratings for choosing an MSST, foreclosure, or bankruptcy, but MSSTs have lingering financial effects because of the tax liability. Given the

62. Miller, *supra* note 59. "Lenders usually require the seller [homeowner] be in arrears on payments for a few months before considering a short sale." *Id*.

63. *See supra* Part II.A

64. *See generally Using Bankruptcy to Provide Relief From Tax Debt*, INTERNAL REVENUE SERVICE (2013), https://www.irs.gov/pub/irs-utl/2013_NTF_Bankruptcy_Relief.pdf.

complexities of the laws, both non-tax and tax-related, and the information asymmetry between lenders, Realtors and homeowners, homeowners were at a disadvantage by not knowing the best alternatives to sell their underwater property, and more importantly, the implications that advantaged and disadvantaged them.[65]

Lenders were motivated to use MSSTs, not to make profits, like commissions, but to avoid additional losses on the mortgages they held. Lenders maximized the profits for investors by securitizing mortgages.[66] To minimize the losses on defaulted mortgages across various high-risk tranches in these securities, known as mortgage-backed securities (MBSs), lenders used MSSTs in lieu of foreclosures. In many instances, foreclosure was a more costly and time consuming mechanism for minimizing loss of profits for investors. Furthermore, lenders and investors who held MBSs potentially faced significant losses from uncollectable toxic mortgage products with more risk of borrowers defaulting. MSSTs could help to mitigate those losses and avoid liabilities associated with defaulted mortgages in at least three areas.[67]

The first liability area relates to the defaulting toxic mortgage products lenders placed in the real estate lending market and includes the costs or liabilities[68] associated with the foreclosure process.[69] In judicial foreclosure jurisdictions,[70] lenders did not want to initiate judicial foreclosure actions,[71] especially with the significant costs associated with litigation and the strict procedural rules that prolonged the foreclosure

65. Debra Pogrund Stark & Jessica M. Choplin, *A License to Deceive: Enforcing Contractual Myths Despite Consumer Psychological Realities*, 5 N.Y.U. J.L. & BUS. 617, 660-62 (2009).

66. *See* Kristin N. Johnson, *From Diagnosing the Dilemma to Divining a Cure: Post-Crisis Regulation of Financial Markets*, 40 SETON HALL L. REV. 1299, 1306-07 (2010).

67. *See* ALVIN L. ARNOLD, MORTGAGE AND REAL ESTATE EXECUTIVES REPORT (2011). The overall difficulty with MSSTs is that mortgage servicers of collateralized mortgage securities, often referred to as collateralized debt obligations (CDOs) or mortgage backed securities (MBSs), need to obtain approval for MSSTs from pools of investors, a process which has proved inefficient at best, taking a few weeks to a couple of months. *See generally* Johnson, *supra* note 66.

68. Once lenders file for foreclosure and pay court costs and attorneys' fees, lenders must then secure the property if the property is vacant, maintain forced property and liability insurance on the property, and pay or redeem any real estate taxes to avoid tax sales that could grant title to another owner. *See* Miller, *supra* note 59, at 9-10 (Noting that short sales are more attractive and less expensive than foreclosures). *See generally* ARNOLD, *supra* note 67.

69. ARNOLD, *supra* note 67.

70. In non-judicial foreclosure states, the delays may be less significant, but homeowners may still be able to ask for court intervention. *See* Department of Consumer and Business Services, *Where to Get Help*, OREGON.GOV, http://www.oregon.gov/DCBS/foreclosure/Pages/where-to-get-help.aspx (last visited May 17, 2016).

71. In non-judicial foreclosures, on the other hand, lenders have lower costs because no court action or delays are involved unless homeowners change the process. *Id*.

process.[72] Lenders expended an average of 40% loss of the mortgage loan balance when lenders foreclosed versus less than half that loss, at 19%, through MSSTs.[73] MSSTs, alternatively, saved lenders money and time by avoiding the mandatory, complex procedures associated with foreclosures. With foreclosures, lenders face significant delays in gaining court-ordered possession of the property even after a judicial foreclosure sale, especially if borrowers engage in motion practice in court hearings and in continuances that extend the time of the court proceedings to allow homeowners additional time to continue to reside in the property until finding somewhere to relocate.[74] In addition, as the new property owner following foreclosure, lenders have to bear the liability and costs of owning the property.

Thus, the second area of liability is the costs associated with the responsibilities of property ownership once the foreclosure process is final. Lenders are in the business of lending money to buy homes, not owning homes themselves.[75] Once lenders become owners, the additional costs post-foreclosure include: (a) holding the unpaid mortgage for which no income will derive;[76] (b) purchasing property and liability insurance to cover potential damage to the property and third parties; (c) paying local

72. Miller, *supra* note 59.

73. According to an analysis in 2008 by Clayton Holdings, Inc., a firm that tracks mortgage loans for investors, for an MSST, lenders do not have to pay "carrying costs." *Id.* If the lender were to foreclose on the property instead of allowing an MSST, the lender incurs significant costs including court filing fees, service of process costs, legal fees, foreclosure related costs (notice, auction, and other fees), maintenance fees (when the property has been abandoned by the homeowner), insurance, and real estate taxes. *Id*. Thus, if lenders cooperate and approve an MSST, they save money. *Id*.

74. In practice, courts allow *pro se* borrowers and borrowers with attorneys time to mediate with lenders, which delays the foreclosure case. During the height of the foreclosure crisis, in some jurisdictions, court dockets were so overwhelmed with foreclosure actions that courts set up mediation programs to deal with the volume of cases. *See* Paul Jackson, *Overwhelmed Illinois Court Postpones Foreclosures Until September*, HOUSING WIRE (Apr. 16, 2009), http://www.housingwire.com/articles/overwhelmed-illinois-court-postpones-foreclosures-until-september.

75. In addition, lenders could face liability exposures, in tort for injury to parties in the property or from local government actions for maintenance, taxes, or securing the property. Lenders also must keep sufficient capital reserves for the outstanding mortgage balance until it is paid-off. Lenders also face maintenance costs and issues for vacant properties, especially in blight communities. When selling a foreclosed property, lenders must be careful to waive all warranties upon contract or face a breach with potential buyers. *See* Ilyce Glink & Samuel Tamkin, *Short sales and deficiency judgments: What you need to know*, CHICAGO TRIBUNE (Dec. 21, 2012), http://articles.chicagotribune.com/2012-12-21/marketplace/sns-201212161100—tms—realestmctnig-a20121221-20121221_1_mortgage-lender-short-sale-forgiven-debt.

76. From my practical experience, lenders are typically the only buyer at the foreclosure sale of the property and, thus, buy the property for the value of their own mortgage balance. In better real estate markets, the hope is that they can quickly resell the property for a profit or cut their losses from holding the property until it sells.

real estate taxes and assessments; and (d) assuring general maintenance of the property to avoid deterioration of vacant property. Lenders do not make money for their investors by holding properties that produce no revenues while expending money to pay for the cost of ownership of properties. MSSTs minimize the time during which lenders realize losses.

The third liability area involves lenders' liability exposure as sellers of the properties. After acquiring title to the property post-foreclosure, lenders seek to resell properties as quickly as possible because of the costs of ownership stated above. In addition, when lenders become sellers of properties, they expose themselves to all the potential contractual responsibilities that any seller of property assumes. While lenders predominately require their prospective buyers to waive almost all warranties and representations as a condition of the sale, lenders who are owners cannot waive federal and state required laws, including disclosure laws, and lenders may, thus, become liable for non-compliance or violation of statutory requirements. MSSTs allow lenders to avoid this set of potential liabilities associated with selling properties when existing homeowners facilitate the sale of the property.[77] This allows lenders to save money and to avoid contract-based liability issues.[78]

The cooperation between lenders and borrowers through MSSTs may allow for a quicker turnaround of the sale between homeowners and prospective third-party buyers. In the best case, homeowners who stay in the property also maintain the property so that the value does not drop further due to deterioration of the property. Lenders benefit from a better chance of having a substantial amount of its mortgage paid off if they cooperate with homeowners who assist in the sale of the property, remain in legal title, and occupy and maintain the property pending the sale. Lenders, as legal title owners, who then must sell the property, run the risk that prospective buyers may not close on the real estate contracts at all and that the property remains vacant, subjecting lenders to further liability as the owner of record, especially to municipalities who require the property be safely maintained.[79]

77. *See generally* Leigh Thompson, *Do Mortgage Lenders Prefer to Do a Short Sale or a Foreclosure?*, SFGATE: HOME GUIDES, http://homeguides.sfgate.com/mortgage-lenders-prefer-short-sale-foreclosure-49815.html (last visited Apr. 2, 2016).

78. Lender costs associated with MSSTs include internal administrative services or fees already contracted with a mortgage servicing company for the additional service of facilitating the MSST. *See also* Julie Schmit, *Lenders Embrace More Short Sales*, USA TODAY (Feb. 19, 2012), http://usatoday30.usatoday.com/MONEY/usaedition/2012-02-20-Short-sales-_ST_U.htm.

79. Jonathan Stempel, *Lawsuit Accuses Wells Fargo of Biased Lending in Chicago Area*, REUTERS (Nov. 28, 2014, 7:44 PM), http://www.reuters.com/article/us-wellsfargo-chicago-lawsuit-idUSKCN0JC24020141129. *See also BofA, Citi, Wells Fargo Accused Of Lending Discrimination In*

For lenders and Realtors, the actual benefits, or liability avoidance, through MSSTs make these transactions less risky. For homeowners, while tangible benefits seem to be the sale of the underwater property and relief from paying the mortgage, the benefits have an illusory effect because inequity arises for homeowners resulting from MSSTs from which they might not so easily recover, specifically financial hardship from federal tax consequences. Recognizing this inequity, Congress has attempted to address it but only in a very narrow scope that still leaves homeowners exposed to federal tax liability.

