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I. INTRODUCTION

The financial markets are in a state of monumental disarray because of imprudent lending practices, irresponsible consumer borrowing, and dysfunctional credit markets. Many Americans have lost their home-equity nest eggs originally earmarked for retirement and emergency situations. One of the root causes of this crisis is excessive withdrawals of home equity. Individuals who borrowed against their equity used the loan proceeds on consumer expenditures, non-mortgage debt, and home repairs. The downstream effects of wasteful spending of home equity contributed to the devastation of our economy.

The current tax system provides a home mortgage deduction, which encouraged many individuals to borrow against their homes. Moreover, there is no tax disincentive for individuals who access home equity because the loan proceeds are nontaxable. While tax policy can promote harmful borrowing, it could also be structured to promote healthy borrowing and limit withdrawals of home equity.

Consequently, this article, a proposal for change, calls for a modification of the current tax treatment of proceeds derived from cash-out refinancings and home equity lines of credit. This modification involves changing the current income tax treatment of principal received in home equity loans by implementing a consumption-tax model. The underlying goals of this policy are: (i) to decrease irresponsible borrowing and frivolous spending of home equity funds; (ii) to preserve homeowners' "nest-eggs" and curtail Americans' substandard personal savings rate; (iii) to prevent individuals from becoming overextended through excessive borrowing; (iv) to maintain a flexible system which permits people to use their home equity for certain meritorious expenditures; and (v) to incentivize loan repayment.

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Part I evaluates how individuals use the money derived from equity extracted from their homes and the downside consequences of borrowing against home equity. Part II introduces a new proposal and highlights the differences between our current income tax system and a consumption tax system. Part III defines "qualified expenditures" and demonstrates how these will act as an exception to the general rule. Part IV develops a plan of administering this proposal. Part V provides examples of the restructured tax plan. Part VI addresses potential concerns and Part VII concludes that this model provides a viable solution to curb irresponsible borrowing of home equity in the future.

II. IF YOU LEND IT, THEY WILL SPEND IT

A. The Home Equity Bubble

Home equity loans became a major source of American borrowing throughout the last decade, with substantial home-equity extraction occurring between 2002 and 2004. Many homeowners' decisions to extract equity from their homes were fueled by a substantial decline in interest rates and significant rise in home prices.[1] Homeowners refinanced via a "second mortgage" or took a "home-equity line of credit" ("HELOC").[2] Most borrowers "cashed out" by withdrawing the total accumulated equity in their home. They used the proceeds to pay down their home acquisition mortgage (the mortgage obtained when the property was purchased) and pocketed the excess. Many borrowers used the proceeds derived from cashing out to finance personal-consumption spending and to pay down their consumer debt.[3] While some individuals refinanced in order to lock in a lower interest rate, others were extracting equity at higher interest rates than their first mortgages. These individuals increased their aggregate debts and the interest rates associated with those debts.[4]

Many borrowers were induced by manipulative brokers and lenders who advised them to take high-risk loans. During the real-estate boom, the mortgage markets saw "improvements in information processing technology, the streamlining of the mortgage application and approval process" thereby reducing various pecuniary costs associated with

1. A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. MARSHALL L. REV. 19, 24 (2004).

2. *See id.* at 23.

3. *See id.*

4. *See id.* at 23–24.

refinancing.[5] Cost reduction, coupled with low interest rates, provided mortgage lenders with an opportunity to develop a production-line method for loan origination. In addition, lenders devised innovative methods to lend money to risky borrowers and employed "smoke-and-mirrors" underwriting policies.[6] Nontraditional mortgages, such as option adjustable-rate mortgages and balloon loans,[7] provided loans to un-creditworthy borrowers that would have been otherwise unavailable to them via a conventional mortgage loan.[8] Also, homeowners saw their home values soar, in part because the vast availability of credit drove up consumer demand for home buying.[9] Karen Dynan and Donald Kohn indicated that "rising house values can also affect indebtedness . . . by providing additional collateral that can be used for portfolio rebalancing or for consumption."[10]

As a result of these supply-side factors, many Americans could not resist the opportunity to extract significant amounts of cash to supplement their incomes. Michele Dickerson noted, "Refinance borrowers essentially are putting their homes at risk to pay for the things inside their homes or in their driveways."[11] However, there is a significant downside risk when individuals increase their wealth-to-income ratios through borrowing on home equity. This risk exists "to the extent that households were counting on borrowing against a rising collateral value to allow them to smooth future spending, an unexpected leveling out or decline in that value could have a more marked effect on

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5. *See* Erik Hurst & Frank Stafford, *Home Is Where the Equity Is: Mortgage Refinancing and Household Consumption*, 36 J. MONEY & CREDIT 985, 988 (2004).

