IDEA BRIEF

HELP FOR RESPONSIBLE HOMEOWNERS | JULY 2009

Deduction for Home Sale Losses

By Anne Kim and Ryan McConaghy

As housing prices continue to decline, Americans faced with the need to sell their homes are taking a direct economic hit. More than one-third of the homes sold in 2008 were sold at a loss. A temporary tax break that would allow homeowners to deduct a portion of their losses can help ease the shock of this blow to personal wealth and limit damage to middle class family finances.

THE PROBLEM

No relief for homeowners selling their homes at a loss

Plummeting home values have left many responsible homeowners faced with an unappealing set of options. They can remain tied to an economic albatross in which they have diminished or even negative equity; they can walk away to trigger foreclosure; or they can sell their homes at a loss. For those who choose to sell, current law provides no relief for their losses.

Current law protects profits from home sales but fails to cushion against losses.

Homeowners lucky enough to profit from a home sale are exempted from taxes on those profits to the tune of $250,000 ($500,000 in the case of a married couple filing jointly).[1] But homeowners forced to sell at a loss don't get similar relief. While other forms of capital losses (such as losses from the sale of stock) can be used to offset capital gains and are deductible from taxable income, losses from the sale of a person's home do not qualify for the same treatment.[2]

More and more homeowners are selling at a loss.

At the beginning of 2009, home prices dropped 19.1% from the beginning of 2008 and over 32% from their peak in the middle of 2006.[3] In this climate, homeowners who must sell their home to pursue a job, cope with divorce, or adapt to any other economic or social circumstance are more frequently being forced to engage in at-loss sales. The rate of at-loss sales has risen steadily, averaging over 31.1% of home sales in the first quarter of 2009, up a whopping 94.3% from the previous year.[4]

TOP FIVE AT LOSS HOME SALE STATES (FIRST QUARTER 2009)[5]	
State	% of Sales at Loss
Georgia	49.84%
Florida	49.82%
Nevada	45.67%
Rhode Island	39.83%
Minnesota	38.71%

Homeowners need relief.

From the end of 2007 to the end of 2008, home values decreased by 11.6%, with value losses estimated at $3.3 trillion.[6] As a result, Americans' personal wealth has vanished at an astonishing rate. Americans have lost almost $1.8 trillion in home equity since the beginning of 2008 and have lost over $2.5 trillion in home equity since 2007.[7] American homeowner equity has also declined on a percentage basis, falling to just over 41% in the first quarter of 2009 from a recent high of over 58% in 2005.[8]

Homeowners faced with the prospect of an at-loss sale are less likely to sell their homes to pursue new economic opportunities, and borrowers who have fallen into negative equity are 50% less likely to be mobile.[9] This combination of factors means that unmitigated losses on home sales do not just have a corrosive effect on middle class finances, but by restricting the movement of the labor force, they contribute to the ongoing economic downturn.

THE SOLUTION

Temporary tax deduction for losses on home sales

In the current economic climate, the gap in the tax code that leaves homeowners exposed to severe impacts from at-loss home sales threatens to add financial insult to severe economic injury for borrowers regardless of their credit history or circumstances. To help alleviate these consequences, Congress should temporarily allow homeowners to deduct losses on residential home sales.

This would be temporary.

Under this proposal, taxpayers would be allowed for the next two years to claim a tax deduction for part of the amount of their losses from a home sale. This deduction would be capped at $3000 annually, and any losses in excess of the cap would be able to be claimed at the same level for two additional tax years. For example, a homeowner who sells his or her home at a loss of $10,000 in 2009 would be allowed to claim a $3000 deduction for 2009, and to apply the remaining $7,000 in losses against the $3000 deduction limit for 2010 and 2011. This structure is similar to the deduction for capital losses now available under the capital loss carryover rules.[10]

This proposal would help to restore middle class wealth.

By easing the financial pain of home sale losses, this benefit will help homeowners to partially recoup the resources invested in their home, and in turn put those funds to use elsewhere. By bridging at least part of the gap between the purchase price and the sale price, the credit will also help to ease the aversion that homeowners may have to selling their home at a loss in order to pursue new jobs and other opportunities.

The deduction would be structured to help homeowners and prevent abuse.

To ensure that this deduction for home sales is not simply used to shield other income from taxation, qualifying homeowners will need to demonstrate that their home sale price is consistent with local property values and sales. This stipulation will prevent any efforts to engage in an artificially discounted sale for the purpose of sheltering other forms of income. In addition, only primary residences will qualify in order to ensure that tax assistance is appropriately targeted.