B. Inequity of the MSSTs

The public policies that the federal government adopts to protect homeowners are essential for the future economic stability of the national economy.[80] Policymakers must take into consideration ways to balance inequities to citizens when new laws create a disparity among taxpayers legitimately deserving relief, as has been the case with the MFRDA. Following the 2007 financial crisis, the introduction into the real estate sales market[81] of the MSST method of selling underwater properties created financial risk for unsuspecting homeowners selling their properties. This financial risk was the federal tax liability created for homeowners who used MSSTs to sell their property. In 2007, without any apparent opposition from lenders or Realtors who promoted the use of MSSTs,[82] the U.S. Congress responded with legislation to provide temporary tax relief for homeowners[83] who faced tax liability for

Miami Suit, HUFFINGTON POST (Feb. 18, 2014), http://www.huffingtonpost.com/2013/12/19/miami-borrower-discrimination_n_4475985.html.

80. DEMOCRACY, SOCIAL VALUES AND PUBLIC POLICY, *supra* note 20. The strength of American democracy lies in its social values, on the way they influence public choice, and how they are reflected in public policies. *Id*.

81. *See* Valenza, *supra* note 9.

82. The lending industry had no true opposition to this type of government aid for taxpayers primarily because the relief for taxpayers did not impact lenders' ability to avoid or mitigate their liabilities in the residential real estate market through the use of MSSTs. In fact, the new law helped lenders increase the payoff of bad mortgages on their books. *See generally* Laurie Goodman & Ellen Seidman, *The Mortgage Forgiveness Debt Relief Act Has Expired—Renewal Could Benefit Millions*, URBAN INSTITUTE: HOUSING FINANCE POLICY CENTER COMMENTARY 6 (Feb. 17, 2014), http://www.urban.org/UploadedPDF/413025-Mortgage-Forgiveness-Debt-Relief-Act-Has-Expired.pdf.

83. For example, short sales were virtually unknown in California prior to 2007. *See* Valenza, *supra* note 9. *See also* BILL ANALYSIS, SENATE BILL 412, *supra* note 13, (As reported by the U.S. Senate, according to the California Association of Realtors, there were approximately 110,000 short sales in California during 2010, up from approximately 90,000 during 2009, a few thousand in 2008, and a negligible amount in 2007.).

engaging in MSSTs.[84]

Congress passed the tax relief act known as the Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA).[85] The MFDRA was intended to address the tax implications for homeowners of using the MSST vehicle, but, as I detail in Part V below, the MFDRA was too narrow in scope and application to provide significant relief to the range of homeowners with underwater property. In Part V, I propose means by which Congress can provide the necessary pragmatic relief to the full range of homeowners. This section, however, will discuss the nature of relief provided to homeowners under the MFDRA and will suggest that Congress make the following changes: (1) extension of the amount of time for relief to be afforded; (2) tax relief for secondary residences similar to that for principal residences; and (3) better tax relief protection for homeowners when they put a residence on the market.

Congress passed MFDRA to address the harm that would arise with lenders' widespread use of MSSTs. The intent was to allow homeowners to sell their underwater homes with some tax relief. Under the tax laws prior to MFDRA, for any forgiven debt by a creditor, the IRS classified the forgiven debt as taxable income to the taxpayer. The reduction of debt that lenders forgave to allow MSSTs, thus, caused a shadow increase in taxable income for homeowners. Taxpayers included the forgiven indebtedness as income in their Adjusted Gross Income, which was then subject to tax under the taxpayers' applicable tax rate. The forgiven indebtedness, therefore, created an additional tax liability.[86] In 2007,

84. It was not long after the 2007 financial collapse that policymakers addressed this inequity for taxpayers trying to sell their underwater properties. *See Fact Sheet: The Mortgage Forgiveness Debt Relief Act of 2007*, THE WHITE HOUSE (Dec. 20, 2007), http://georgewbush-whitehouse.archives.gov/news/releases/2007/12/20071220-6.html (citing President George W. Bush on Sep. 1, 2007: "When your home is losing value and your family is under financial stress, the last thing you need is to be hit with higher taxes. So I'm working with members of both parties to pass a bill that will protect homeowners from having to pay taxes on cancelled mortgage debt."). *Id*. Such action by the U.S. Congress seemed *apropos* to aid homeowners drowning in the underwater real estate market and, especially after Congress gave national banks that held mortgages a monumental amount of funds to recover from the mortgage market collapse, through the Trouble Assets Relief Program (TARP). *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 1-303, 122 Stat. 3765 (2008); Porter, *Pawns for a Higher Greed*, *supra* note 25.

85. I.R.C. § 108 (LEXIS, through PL 114-115, approved 12/28/15). The section, in its entirety, includes: discharge of indebtedness exclusion from gross income for bankruptcy, insolvency, qualified farm indebtedness, qualified real property indebtedness, and qualified principal residence indebtedness before January 1, 2015. As of December 31, 2014, Congress extended MDFRA to apply to taxpayers filing 2014 tax returns who sold a home between January 1, 2014, and December 31, 2014. *See* H.R. 3856 (113th): Homeowners Debt Relief Extension Act of 2014, GOVTRACK.US, https://www.govtrack.us/congress/bills/113/hr3856 (last visited Dec. 8, 2014). In December 2015, MDFRA was extended through the end of 2016. Ricci, *supra* note 3.

86. Lenders faced no such tax consequences because the tax laws for businesses, such as large

when lenders were entering into MSSTs to allow homeowners to sell their underwater properties, in extreme situations, lenders were forgiving hundreds of thousands of dollars of debt under mortgages, creating a potentially devastating tax burden for taxpayers. In addition to the potential tax liability concern, property sales under the poor national economic climate became stagnant, and the saturation of underwater homes in the market, plus the mortgage-lending freeze, made it impossible for taxpayers to sell their homes without lenders' approval of MSSTs.

MFDRA's terms, however, were too narrow and failed to account for, and adjust to, the evolving landscape of underwater properties in the real estate market.[87] The law was too narrow as to its coverage period, its scope of eligible taxpayers, and its flexibility to changes in the real estate market during the volatile recovery period long after the 2007 financial collapse, during the Great Recession, and even nine years later. The underwater properties in the real estate market did and still do require a broader scope of MFDRA. During the years after MFDRA became effective, a variety of scenarios for taxpayers with principal and secondary residences morphed in a distressed residential real estate landscape.

First, Congress only intended MFDRA to be temporary tax relief for homeowners who faced potential tax burdens for engaging in MSSTs. MFDRA, originally applied to debt forgiven by lenders through MSSTs in calendar years 2008 through 2010, but has now been extended three times, with the most recent extension by President Barack Obama in December 2015 for an additional year to cover tax year 2016. Given the statistics in 2015, almost 10 million homes nationwide that are currently underwater, Congress's one-year extension will not have the impact of protecting taxpayers in the long term given the continued fallout of the financial crisis,[88] which will continue well beyond 2016.

Second, MFDRA failed to take into account owners of underwater secondary residences.[89] MFDRA provides tax relief for only those

lenders, are uniquely different from those affecting individual taxpayers. For lenders, the reduction in debt was a deduction as an ordinary business loss, or capital loss depending on the tax rules, that created no taxable income event. As a result, the MSST created an inequity in which the government could tax individual taxpayers but not lenders. *See generally* IRS, https://www.irs.gov (detailing business and corporation tax rules).

87. *See* BILL ANALYSIS, SENATE BILL 412, *supra* note 13.

88. Florida, for example, has in excess of 1 million of those properties. Harwell, *supra* note 4; Barringer, *supra* note 4.

89. During the mortgage boom, secondary home purchases increased at a significant rate, although not at the ridiculous pace of primary homes purchases. *See generally* Ing-Haw Cheng, Sahil Raina, & Wei Xiong, *Wall Street and the Housing Bubble*, 104 AM. ECON. REV. 2797 (2014), *available at* https://www.princeton.edu/~wxiong/papers/WallStreet.pdf (discussing Americans investing in second and investment properties). The statistics are difficult to find for secondary homes

taxpayers who sold or sell their principal residence properties through MSSTs. MFDRA does not allow for tax relief for secondary homes. Congress's passage of MFDRA, however, should have taken into account the unfairness in not offering broad enough tax relief to solvent middle-class taxpaying homeowners whom lenders and the tax laws incentivized to invest in secondary residences. Millions of homeowners invested in secondary homes during the mortgage boom because of favorable lending standards.[90] New tax laws that deal with MSSTs should give taxpayers the option of selecting MFRDA relief for either principal or secondary residences, which would at least give taxpayers some flexibility in how to best mitigate the financial distress from owning these types of underwater properties. Even though a secondary home, as defined by tax law, is only occupied by the homeowner for finite periods during the year, the existing tax laws have always given both principal and secondary homes the same treatment for tax deduction purposes. The tax code provides the exact same tax treatment for secondary homes as principal residences for mortgage interest and real estate tax deductions.[91] Even though both principal and secondary homes suffered staggering devaluation,[92] only homeowners with principal residences could sell their properties through MSSTs and exclude the debt that lenders forgave from their taxable income.[93] With the exclusion limitations under MFDRA as to the amount of forgiven debt taxpayers could exclude from taxable income,[94]

sales, especially those sold as MSSTs, but the market for these homes existed from 2000 to 2007, well before the financial crisis.