6. *See* KAREN E. DYNAN & DONALD L. KOHN, FEDERAL RESERVE BOARD, RISE IN U.S. HOUSEHOLD INDEBTEDNESS: CAUSES AND CONSEQUENCES, 2 (2007), *available at* http://www.federalreserve.gov/Pubs/Feds/2007/200737/200737pap.pdf .

7. Option-ARMs (Adjustable Rate Mortgages) and balloon loans are examples of nontraditional mortgages. Option-ARMS, for example, permit a borrower to choose her payment option. A borrower can choose to pay her monthly payments of principal and interest, interest-only payments, or minimum monthly payments (referred to as "teaser payments"). Balloon loans usually are 30-year loans that are amortized over 40 or 50 years. This lowers the monthly payments. However, the borrower must pay a balloon payment at the end of the mortgage term for the loan balance. *See* The Federal Reserve Board, *Interest-Only Mortgage Payments and Payment Option ARMS* (2007), *available at* http://www.federalreserve.gov/pubs/mortgage_interestonly/; *see also* U.S. Dept. of Housing and Urban Development: Glossary, *available at* http://www.hud.gov/offices/hsg/sfh/buying/glossary.cfm.

8. *See* Andrew Pavlov & Susan Wachter, *The Inevitability of Market-Wide Underpricing or Mortgage Default Risk*, 4 (Inst. for Law & Econ., Research Paper No. 06.14, 2005) (suggesting that by underestimating market risk, lenders provided loans to borrowers that should not have qualified).

9. *See* DYNAN & KOHN, *supra* note 6, at 4–5.

10. *Id.* at 17.

11. Dickerson, *supra* note 1, at 19.

consumption by, in effect, raising the cost or reducing the availability of credit."[12]

The result of excessive borrowing is that "households . . . become very highly indebted relative to income and wealth."[13] Borrowing against equity when home prices are overvalued is essentially gambling against future economic downturns. In 2004, Andrew Olszowy accurately predicted that "a downturn [in real estate values] could hurt both consumers and financial institutions holding a sizable portfolio of such [creative and underpriced] loans."[14] When the dust settled, many borrowers were left upside down in their homes. As a result, our financial institutions suffered significant losses as individuals walked away from their loan obligations.

B. What Did Americans Do with Their Loan Proceeds?

One study by Alan Greenspan and James Kennedy investigated borrowers' use of the free cash generated from refinancing and HELOCs. This study focused on "gross equity extraction from existing homes as the discretionary initiatives of home owners to convert equity in their homes into cash by borrowing in the residential mortgage market."[15] Statistics relating to the use of cash-out refinancing proceeds indicated that approximately 33% of the cash derived from equity was used to fund home improvements and repairs; approximately 27% was used to pay-down non-mortgage debt such as credit card and installment debt; and approximately 17% was used to finance personal consumption expenditures (PCE).[16] Furthermore, closing costs averaged about 2%, and repaid home-equity debt averaged 4%.[17] The remaining 17% of the loan proceeds were used to pay other costs, such as prepayment penalties, or remained as free cash.

HELOCs tend to be divided evenly between PCE, home improvements, and debt consolidation.[18] Generally, the data shows that a substantial amount of money derived from cash-out refinancing and home-equity loans was used to fund non-mortgage debt and consumer spending. The study showed that consumers used credit cards "as bridge

12. *See* DYNAN & KOHN, *supra* note 6, at 32.

13. *Id*.

14. Andrew Olszowy, *Alternative Mortgages: Managed Risk or Gamble*, COMMUNITIES & BANKING MAG., Spring 2006, at 4.

15. Alan Greenspan and James Kennedy, *Sources and Uses of Equity Extracted from Homes*, 24 OXFORD REV. ECON. POL'Y 120, 121–22 (2008).

16. *Id.* at 139.