THE ROLLOUT

Ideas for launching and publicizing a tax deduction for losses on home sales

- Hold a press conference/speech with a local family coping with home value loss.
- Release a report highlighting local losses of home value.

CRITIQUES & RESPONSES

Deduction for Losses on Home Sales

It's too expensive.

This is not a permanent program or a new special interest tax giveaway. It is a temporary investment in economic recovery, and therefore worth the short-term cost. In a market where Americans have literally seen trillions of dollars in home equity evaporate, providing a tax benefit to struggling homeowners is a constructive step in halting an economic freefall. The existing tax code has helped to steer middle class families toward home investments and encouraged them to use their homes as the cornerstone of their prosperity. Now that market conditions have become so hostile, providing a backstop to alleviate some of the pain of home sale losses is a matter of fairness.

This provision is open to abuse and will encourage people to sell homes at a loss to create tax shelters for other income.

This tax break includes a value verification requirement to ensure that a home sale cannot be rigged to create an artificial loss for tax evasion purposes. The amount of the deduction and duration of the authorization are also limited in order to guard against abuse.

The capital loss deduction is too small to make a difference.

According to the National Association of Realtors, by May of 2009 the average sale price of an existing home has declined by just under $53,000 from the average price in 2006.[11] While the proposed deduction would not allow homeowners to recover their entire loss, it would provide a meaningful cushion to help them absorb the financial blow of the home sale and recover more quickly.

Doesn't this proposal just constitute another bailout and reward bad behavior?

No. As foreclosure activity rises, home values drop, and the recession has a negative impact on employment and earnings, even responsible homeowners are feeling the effects of a weakened housing market. This proposal is intended to help those borrowers cope with the overall economic circumstances that are largely beyond their control.

Isn't debt discharge already protected from taxation?

Under current law, if a home loan is modified, a home is foreclosed, or a home is sold at a loss AND the lender forgives any outstanding debt, the amount of debt forgiven is considered debt discharge income, which is currently eligible to be excluded from taxation.[12] However, this only applies if there is debt that is forgiven by a lender, and does not apply to actual losses realized from a home sale.

Housing already benefits from significant tax favoritism, why is another housing tax benefit necessary? Didn't runaway housing tax subsidies help to create this mess?

Housing tax incentives are currently geared to support home purchases and investments, not to help homeowners cope with falling values and sales losses. In a healthy, functioning housing market a capital loss deduction would be less necessary. However, following a housing collapse that was spurred by a meltdown in the subprime mortgage markets, this benefit can provide needed assistance to struggling homeowners. Accordingly, the capital loss deduction is not intended to become a permanent fixture of the tax code.

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ENDNOTES

1 Internal Revenue Service, "Publication 523 (2008), Selling Your Home," available at http://www.irs.gov/publications/p523/index.html.

2 Ibid.

3 Standard and Poors Press Release, "Nationally, Home Price Began 2009 with Record Declines According to the S&P/Case-Shiller Home Prices Indices," May 26, 2009, available at http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_052619.pdf.

4 Zillow Real Estate Market Reports, available at http://www.zillow.com/local-info/, accessed on June 29, 2009.

5 Ibid.

6 Stan Humphries, "Americans Lose $1.4 Trillion in Home Values in Q4," Zillow.com, February 2, 2009, available at http://www.zillowblog.com/americans-lose-14-trillion-in-home-values-in-q4/2009/02/.

7 Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States, Flows and Outstandings, First Quarter 2009,"Table B.100, June 11, 2009, available at http://www.federalreserve.gov/releases/z1/Current/z1.pdf.

8 Ibid.

9 Ray Fisman, "You've Just Been Offered a Great New Job in Charlotte! Too Bad You Can't Sell Your House in Tampa.," Slate.com, September 29, 2008, available at http://www.slate.com/id/2200916/.

10 Under current law, if capital losses exceed capital gains losses up to $3000 can be deducted from income. If losses are greater than $3000, the remainder can be carried over to the next year and applied as though the loss had occurred in that year. Internal Revenue Service, "Topic 409 – Capital Gains and Losses," available at http://www.irs.gov/taxtopics/tc409.html.

11 National Association of Realtors, "Sales Price of Existing Homes," available at http://www.realtor.org/wps/wcm/connect/c4b25d004e9218ff829fd3d7836abc56/REL0905EHS.pdf?MOD=AJPERES&CACHEID=c4b25d004e9218ff829fd3d7836abc56.

12 Internal Revenue Service, "The Mortgage Forgiveness Debt Relief Act and Debt Cancellation," available at http://www.irs.gov/individuals/article/0,,id=179414,00.html.