90. Many homeowners entered the secondary residence market, especially with available mortgages lenders provided and with the ability to deduct the interest and real estate taxes just as they did for their mortgages on their primary residences. Thus, the secondary home market grew with the hope of many existing homeowners of having retirement homes in warmer climates or an investment for future inheritance or use. Daria Kelly Uhlig, *The Advantages & Disadvantages of Buying a Second Home*, SFGATE: HOME GUIDES, http://homeguides.sfgate.com/advantages-disadvantages-buying-second-home-50334.html (last visited Apr. 2, 2016). *See also Why Have a Second Home?*, DISCOVER (Jul. 26, 2014), https://www.discover.com/home-loans/blog/why-have-a-second-home.

91. I.R.C. § 163(h)(3) (LEXIS, through PL 114-115, approved 12/28/15).

92. There is scarce data or information in the market for second homes but several warmer region states are notorious for second home purchases including Arizona, Florida, Nevada, and Southern California.

93. In a normal market where property values exceed mortgage balances, § 121 of the Tax Code would allow homeowners to exclude gains from the sale of primary residences up to $250,000 for single taxpayers and $500,000 for married taxpayers. I.R.C. § 121 (LEXIS, through PL 114-115, approved 12/28/15). The same is not true for the sale of secondary residences. *Id*.

94. The federal exclusion applies to qualified principal residence indebtedness with a $2 million limit ($1 million for a married taxpayer filing a separate return). I.R.C. § 108(a)(1)(E) (LEXIS, through PL 114-115, approved 12/28/15). Some states promulgated tax laws that mirrored MDFRA. Now passed into law, Assembly Bill 1393, introduced by Henry Perea, D-Fresno, amends California's tax code so that homeowners do not have to report as income certain debt that was canceled or

classification of the property as principal or secondary should not be the deciding factor. Instead, Congress should allow those homeowners to choose the MSST property to which they will apply the tax relief. The impact on potential lost tax revenues for the government would not be affected by their choice, but the option would have a significant impact in allowing a broader scope of homeowners with underwater property to improve their financial positions, especially those whose only option is to use MSSTs to sell those underwater properties.

Third, MFDRA is inflexible to changes in the real estate market landscape for taxpayers who owned underwater property that they originally may have classified as their principal residence, but, due to personal economic circumstances and the stagnancy in real estate market, the property no longer qualifies as a principal residence under the IRS occupancy rules for tax purpose. Homeowners who move out of the property or rent it to mitigate their financial losses could find themselves not qualifying for MFDRA tax relief if they ultimately sell the property through MSSTs. Many homeowners are forced to vacate properties they cannot sell due to volatile market conditions, which forced them to leave their properties to relocate for better job opportunities,[95] or because of economic distress from income reduction or job loss.[96] To mitigate the financial distress or avoid defaulting on their mortgage loans, homeowners rented principal residences until the market recovered so they either could sell the homes under better property value conditions or stabilize their financial distress to be able to afford living in the residence again.[97] Under MFDRA, once the home is no longer one's principal

forgiven by a lender due to principal reduction from a loan modification. *See* Evan Nemeroff, *Calif. Law Covers Lapse in Mortgage Forgiveness Tax Protection*, NATIONAL MORTGAGE NEWS (Jul. 22, 2014), http://www.nationalmortgagenews.com/news/regulation/calif-law-covers-lapse-in-mortgage-forgiveness-tax-protection-1042192-1.html.

95. *See generally* Christopher J. Goodman & Steven M. Mance, *Employment loss and the 2007-09 Recession: An Overview*, BUREAU OF LABOR STATISTICS (2011), http://www.bls.gov/mlr/2011/04/art1full.pdf.

96. The financial crisis also affected ancillary industries that collapsed due to the mortgage crisis, bank closings, lenders downsizing staff, construction industry, real estate market professionals, among other causes. *See generally* Amir Sufi & Atif Mian, *Why the Housing Bubble Tanked the Economy and the Tech Bubble Didn't*, FIVETHIRTYEIGHT (May 12, 2014, 6:03 AM), http://fivethirtyeight.com/features/why-the-housing-bubble-tanked-the-economy-and-the-tech-bubble-didnt/.

97**.** This scenario distinguishes those investors who purchased property not to occupyy it but for profit through flipping or rental and who designated such properties as business investments for tax purposes. The risks taken by those investors are not the conservative risks anticipated by borrowers who buy property for personal residences. Leonard Baron, *Rental Property Investing 101—Tips for Future Property Moguls*, FOX BUSINESS, (Apr. 23, 2012), http://www.foxbusiness.com/personal-finance/2012/04/23/rental-property-investing-101-tips-for-residence, the law does not provide tax relief for MSSTs forgiven indebtedness. Given homeowners' inability to sell their homes in a depressed real estate sales market, for several years in many cases, and the need for economic recovery from their personal financial crisis in the Great Recession, the law should extend protection to this class of homeowners whose principal residence changed classification due to market conditions after the financial crisis.

These circumstances justify policymakers modifying MFDRA, or other existing tax laws, in order to address the gross inequities in tax relief these homeowners face. Underwater homeowners and those who sold underwater property through 2014, which property was not a qualified principal residence, potentially face a rude awakening even with Congress's latest extension of the law. Congress has not provided broad enough tax relief coverage of MFDRA for the various scenarios that are ongoing many years after the financial crisis. These consequences were reasonably foreseeable under MDFRA, especially as Congress was considering the extensions of the law. If the objective of MFDRA was to aid taxpayers, policymakers should have kept up with the changing circumstances and should have modified the type of aid to fit what would truly help homeowners in the existing real estate market.[98] The impact of the qualified principal residence requirement could financially devastate many American taxpayers who perceived that they escaped the burdens of owning underwater property.

For the millions of American homeowners with underwater property, the impact of the potential federal tax liability could result in a further crisis of civic consciousness.[99] The government's adoption of tax policies to protect its citizen homeowners is essential for the future stability of the national economy upon which all Americans thrive or perish.[100] Citizens perceive that the government passed laws like MFDRA to aid them, not harm them. When the law imposes further financial burden for citizens, the resulting hardship perpetuates the lack of confidence Americans have in our government's ability to protect its citizens.

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98. Significant property devaluation has plagued many communities but disproportionately affects blacks, Latinos and other minority group communities. *See* DEIER ET AL., *supra* note 2.

99. William M. Rohe & Mark Lindblad, *Reexamining the Social Benefits of Homeownership After the Housing Crisis*, HARVARD UNIVERSITY: JOINT CENTER FOR HOUSING STUDIES (Aug. 2013), http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/hbtl-04.pdf.

100. FCIC REPORT, *supra* note 2.

C. The Implications of Alternatives to MSSTs

Financially distressed homeowners who own underwater properties perceive MSSTs as a more favorable method to sell their homes than the threat of forcibly losing their homes to foreclosure. Homeowners may perceive that lenders created, in the MSST, an alternative process that could help them out of the distressed property that they would otherwise not be able to continue to afford or to incentivize the sale of an underwater property that had been on the market for a long duration. However, the neighborhoods of homeowners who remained in their underwater properties, neighborhoods saturated with properties in foreclosure, became less than desirable for homeowners and their families to continue living in.[101] Whatever the reasons homeowners used MSSTs to sell their homes, other than a sentence in a real estate contract, it is highly probable that neither the lenders nor Realtors discussed the potential tax liabilities associated with engaging in MSSTs. The government also fell short of ensuring homeowners understood the consequences of not strictly complying with provisions of MFDRA.

Homeowners perceived lenders who promoted government-approved programs as rescuers of distressed homeowners who owned underwater properties because homeowners now could sell their homes or modify their mortgage loans. This rescuer perception was misplaced. Without understanding the tax and financial implications of engaging in MSSTs, homeowners perceived that lenders' approval of MSSTs allowed them to voluntarily participate in the sale of the property, to vacate the property on favorable terms, and to negotiate with lenders. This voluntary participation appeared more favorable to homeowners than the distress of a foreclosure action.[102] For homeowners, unfortunately, the motivations of lenders and borrowers for engaging in MSSTs are incongruent. Even though the ultimate goal of selling the property and paying off the mortgage offers some benefits for both homeowners and lenders, the implications of doing so are inequitably balanced against homeowners, especially given the current tax law regime, best seen through an example, such as the following:

> A homeowner sells an underwater home with a current market value of $100,000. The original property value was $150,000. The mortgage loan

101. Blighted communities resulted from mass foreclosures. *See generally* David Streitfeld, *Blight Moves in After Foreclosures*, LA TIMES, http://www.latimes.com/la-fi-vacant28aug28-story.html#page=1 (last visited Apr. 5, 2016).

102. Babbit, et al., *supra* note 61.

balance at the time of the MSST is $120,000 (based on an original purchase price of $150,000 where the homeowner paid 20 percent, or $30,000, as a down payment).[103] The lender must agree to approve the MSST for at least $100,000, the price a willing buyer may pay given the current market value of the property, but more likely would pay less or shop for other properties where homeowners and their lenders are willing to negotiate for less than the current depressed market value. The lender must forgive $20,000 of the $120,000 mortgage loan balance in order for the homeowner to sell the property. In addition to the mortgage payoff, the homeowner, however, has additional costs associated with closing the real estate transaction, such as Realtor commissions and fees, title/escrow company fees, local government fees and real estate taxes, county recording fees, and other related transaction fees. If these costs are an additional estimated $12,000,[104] the homeowners will need to come up with the money to pay them at closing or the lender will have to pay them and accept less than $100,000 of the sales price as the payoff. The latter is more likely because distressed homeowners are typically unable to come up with the money to pay off the additional costs at closing. If the lender does not agree to pay the additional closing costs, the MSST cannot occur under the lender's terms. For homeowners unable to afford to continue paying the mortgage, the inability to sell the property may possibly result in the lender filing a foreclosure action.

Given the significant financial loss lenders incur in foreclosures, almost double the costs of MSSTs,[105] the lender would likely better benefit by approving the MSST and accepting whatever sales proceeds are available after closing. Thus, the lender will accept an amount taking into account the additional costs, which the borrower cannot pay to facilitate the closing. In this case, the homeowner walks away without

103. For this example, one needs to do amortization values for 7 years and with interest rate calculated and resources on average devalued price of property in certain areas. *See* LOAN AMORTIZATION TABLE CALCULATOR, http://www.amortizationtable.org/ (last visited Apr. 5, 2016).

104. Seller's costs that might not be paid by another source based on a $100,000 purchase price include Realtor's commission at as high as 7% in some jurisdictions ($7,000), unpaid real estate taxes or back taxes if the homeowner has not paid them is estimated at 2.5% of the property value ($2,500), title/escrow fees for owner's policy and associated fees for certain title coverages, recording fees, appraisals, government taxes or other liens, etc. ($1,000), and maintenance or repair related credits seller is responsible for paying ($1,500).

105. Theoretically, at 40% of the $120,000 mortgage balance, the lender will pay 40% in costs associated with a foreclosure, or $48,000, receiving only $52,000 ($120,000 - $20,000 - $48,000). At 19% in cost in an MSST, the lender will pay $22,800 in costs, receiving $77,200 ($120,000 - $20,000 - $22,800). If this example was an actual deal with only $20,000 underwater in the property value versus the mortgage loan, then the lender receives $88,000 ($120,000 - $20,000 - $12,000). In either MSST situation, the lender saves money by engaging in an MSST rather than pursing foreclosure, both in finance terms and time saved. *See* LOAN AMORTIZATION TABLE CALCULATOR, http://www.amortizationtable.org/ (last visited Apr. 4, 2016).

owing the lender, but tax consequences may arise because the lender has forgiven $32,000 of the mortgage indebtedness,[106] resulting from the MSST—$20,000 of the loan balance plus $12,000 to pay costs, and only receiving $88,000 in proceeds from the sale to pay off the original $120,000 mortgage balance. The homeowner experiences the benefit of the sale of the property and is emancipated from paying the mortgage and owing the lender, but the borrower may now face federal tax liability based on $32,000 of taxable income, unless the law excludes the forgiven loan balance from taxable income. MFDRA provided that exclusion only for those homeowners who sold a qualified principal residence from 2007 to 2014. For homeowners with secondary residences, under the same scenario, the forgiven indebtedness of $32,000 is treated as taxable income. Lenders, overall, have greater benefit than homeowners in using an MSST because borrowers/sellers do all the work to consummate the real estate sales transaction, borrowers must deal with adverse tax treatment or find ways to avoid it, and borrowers remain subject to all the costs and liabilities associated with homeownership until the sale concludes.

Millions of borrowers with underwater properties are unaware that they have options for avoiding the tax liability and deficiency judgments,[107] (1) by allowing foreclosure on the property;[108] (2) by signing an unsecured, recourse note for the $32,000 and repaying the lender the short amount from the sale over a period of years;[109] (3) by,

106. The $32,000 is calculated by deducting the $20,000 forgiven debt balance owed on the original outstanding $120,000 mortgage balance (based on the $100,000 sale price), then deducting $12,000 in seller related closing costs. Thus, the lender will only receive $88,000 ($120,000 - $20,0000 - $12,000) of the outstanding loan under an MSST.

107. Anti-deficiency judgment legislation in some states evidences strong public policy against placing the burden on consumers for loan products introduced into the market. The California legislature's primary purpose for passing its anti-deficiency judgment statute was to prevent the overvaluation of property by placing the risk of inadequate security on lenders to discourage risky lending practices and precarious land schemes. *See* Spangler v. Memel, 498 P.2d 1055, 1060-62 (Cal. 1972). California law also forbids consumers from waiving the anti-deficiency protections either at the time the loan is made or in a forbearance agreement, such as through an MSST. CAL. CIV. PROC. CODE § 580(b) (LEXIS, through Chapter 1 of the 2016 Session). *See generally* Jackson v. Taylor, 272 Cal. App. 2d 1, 5 (1969); s*ee also* Thompson v. Allert, 233 Cal. App. 3d 1462, 1466-67 (1991); Palm v. Schilling, 199 Cal. App. 3d 63, 69 (1988).

108. In states without deficiency judgment statutes, the amount could be dischargeable in bankruptcy. 11 U.S.C.A § 727 (LEXIS, through PL 114-115, approved 12/28/15).

109. Mortgage payment of $1500 then repayment of unsecured debt estimated at $650 for 5 years, under current laws. *See generally* Credit Card Accountability Responsibility and Disclosure Act of 2009, 2009, Pub. L. No. 111-24, 123 Stat. 1734, 15 U.S.C. §§ 1601-1667f. However, lenders may be unwilling to enter into an unsecured debt with financially distressed borrowers who have an inability to pay, and would prefer an MSST versus pursuing a more costly foreclosure process. The MSST option does not have as significant of an impact on the borrower's credit because borrowers

under certain circumstances, negotiating with the lender for a deed in lieu of foreclosure in full satisfaction of the mortgage amount;[110] or (4) by filing bankruptcy.[111] The second and third options, however, are at the lender's discretion, much like MSSTs, and a lender would agree to them only if the options provide more substantial benefit to the lender than an MSST. The options allow homeowners to dispose of underwater principal and secondary residences, or other underwater property as well. Although homeowners suffer negative credit rating implications in all these scenarios, just as with MSSTs,[112] borrowers can financially recover and, importantly, avoid the significant financial burdens associated with tax liability that could plague them for many years. This Article does not mean to suggest that bankruptcy and foreclosure are uniformly available or uniformly desirable. As I note in the next section, they are not. Nevertheless, homeowners should have complete information regarding each option for dealing with underwater properties.

can negotiate with lenders to report to credit agencies that the loan has been satisfied, as agreed. MSSTs and foreclosure both have negative impact on credit reports, up to 7 years, and bankruptcy up to 10 years. In either situation, borrowers incur time to recover financial without owing the IRS for taxes and penalties, subject to onerous collection methods.

110. The deed in lieu (DIL) of foreclosure method is available from lenders and allows homeowners to negotiate with lenders for the friendly surrender of the property, which prevents costly foreclosure litigation, but few, if any, lenders ever use this option. DIL will not necessarily avoid tax consequences unless lenders agree that the value of the property is worth less than the value of the mortgage loan balance. In the author's real estate practice, she only negotiated one successful DIL transaction where the homeowners voluntarily relinquished the property and transferred title back to the lender by deed without the lender negatively reporting the transaction on the homeowners' credit report. *See generally* 735 ILL. COMP. STAT. 5/15-1401 (2016) (Illinois is in the minority of states with statutes dealing with DILs); s*ee also* Thompson v. Smith, 793 P.2d 449, 449, 451 (Wash. Ct. App. 1990) (finding that homeowners do not owe a deficiency judgment for DILs). Lenders generally do not allow DILs if there is also a second mortgage or other liens, such as federal tax lien, against the property.

111. In a Chapter 7 bankruptcy, taxpayers must qualify for the Income Means Test to be eligible to file. Chapter 7 is for individuals who have no means to repay their debts under Chapter 13. Before the law changed, there were fewer restrictions on eligibility for those who wished to wipe out credit card debt, medical bills, and most personal loans through Chapter 7 bankruptcy, regardless of their ability to repay their debts. For solvent taxpayers, they would need to liquidate all assets to pay any debts or tax liens to qualify, which most people choose not to do in lieu of a tax lien. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified at 11 U.S.C. § 101). With lenders as unsecured creditors, borrowers who fall into further financial hardship may qualify for relief under bankruptcy laws that might allow them to discharge the debt.

112. The government, through the Home Affordable Foreclosure Alternative (HAFA) Program, attempted to give additional options for lenders to avoid costly foreclosures and incentivized them to enter into MSSTs or DILs with homeowners to avoid foreclosures. HAFA, *supra* note 39 (see link to MHA Compensation Matrix, last updated Nov. 3, 2014, using taxpayer dollars to pay lenders for successfully negotiating mortgage related transactions).

D. Bankruptcy and Foreclosure Alternatives to MSSTs

There are few alternatives to MSSTs for homeowners who wish to avoid a potential tax liability upon the sale of their homes. Moreover, these alternatives might not readily be available for many middle-class citizens because of the qualifications required for homeowners to take advantage of them. A primary alternative to MSSTs is bankruptcy coupled with foreclosure.

Bankruptcy[113] and foreclosure correlate. They are discussed together because bankruptcy only stalls the foreclosure action in state court for a period of time so the homeowners can negotiate the sale of the property through MSSTs.[114] The federal bankruptcy laws do not permanently prevent lenders from instituting a foreclosure action when a taxpayer files for bankruptcy. The bankruptcy filing only invokes the automatic stay provision under the Bankruptcy Code Section 365 temporarily because secured creditors and lenders can lift the automatic stay with the bankruptcy court's permission and proceed with either a judicial or non-judicial foreclosure action.[115]

Once lenders are no longer subject to the bankruptcy automatic stay, lenders can pursue foreclosure in state court or negotiate possession of the property with borrowers in lieu of a foreclosure action. In the case where the homeowner wants to keep the property, lenders may negotiate a repayment plan with borrowers, including reduction of principal balance, or an extended term of the mortgage. However, any loan modification that lenders allow, whether done while the taxpayer is subject to the bankruptcy court or not, may create a taxable event for any reduction in principal for cancellation of indebtedness, much like for MSSTs. The bankruptcy court cannot require any modification of the loan between debtors/borrowers and lenders for MSSTs or modifications.

The United States Supreme Court ruled that the bankruptcy court does not have jurisdiction to force lenders into a loan modification,[116] or arguably MSSTs to sell the property. However, the deficiency judgment lenders obtain against borrowers resulting from a foreclosure action

113. *See supra* note 111.

114. Lenders have a right to foreclosure under the terms of the mortgage and through state law. *See generally National Mortgage Law Summary*, AMERICAN COLLEGE OF MORTGAGE ATTORNEYS (2013-14), https://www.acmaatty.org/resource/mls.cfm (listing foreclosure statutes for all 50 states).

115. *See* 11 U.S.C.A. § 365 (LEXIS, through PL 114-115, approved 12/28/15).

116. Bankruptcy courts, to date, cannot renegotiate or force negotiation of mortgage terms for borrowers. In a 1993 decision, *Nobelman v. American Savings*, the Supreme Court held that it was a reasonable statutory interpretation of the legislative history of the law that debtors could not modify even the unsecured portions of mortgages on a principal residence. 508 U.S. 324, 324 (1993).

would be a dischargeable unsecured debt under bankruptcy laws, especially in jurisdictions that do not have anti-deficiency judgment statutes.[117] For tax purposes, there would be no taxable event by combining bankruptcy and foreclosure because, once the foreclosure action is final, the lenders' unsecured judgments are not classified as forgiven indebtedness and the cancellation of the debt through the Bankruptcy Code is allowed for unsecured debts. Thus, the taxpayer/debtor walks away with a fresh financial start, and, most importantly, is not subject to a tax liability, unlike in MSSTs.

While bankruptcy may relieve the tax liability resulting from MSSTs for some taxpayers, bankruptcy is not always a viable option. Under 11 U.S.C. § 523 of the Bankruptcy Code, federal tax liens are dischargeable debts in bankruptcy within three years of the filing date of the tax return.[118] In essence, the IRS would have at least three years to pursue a collection action for the tax liability, and if it does not take collection action, the taxpayer can discharge the tax liability by filing bankruptcy. However, if the IRS takes collection action, it stops the tolling of the three-year period. For many taxpayers, filing for bankruptcy to avoid a tax liability would not be prudent if the only reason for filing bankruptcy is to avoid the tax liability.[119] Additionally, many taxpayers trying to get back on their feet would not likely qualify for bankruptcy because of the strict income requirements[120] that make filing almost impossible. Middle-class taxpayers, for example, would suffer more harm to their financial health and credit worthiness by filing bankruptcy to avoid tax consequences of MSSTs than by Congress amending MFDRA to address the tax burden created by MSSTs, at least during this ongoing time of crisis for homeowners suffering from the underwater real estate property market.[121]

E. The Relevance of MSSTs to National Economic Recovery

The housing market has not sufficiently stabilized, with home values in many states still significantly below pre-2007 market values. The lack

117. *Supra* note 16.

118. 11 U.S.C.A. § 523 (LEXIS, through PL 114-115, approved 12/28/15) (setting forth exceptions to discharge). The IRS has no limitation period on collection if a tax return is never filed and has seven years if the taxpayer commits fraud or understates income by 25%. *Id.*

119. *Letter of Understanding*, DEPT. OF THE TREASURY, IRS, NO. 2013-0036 (Sept. 19, 2013), https://www.irs.gov/pub/irs-wd/13-0036.pdf.

120. *See generally* 11 U.S.C.A. § 101 (LEXIS, through PL 114-115, approved 12/28/15).

121. Arguably, the reckless conduct of financial institutions in the residential mortgage market, which abused their duty of care to borrowers in the market, caused the harm to the overall economic stability of the United States as well as taxpaying homeowners. *See* Porter, *Pawns for the Higher Greed*, *supra* note 26 (citing FCIC REPORT, *supra* note 3).

of economic wealth caused by the loss of home values has impeded the growth of the national economy because millions of Americans are unable to sell their homes at prices at which they can recover their equity wealth for spending, investing, and saving.

In April 2014, housing data suggested that the spring selling season was off to a slow start. A year-to-year decline in March 2014 homes sales persisted in several markets, including Las Vegas, Phoenix, San Diego,[122] the Inland Empire of California, and many other urban communities.[123] The market conditions forced homeowners wishing to sell their underwater homes to further reduce sale prices because of the saturation of properties in the housing market. In some markets, the volume of properties with reduced housing prices was shockingly dramatic, such as in Phoenix, where 45% of the February 2014 listings cut sale prices, compared to 32% in 2013.[124] The housing market remained slow going into the last quarter of 2014.[125]

The loss of home values and lack of economic wealth for homeowners in many communities across the country impeded the growth of the national economy in several ways. First, if borrowers had been able to sell their homes for a price which allowed them to pay-off their mortgage and potentially receive some of their paid-in or accrued equity, they would have walked away with monies to save for future spending or to invest in the other markets now that the national economy has survived the Great Recession.[126] Second, depressed property values caused risk-adverse lenders, who escaped the worst of the financial collapse, to be resistant to future lending in the real estate market, as well as in non-real

122. According to DataQuick, a San Diego research company, quoted in the Wall Street Journal. *See* Conor Dougherty & Nick Timiraos, *Housing Market Slow to Hits Its Spring Stride*, WALL STREET JOURNAL (Apr. 16, 2014), http://www.wsj.com/articles/SB10001424052702303887804579503662947889776.

123. These areas are unfortunately predominately minority communities, hardest hit by property devaluations. The eleven states with the highest number of hardest-hit ZIP codes are (in order): Georgia, Florida, Illinois, Michigan, Ohio, New Jersey, Maryland, Missouri, California, Nevada, and North Carolina. *See* DEIER ET AL., *supra* note 2, at 6.

124. *See* DEIER ET AL., *supra* note 2; Dougherty & Timiraos, *supra* note 122.

125. While there are statistics on foreclosure rates of properties across the country, unfortunately, there are no such statistics on MSSTs because MSSTs are not a matter of public record given the private nature of the transaction between lenders and borrowers.

126. As a result of the financial crisis in the United States, eight million jobs were lost, millions of families lost their homes, trillions of dollars of wealth disappeared, and trillions of dollars of economic production failed to occur. *See* John Irons & Isaac Shapiro, *Regulation, Employment, and the Economy: Fears of Job Loss are Overblown*, ECONOMIC POLICY INSTITUTE (Apr. 12, 2011), http://www.epi.org/publication/regulation_employment_and_the_economy_fears_of_job_loss_are_overblown/. As is typically the case in the wake of a financial collapse, the recovery has been slow, and the unemployment situation remains painful. *Id*.

estate related lending, such as small business lending.[127] Third, new homebuyers have become hesitant to enter, or re-enter, the real estate market due to the ongoing volatility of home values. Finally, the potential future tax liability the government may place on taxpayers who engaged, or may engage, in MSSTs has created too great a risk of future economic uncertainty for the taxpayers who are now forced to conservatively spend, or who do not have money to spend. Thus, the underwater market has resulted in significant financial instability and wealth loss for citizens, and may be contributing to stagnancy of the national economy.

IV. CURRENT TAX LAW REGARDING FORGIVENESS OF INDEBTEDNESS FOR MSSTS

Prior to and after Congress passed MFDRA,[128] the tax laws treat any forgiveness of indebtedness as taxable income to taxpayers.[129] For tax years 2007 through 2015, the IRS treats MSST cancellation of indebtedness as an exclusion from taxable income,[130] but only for "qualified principal residence indebtedness."[131] The goal of adding the MFDRA amendment to existing tax law was to provide tax relief on canceled debt for "*homeowners involved in the mortgage foreclosure crisis currently affecting much of the United States*."[132] The effect of the financial crisis will last for an unpredictable time; thus, MFDRA should have permanency in the tax laws with some modifications to the existing law, using other existing tax law to support this modification, such as Section I.R.C. § 121.

The MFDRA exclusion allows taxpayers to exclude up to $2,000,000 ($1,000,000 if married filing separately) of canceled "qualified principal

127. For examples of small business lending that was affected or other lending lines that dried up because of residential real estate mortgage lending problems, see Rebel A. Cole, *How Did the Financial Crisis Affect Small Business Lending in the United States?*, SBA: OFFICE OF ADVOCACY (Nov. 2012), http://www.sba.gov/sites/default/files/files/rs399tot.pdf.

128. *See Topic 431: Canceled Debt: Is it Taxable or Not?*, IRS, http://www.irs.gov/taxtopics/tc431.html (last visited Apr. 15, 2016).

129. I.R.C. § 61(a)(12) (LEXIS, through PL 114-115, approved 12/28/15) treats discharged indebtedness as gross taxable income.

130. *See* MFDRA, *supra* note 85.

131. "Qualified" refers to the debt associated with the principal residence and includes the purchase money mortgage and in some circumstance debt acquired from refinancing in which monies were used to improve the property. *See Publication 4681 (2015), Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals),* IRS, https://www.irs.gov/publications/p4681/index.html#en_US_2015_publink100024646.

132. *Cancelled Debt—Is It Taxable or Not?* IRS TAX MAP 2014 (Dec. 8, 2014), http://taxmap.ntis.gov/taxmap/archive2014/taxmap/taxtp/Tt400_14-025.htm (emphasis added).

residence indebtedness."[133] MFDRA created the amendment to section I.R.C. § 108(a)(1) by providing exclusion of cancellation of indebtedness from gross income under limited circumstances.[134] Section 108 provides as follows:

> Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—
>
> . . .
>
> (B) the discharge occurs when the taxpayer is insolvent,[135]
>
> . . .
>
> (E) *the indebtedness discharged is qualified principal residence indebtedness, which lenders have discharged before January 1, 2017*.[136] [This section (E) is the amendment to the tax law created by MFDRA].

The goal of MFDRA was laudable; however, the scope and resulting impact of the law was ineffective in at least two significant respects, given the financial conditions of homeowners and the deluge of underwater properties that resulted from the 2007 market collapse. First, the application of the solvency rules to middle-class taxpayers created an ongoing inequitable impact for taxpayers who own underwater property, whether principal or secondary,[137] and will last beyond year 2016. Second, related to the contradictory treatment of debt cancellation as taxable income under I.R.C. § 61(a)(12), the law should permanently apply the same or similar policy for exclusion criteria as under I.R.C. § 121 (gains from the sale of a principal residence) because taxpayers who realize actual profits from a sale have no tax liability but shadow income from MSSTs is treated as a tax liability. If the law were to apply a forward-thinking policy, it would alleviate the need for Congress to consider a la carte renewal of MFDRA until such time as the underwater real estate market has recovered from the financial crisis.

133. *See generally* I.R.C. § 108(a)(1)(E) (LEXIS, through PL 114-115, approved 12/28/15).

134. I.R.C. § 108. The section, in its entirety, includes: discharge of indebtedness exclusion from gross income for bankruptcy, insolvency, qualified farm indebtedness, qualified real property indebtedness, and qualified principal residence indebtedness before January 1, 2015.

135. I.R.C. § 108(a)(1)(B).

136. MFDRA, *supra* note 85 (emphasis added).

137. While section 108(a)(1)(E) protected many homeowners of qualified principal residences from tax liability for MSSTs, when Congress created and renewed MFDRA, it did not address the narrow-sightedness of the law by only including principal residences.

A. Inequitable Impact of Tax Law Solvency Rules

For MSSTs, the IRS treats the forgiveness of qualified principal residence indebtedness as taxable income under I.R.C. § 61(a)(12) but MFDRA, codified as I.R.C. § 108(a)(1)(E), allows all taxpayers who are solvent to exclude the forgiven indebtedness from taxable income, for tax years 2008 through 2016. Without the exclusion under MFDRA, the resulting effect on both insolvent and solvent homeowners who engage in MSSTs is the creation of tax liability. The existing tax law, however, provides for the exclusion of forgiven indebtedness for insolvent taxpayers under I.R.C. § 108(a)(1)(B), with some restrictions, whether for principal or secondary residences, that could even make insolvent taxpayers subject to tax liability. Thus, truly insolvent taxpayers would face no liability. However, any solvent middle-class homeowner (at any level of solvency) and insolvent taxpayers for whom the forgiven indebtedness does not exceed their level of insolvency both face potentially severe tax liability; severe when compared to their actual adjusted gross income.[138]

For insolvent homeowners, § 108(a)(1)(B) applies, but the IRS rules define who qualifies as an insolvent taxpayer.[139] As this section applies to MSSTs that do not qualify as principal residences, if the debt the lender forgives is equal to, but does not exceed, the taxpayer's insolvency level, then the IRS will not treat the forgiven indebtedness as taxable income. However, to the extent the forgiven debt exceeds the taxpayer's insolvency level, the IRS generally treats that excess of forgiven indebtedness as taxable income, subject the excess to tax liability.[140] The following example provides a basic application of the tax rules, although tax laws are never simple to understand, and only those who are astute practitioners of tax law know how to apply the maximum savings for individual taxpayers, taking into account the taxpayer's overall financial landscape:

> Taking the amounts from the example in Section III(C), an insolvent taxpayer may face two different outcomes. Under the first insolvency scenario, if the taxpayer's insolvency level is $32,000, and $32,000 is the forgiven indebtedness resulting from the MSST, the IRS will allow the taxpayer to exclude the entire $32,000 from taxable income, leaving

138. If a taxpayer has only $1.00 of net worth, the taxpayer is considered solvent. The insolvency rule under § 108(a)(3) states as follows: "In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) *shall not exceed the amount by which the taxpayer is insolvent*." I.R.C. § 108(a)(3) (emphasis added).

139. *Id*.

140. *Id*.

> the insolvent taxpayer with no tax liability. However, the second insolvency scenario yields a different outcome, in that if the taxpayer's insolvency level is only $20,000, and $32,000 is the forgiven indebtedness resulting from the MSST, the IRS will only allow taxpayer to exclude $20,000 from taxable income, but treat the remaining $12,000 of forgiven indebtedness as taxable income that would create a tax liability, even though the taxpayer is still insolvent after the MSST.[141]

Thus, insolvent taxpayers who sell underwater properties through MSSTs are treated unequally based on the level of their insolvency—applying harsher standards to those who have more indebtedness than to other insolvent taxpayers. This latter scenario makes it almost impossible for financially suffering taxpayers to recover from the impact of the financial crisis and Great Recession.

B. Tax Treatment of Actual versus Shadow Income

Taxpayers who are unaware of the intricacies of the tax code might find themselves in dire financial straits after engaging in MSSTs because the IRS's application of rules from other sections of the tax code apply to MFRDA, and can result in disqualification of MFDRA's protection from tax liability. In particular, the rules under I.R.C. § 121, dealing primarily with gains from the sale of a principal residence, apply in determining when a property qualifies as a principal residence under MFDRA.[142]

Section 121 is a part of the Taxpayer Relief Act of 1997.[143] Under § 121, taxpayers who sell their principal residence are entitled to a permanent exclusion from taxable gross income for capital gains from the sale of up to $250,000 for individuals, and $500,000 for married couples filing jointly. The section, in effect, allows taxpayers to keep the wealth from the sale without any tax consequences. While the exclusion under § 121 is not applicable under MFDRA, some other rules from § 121 apply to MSSTs subject to MFDRA. For example, taxpayers must own and occupy their principal residence for at least two calendar years in the last five years prior to the date of the MSST to qualify for MFDRA protection,

141. Taxpayers are allowed the exclusions from gross income versus adjustable gross income where taxpayers are allowed deductions to offset the adjustable income or credits allowed against any ultimate tax liability a taxpayer may owe. As an alternative to exclusion for income under MFDRA, any tax liability resulting from MSSTs could be offset by a dollar-for-dollar credit to eliminate taxpayers' tax liability.

142. I.R.C. § 121 (LEXIS, through PL 114-115, approved 12/28/15).

143. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997). The law also created the child tax credit and Roth IRAs for retirement. *Id*.

the same as under § 121.[144] While ownership in title cannot be broken during the five-year period, the occupancy requirement does not have to be continuous. Thus, if taxpayers engaged in MSSTs in December 2009, the prior five years run back to 2004, so taxpayers must have occupied the property for two calendar years with the intent that the property was their principal residence. However, homeowners who may have been unaware of the ownership and occupancy rule under § 121 that applied to MFDRA protection could have easily become subject to tax liability if they missed the two-year occupancy requirement by even one day.

In addition to the principal residence classification rule under § 121, the treatment of forgiven indebtedness from MSSTs as taxable income is unfair because § 121 excludes actual profit from the sale of the principal residence from taxable income. This aspect of the § 121 exclusion could have easily been incorporated into MFDRA upon its passage, if the tax code had been considered in its entirety. And even if Congress considered § 121's exclusion treatment, then it should have addressed the inequality in the application of § 121 and § 108(a)(1)(E) that creates an unfair penalty on some taxpayers while rewarding others. In better market conditions, not affected by a financial crisis or Great Recession, the law is permanently in place for taxpayers who would have no tax liability for actual realized monetary gain from the sale of their principal residence under § 121, in which taxpayers keep the actual money without any tax recourse. However, in the ongoing depressed market conditions, almost 10 million taxpayers with underwater properties going into 2015 face a different situation. These homeowners face tax liability if they sell underwater property and they do not realize any actual money, just a canceled debt. The tax laws penalize these homeowners. Thus, the government's attempt to provide relief to taxpayers has penalized some taxpayers with underwater property, but has rewarded other taxpayers who are allowed to walk away with actual profits from the sale of their property without penalty—an awful disparity in the law that Congress must correct. Moreover, the problem with underwater properties sold under MSSTs and the resulting tax liability will perpetuate into the future without an expansion of MFDRA's coverage.

C. IRS Collection Actions for Tax Liability Created by MSSTs

For taxpayers who sell their underwater property and who do not qualify for either MFDRA relief or the insolvency rule under §

144. *Supra* note 141.

108(a)(1)(B), there is the possibility of facing the burden of not only a tax liability but also an IRS collection action. The IRS has up to seven years from the date a taxpayer files a tax return to initiate a collection action for "substantial misstatement of income," which would include forgiven indebtedness.[145] In our example earlier in this section, a $32,000 cancellation of debt may be a substantial misstatement of income depending on the taxpayer's adjusted gross income. Not only are taxpayers subject to an extended collection period, but also the IRS's collection action can create devastating hardship on taxpayers, as Congress has noted in the past.[146]

It is likely that millions of taxpayers are unaware of these rules or the impact on their financial wellbeing until it is too late. To further burden taxpayers, the burden of proof is on the taxpayer to prove that the property was a qualified principal residence for the requisite period. If the IRS challenges the sale as a qualified principal residence, it has up to seven years from the time the taxpayers filed the tax return in question to seek collection of the tax liability. This is problematic for taxpayers who may be unable to produce credible evidence of their intent to claim the qualified principal residence exclusion under MFDRA after they vacate the property or rent it. Such an audit by the IRS places further unnecessary burden and stress on taxpayers, especially in light of the challenging landscape created by the financial crisis.

Thus, the worst is not over for millions of homeowners who still own underwater property they cannot sell, or if they do sell will do so with potential tax liability and face an IRS collection action. Congress' action has still not adequately addressed the ongoing problems that persist for "*homeowners involved in the mortgage foreclosure crisis.*"

V. SOLUTIONS TO THE HOMEOWNERSHIP TAX POLICY CRISIS

Congress needs to act to resolve the problems of the tax burden imposed on homeowners who sell underwater property and the disparate treatment of taxpayers under the current MRFDA.[147] This Part provides a

145. The tax code definition includes "substantial misstatement of income." *See* I.R.C. § 6662 (LEXIS, through PL 114-115, approved 12/28/15). For the 2014 tax year, in which taxpayer files returns on April 15, 2015, the seven years runs from April 2015. In addition, while the IRS is able to waive penalties, it cannot waive interest that accrues for the time the tax liability accrues in April 2015. *Id*.

146. Unlike creditors, the IRS is not subject to the FDCPA and have almost unrestricted collection methods for collecting tax liabilities taxpayers owe the government. Fair Debt Collection Practices Act, Pub. L. No. 104-208, 110 Stat. 3009, (codified at 15 U.S.C. §§ 1601-1667f). In the author's humble opinion, it would be better to owe a creditor than the government through the IRS.

147. This could give the perception that they were placing consumers' interests above their own

number of important provisions that Congress should include in congressional corrections to remedy problems with MSSTs.

Until progressive legislative tax reform is enacted, the lending industry will continue to use MSSTs to its advantage to avoid the liability of taking title to underwater properties, thus allowing unwary borrowers to accrue potential tax and resulting financial burdens from these transactions. Both the government and industry, however, can play an essential role in relieving the tax burdens of MSSTs for consumers if the government amends current tax laws and the banking and real estate industries support the passage of consumer-focused legislation. While the banking and real estate industries' support may seem unnatural to advocates for consumers whose interest may be in direct conflict with these industries, tangible benefit for these industries and the economy is attainable, especially by rebuilding a financially healthy consumer-market, which would support a stabilized national economy and future lending opportunities. Legislators and the banking and real estate industries could compromise in supporting legislative change in the following areas: (1) a permanent extension and expansion of MFDRA, (2) new government-issued disclosures to homeowners, and (3) a permanent moratorium on the IRS's collection of taxes related to MSSTs.

A. Extension and Broader Scope of MFDRA

The government should extend MFDRA's applicability and scope until underwater property values are at insignificant levels. With the support of President Barack Obama, Congress extended MFDRA in its existing form in late December 2015 to cover MSSTs for tax year 2015.[148] The failure of Congress to extend the MFDRA's coverage beyond 2016, however, leaves little hope for millions of underwater homeowners who may not avoid tax liability since they may have to engage in MSSTs beyond 2016.

Although the main body of the law may not need redrafting, the government should amend the law to include:

(1) the same exclusion treatment for secondary homes;

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profitable interests. Porter, *Pawns for the Higher Greed*, *supra* note 25.

148. *See generally* H.R. 3856 113th Cong. (2d Sess. 2014):

Section 1. Short title

This Act may be cited as the Homeowners Debt Relief Extension Act of 2014.

Section 2. Extension of exclusion from gross income of discharge of qualified principal residence indebtedness

> (a) In general—Subparagraph (E) of *section 108(a)(1)* of the Internal Revenue Code of 1986 is amended by striking January 1, 2014 and inserting January 1, 2016.

(2) the inclusion of any principal residence that changed status due to economic hardship but qualified as a principal residence anytime after 2007;

(3) an exclusion from taxable income similar to the I.R.C. § 121, for either a principal residence or a secondary residence; [149] and

(4) extension of these provisions until the underwater property market is eliminated, or at a superficial volume.

These amendments would provide real and practical solutions for taxpayers. Only the taxpayers that truly need the relief of MFDRA would use it because the scope and coverage would be broad enough to redress only the tax liability issue of underwater principal and secondary residences, not any other type of investment property. Congress would also have the power to repeal the law when MFDRA's full usefulness is exhausted and there are no longer huge numbers of taxpayers under the burden of ownership of underwater property.

The banking and real estate industries should have little reason to oppose such reform, but in fact may benefit by urging the support of this legal reform because these proposals of law do not threaten their interests and would eliminate their need to take any adverse action against their own profitable interests. Because millions of American properties are still underwater, this pragmatic solution would protect millions of homeowners from further financial distress. Public policy calls for the government to rescue consumers by taking action within its powers.

B. The Disclosure Regime—Government Duty to Disclose

Some perceive disclosure laws as the strongest consumer weapons against asymmetry of information, but creditors have been most willing to undermine this method of regulation.[150] Indeed, the financial and real

149. Under I.R.C. § 121 (LEXIS, through PL 114-115, approved 12/28/15), the government, through the Tax Code, allows anyone who sells a principal residence to exclude from one's taxable income any profits, or gain, from the sale of the property; single persons up to $250,000, married persons up to $500,000. This class of consumers does not have to pay taxes on this profit from the sale that appreciated in value, either through their own improvements or maybe just due to market forces. The reverse should also hold true because consumers who failed to make a profit on the sale of a principal residence are unfairly penalized, especially in this unique world where MSSTs evolved due to market conditions that the lending industry facilitated and the real estate industry perpetuated to both industries' very profitable ends.

150. *See* Tracie R. Porter, *The Field Between Lions and Zebras . . . Evening the Playing Field Between Lenders and Borrowers: Conflicts of Interest and Legal Obligations in the Residential Mortgage Transaction*, 30 QUINNIPIAC L. REV. 623, 631 (2012) [hereinafter Porter, *Conflicts of Interest*]. *See also* Elizabeth Renuart & Diane E. Thompson, *The Truth, The Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 YALE J. ON REG. 181, 209-11 (2008) (finding that most borrowers do not sufficiently understand how this information is processed by

estate industries have viewed disclosure legislation as extremely intrusive regulation of their industries. The Banking and Financial Services Industry (BFSI) and Realtors Associations have engaged in massive lobbying efforts against disclosure regulation whenever possible, including the Truth in Lending Act and some aspects of the Wall Street Reform Act and Consumer Financial Protection Bureau Act, also known as the Dodd-Frank Act.[151] The disclosure solution proposed here, however, is different from those already in effect, in that it protects consumers not against the perils of dealing with the industry players but in dealing with the government through the IRS. The complexity of tax laws inherently creates asymmetry of information for taxpayers, which subjects them to tax liability that, once created, is almost impossible to get relief from.

When homeowners use MSSTs, unlike situations in which consumers buy a home, refinance a home, buy a car, or even lease property, lenders and Realtors are not required by law to inform consumers of any potential onerous financial, or tax, consequences of engaging in MSSTs. To the contrary, once lenders approve MSSTs, they are not required to report the transaction until months after MSSTs are consummated and the property sells. Under the proposed new disclosure approach, the government, through the Consumer Financial Protection Bureau (CFPB), would be required to give all borrowers with underwater properties disclosures explaining the potential tax implications from MSSTs on a quarterly basis until the property is no longer considered an underwater property.[152] A quarterly basis is preferred in case homeowners attempt to engage in MSSTs, which take several months for lenders to

lenders, or how to evaluate information in the legal disclosures—if they understand the disclosed information at all). Disclosures are arguably an ineffective method for protecting and educating consumers about mortgage industry practices. *Id*. *See* Stark & Choplin, *supra* note 65 (referring to Truth in Lending Act disclosures and noting that "Judge Posner pointed [out] . . . '[n]ot all persons are capable of being careful readers"').

151. Credit Card Accountability Responsibility and Disclosure Act of 2009, 2009, Pub. L. No. 111-24, 123 Stat. 1734 (codified at 15 U.S.C. §§ 1601-1667f). The BFSI and Realtors Associations have engaged in massive lobbying efforts against disclosure whenever possible, such as with the CARD Act. *Id*.

152. *See* HAFA, *supra* note 39 (providing text of Short Sale Agreement the government posted to the website for borrowers). The text reads:

> The difference between the remaining amounts of principal you owe and the amount that we receive from the sale must be reported to the Internal Revenue Service (IRS) on Form 1099C, as debt forgiveness. In some cases, debt forgiveness could be taxed as income. The amount, if any, we pay you or your tenant for moving expenses may also be reported as income. *We suggest that you contact the IRS or your tax preparer to determine if you may have any tax liability*.

Id. (emphasis added).

come to an agreement. In the alternative, the CFPB would submit a notice through lenders in monthly mortgage statements. The cost to the CFPB would be administrative, which to an agency charged with oversight and reporting on financial institutions in order to protect consumers is a nominal cost compared to the financial devastation that could result from tax liability for homeowners who engage in MSSTs. Thus, disclosure through the government's CFPB is likely the most reliable method of getting the homeowners attention about the tax implications for selling underwater property.[153] The government also benefits from the public good it does for its citizens by protecting them at the outset of the transaction and expending fewer resources than when instituting tax collection actions against taxpayers.

In MSSTs, the consumers' biggest adversary is the IRS, not the lenders or Realtors; therefore, neither industry has any real reasons to oppose such reforms in the disclosure laws. More importantly, the potential tax liability to taxpayers is too great to ignore the necessity of information needed to make an informed decision about MSSTs.

C. Permanent Moratorium on IRS's Collection of Tax Liability Resulting from MSSTs

Congress should also place a permanent moratorium on the collection of tax liability resulting from MSSTs until the real estate market in many jurisdictions stabilizes and underwater properties in the market are insignificant in nature. Similar to the April 2014 letter of understanding the IRS issued to the State of California in which the IRS stated that it would not enforce collection against taxpayers in California, the government and IRS can maintain a similar stance with all taxpayers who sell their homes through MSSTs and face possible tax liability.

The collection actions of the IRS are the most aggressive of any vendor in any industry so such a permanent moratorium would stop aggressive collection actions that often result in unbearable financial and psychological effects from the IRS's sometimes futile attempts to collect tax revenues. In pursuing collection, the government, through the IRS,

153. *See* Porter, *Conflicts of Interest*, *supra* note 150. They must then provide consumers with a cooling period to seek representation on the issue of at least five business days so that consumers can get un-conflicted legal or financial advice from a professional best suited to represent their interests. The delay in transaction is no more onerous on the lenders and Realtors than any other disclosure required for the transactions that the government deemed important to protect consumer rights such as the three-day grace period for refinancing homes. Another option is to provide lenders with a safe harbor protection for early reporting of the 1099-C event, at such time as lenders present the MSSTs offer to borrowers so borrowers still have time to cancel the deal and pursue other options.

places a burden on consumers that need not exist and for a transaction that lenders walk away from with little or no losses while consumers continue to suffer. Thus, the government should initiate a permanent moratorium on collection of any potential revenues generated from MSSTs. Moreover, the potential lost tax revenue is insignificant, especially in comparison to § 121 discussion above where the government is willing to forego tax revenues on real profits from a sale of property, foregoing substantial revenues that can actually be collected, versus uncollectable revenues from shadow income from MSSTs.

As of April 2014, California is the only state with a special agreement with the IRS that allows its residences to avoid tax liability from MSSTs regardless of solvency, but only related to principal residences. On April 29, 2014, the IRS issued a letter of understanding (LOU) to the Honorable Senator Barbara Boxer (D-CA).[154] The LOU included the IRS's response to the Senator's request and clarified the IRS's letter, dated September 19, 2013, in which Senator Boxer addressed the question of whether cancellation of indebtedness from a lender-approved [mortgage] short sale would be considered taxable income for California homeowners.[155] California passed an anti-deficiency judgment statute, under California Civil Procedure Act § 580e, that prevents lenders who foreclose on principal residences from collecting any deficiency judgments resulting from foreclosures. Section 580e only applies to qualified principal residences that homeowners acquired with purchase money mortgage loans.[156] Section 580e treats the deficiency for cancelled mortgage amounts as a non-recourse debt obligation. Thus, for federal tax purposes, the IRS agreed not to treat the cancellation of indebtedness as taxable income based on Section 580e.

This limited exception for California homeowners with underwater principal residences[157] should not apply to only California taxpayers when the impact of the financial crisis affected all U.S. taxpayers. Additionally, this limited circumstance in California created by Section 580e does not

154. *Letter of Understanding*, DEPT. OF THE TREAS., IRS, No. 2014-0018 (Apr. 29, 2014), www.irs.gov/pub/irs-wd/14-0018.pdf.

155. The letter of understanding and CA law do not apply to non-judicial foreclosures or mortgage loan modifications. *See infra*, note 161.

156. Section 580e requires that the mortgage loan is the only secured indebtedness against the property, so there are no second lien holders. The law applies to dwellings of not more than four units. The lender must consent in writing to the MSST, indicating that the loan will be tendered, and ultimately is tendered, to the lender at less than the outstanding balance owed. Title must transfer to a third-party buyer and be recorded. CAL. CIV. PROC. CODE § 580e (LEXIS, through Chapter 11 of the 2016 Regular Session and Chapter 3 of the 2015-16 2nd Extraordinary Session).

157. *Supra* note 93.

reflect the various situations that impact taxpayers across the country with underwater properties that may no longer qualify as principal residences. The IRS even stated in its original September 19, 2013, letter to Senator Boxer that, although other states have enacted anti-deficiency judgment statutes, the letter only limited the consequences under California Civil Procedure Act, Section 580e.[158] The LOU with California reveals that the IRS is not myopic but will act when pressed by legislators, even if informally through an LOU. Formal action, through legislation passed by Congress, that creates equal treatment for all taxpayers is paramount.

D. Government Paternalist Action Required

Governmental paternalist action is warranted to assist in resolving the problem of tax liability that accompanies MSST transactions. Congress is in a better position to protect taxpayers and to inform them about the tax consequences of MSSTs than are Realtors or lenders through provisions contained in sales contracts or MSST agreements. Realtors and lenders also inherently have a conflict of interest with homeowners given their motivation to sell the property for commission in regard to Realtors and to minimize liability and increase profitability for lenders.[159] At a minimum, the government, through agencies like the Consumer Financial Protection Bureau (CFPB), should assure that borrowers with underwater properties who are considering MSSTs receive all pertinent information about the tax rules and consequences before engaging in MSSTs. The CFPB, to which some mortgage lenders report, should provide the information to all homeowners with underwater properties so that taxpayers are allowed adequate time to consider or to seek counseling about how to avoid the tax liability associated with MSSTs. However, informing taxpayers about tax liability is just one thing Congress can mandate to ensure consumer protection.

Legislative reform by extending MFDRA and expanding the tax rules that apply under MFDRA is another means Congress can use to protect homeowners using MSSTs to relieve their financial burdens. The disparity in tax treatment between solvent and insolvent taxpayers[160]

158. *Letter of Understanding*, No. 2013-0036, *supra* note 119.

159. Porter, *Conflicts of Interest*, *supra* note 150. Furthermore, they are not qualified tax advisors, they may be unaware of the implications of the rules on the particular taxpayer or inadequately knowledgeable about the rules themselves, or they might not want to manage the conflict of interest that exists between their own interest to close the deal versus what is in the best interest of the taxpayer/borrower/homeowner. *Id*.

160. The mortgage lending industry further perpetuated the gambling by using insolvent taxpayers (through the riskiest lending standards, such as no documentation loans) as pawns for the

related to MSSTs is so significant that Congress must take action to protect homeowners. Congress's expansion of the law to address, in a practical way, the hardship taxpayers could face will put taxpayers in a better financial position in the long-run and may alleviate the need for costly and stressful foreclosure actions, for both lenders and homeowners. Until then, the Tax Code should continue to provide leniency for all taxpayers who may realize tax liability from cancellation of indebtedness due to MSSTs into the future until only a *de minimis* portion, not ten million, of the properties in the national real estate market remain underwater; an ongoing consequence of the "*mortgage foreclosure crisis still affecting most of the United States*."[161]

VI. CONCLUSION

Congress must provide a solution to the quagmire of financial indebtedness that is promoted by current tax policy associated with MSSTs. The massive introduction of MSSTs following the 2007 financial crisis and subsequent mortgage foreclosure crisis created a financial quagmire for many homeowners that Congress has not effectively resolved. This Article has outlined how Congress can and should act to relieve middle-class taxpayers of the burden of substantial federal tax liability that currently results when lenders forgive indebtedness of homeowners through the use of MSSTs. For the still-evolving, residential real estate landscape that includes almost ten million homeowners who own underwater properties, Congress must enact a broader, more comprehensive law that adequately addresses the continuing crisis in the residential real estate market. The alternative is that middle-class taxpayers with underwater properties, including both principal and secondary residences, will continue to suffer severe financial impacts under the tax code when they sell underwater property using lender-controlled and approved MSSTs.[162]

Further, in order for the government to prevent perpetuation of the

most risky mortgage products ever introduced into the residential mortgage market. *See* Porter, *Pawns for the Higher Greed*, *supra* note 25; *see also* FCIC REPORT, *supra* note 2, at 61.

161. I.R.C. § 61(a)(12) (LEXIS, through PL 114-115, approved 12/28/15) treats discharged indebtedness as gross taxable income. *See* DEIER ET AL., *supra* note 2 (identifying the many zip codes in minority communities impacted by property devaluations). If citizens are experiencing hardship and unable to survive financially, the health of the economy suffers because citizens have no money for stimulating spending in the markets, more citizens may need greater government assistance for survival, and the progression to economic recovery and stability is stifled at a slow pace for middle-class Americans. *See generally id*.

162. The Tax Code already provides relief for insolvent taxpayers under I.R.C. § 108(a)(1)(B) (LEXIS, through PL 114-115, approved 12/28/15).

misconception to homeowners that the lending[163] and real estate industries' facilitation of residential MSSTs are financially beneficial to homeowners,[164] Congress must provide relief through federal legislative tax reform. Among other provisions, the reform should extend the MFRDA until the number of underwater properties is insignificant, and it should amend MFDRA to include a broader scope of coverage for principal and secondary residences. The tax code should also be amended to consistently apply rules for true profit gains under § 121 versus shadow profits from cancellation of indebtedness from MSSTs under § 108. The proposal would also require the government to disseminate disclosures through the Consumer Financial Protection Bureau, effectively informing borrowers with underwater properties of the tax consequences of engaging in MSSTs and that, currently, the federal government through the IRS may initiate onerous collection actions against taxpayers.

Effective public policy in relation to tax reform should not only change specific provisions of the law, but it should also do so to implement social policy that reflects the social values of American citizens. The 2007 financial crisis was a catastrophic earthquake the after-shocks of which are still being felt and will continue for many years to come. The government can and should come to its citizens' aid in this ongoing crisis, and it should resurrect long-standing American policies that promote and protect homeownership.

163. "BFSI" is a term coined by the author. *See* Porter, *Pawns for the Higher Greed*, *supra* note 25.

164. The majority of solvent middle-class taxpayers in need of tax relief are already in higher income tax brackets than lenders who receive favorable corporate tax rates. Although the U.S. Corporate Tax Rate is between 15% and 35%, most large corporations find a way to zero out their tax liability. Matt Krantz, *Large Companies Find a Way to Zero Tax Rate*, USA TODAY (Feb. 19, 2014), http://www.usatoday.com/story/money/business/2013/10/23/big-companies-pay-no-taxes/2480281/. A surprising number of companies in the Standard & Poor's 500, 57, have found ways to pay effective tax rates of zero, according to a USA Today analysis of data from S&P Capital IQ. The news comes months after the Government Accountability Office released a report showing that companies in 2010 reported an average effective tax rate of 12.6%, well below the 35% federal corporate tax rate. *Id*.