17. *Id.*

18. *Id.* at 130.

financing for PCE" [19] and then used proceeds from home-equity loans to pay off the credit cards. These findings are accentuated in the subprime market where the majority of loans originated were cash-out refinancings and HELOCs used for "debt consolidation and general consumer credit purposes."[20]

C. What Do You Mean I Have To Pay that Back?

Greenspan and Kennedy's study postulates that "discretionary extraction . . . of home equity accounts for about four-fifths of the rise in home mortgage debt since 1990."[21] This discretionary borrowing can be equated to gambling on capricious market valuations. Unlike a borrower who sells her home in an up market, "home-equity loans and cash-out refinancings are extractions of unrealized capital gains."[22] When the market busts, the borrower may have extracted more money than the home is worth. When home prices depreciate, the equity in the home is wiped out.[23] As such, borrowers are more likely to walk away from equity-depleted homes.[24] When the borrower walks away, banks suffer significant financial losses that they are unlikely to recoup through a foreclosure proceeding.[25]

Erik Hurst and Frank Stafford noted that "housing is by far the largest single nonpension asset in a household's portfolio, comprising over 35% of the median household's wealth."[26] However, "unlike drawing down other nonpension assets, accessing home equity often entails large pecuniary costs."[27] Despite these costs, liquidity constrained households converted two-thirds of every dollar of home equity removed

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19. *Id.* at 140.

20. *See* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 723 (2006) (noting that only between 10% and 20% of subprime loans were used to fund home purchases).

21. *See* Greenspann & Kennedy, *supra* note 15, at 122.

22. *Id.*

23. Mara Der Hovanesian, *The Home Equity Crisis Ahead: Even Banks that Dodged the Subprime Bullet Face Losses From Loans Based on Homes Now at Risk,* BUS. WK., Jan 16, 2008, *available at* http://www.businessweek.com/magazine/content/08_04/b4068000575390.htm?chan=magazine+channel_news.

24. *Id.*

25. *Id.*

26. *See* Hurst & Stafford, *supra* note 5, at 986.

27. *Id.* (noting that origination fees constitute 1.5 – 2.5% of the loan. Other costs include searching for a lender, filling out mortgage applications, prepayment penalties, and various miscellaneous costs.).

in refinancing to current consumption.[28] A detrimental long-run consequence of financing personal-consumption spending through home equity is that "PCE financed from other than disposable income results in a reduction in the savings rate."[29] In fact, Greenspan and Kennedy's study identified a correlation between increased PCE financed by home equity and the decline in the personal savings rate since 1998.[30]

The United States consistently claims one of the lowest personal savings rates in the world. A 2005 New York Times article noted that America's personal savings rate fell below 0% that year and compared the US to China, which claimed a personal savings rate that hovered at around 50% during the same time period.[31] Moreover, our average personal savings rate has significantly declined in the past twenty years from approximately 9.1% in the 1980's to 1.7% in the first decade of this century.[32] The decline in America's personal savings rate "reflects the country's weakened fiscal position" and increases our reliance on foreign investment.[33]

Retirees face upcoming challenges as the cost of living steadily increases.[34] Individuals are forced to work longer and often lack adequate savings to maintain a reasonable standard of living during retirement.[35] The recent market bust has accentuated this problem as many soon-to-be retirees watched the value of their hard-earned investments drop dramatically.[36] America's failure to adequately save for retirement makes home ownership an essential savings mechanism for the majority of the population. However, the boom in equity extraction weakened the integrity of real estate as one of America's safest long-term investments. Without change, America's financial situation will continue to look bleak.

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28. *Id.* at 1012.

29. Greenspan & Kennedy, *supra* note 15, at 122.

30. *See id.* at 140.

31. Edmund Andrews, Editorial, *Snow Urges Consumerism on China Trip*, N.Y. TIMES, Oct. 14, 2005, at C1, http://www.nytimes.com/2005/10/14/business/14yuan.html?scp=1&sq=china%20savings%20rate&st=cse.

32. *See* DYNAN & KOHN, *supra* note 6, at 2.

33. Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt,* 4 HASTINGS BUS. L.J. 77, 94 (2008).

34. *See* Jeff Madrick, *Empty Nest Egg*, N.Y. TIMES, May 4, 2008, at BR6.

35. *See* Steven Greenhouse, *Working Longer As Jobs Contract*, N.Y. TIMES, Oct. 23, 2008, at F8 ("20 percent of boomers said they had stopped contributing to their retirement plans, 34 percent said they were thinking of delaying retirement and 27 percent acknowledged problems paying rent and mortgages.").

36. *See id.* (noting that many people's retirement accounts are shrinking in excess of 20 percent of their value).

III. SHIFTING IRS TAX TREATMENT ON HOME EQUITY DRAWS

Academic debate has shifted from adopting a more comprehensive income tax base to replacing our current income tax system with a consumption tax system.[37] This section will describe the fundamentals of both the income and consumption tax theories. It will also introduce a proposal to infuse a consumption tax platform into our current income tax system, specifically and exclusively for dealing with the tax treatment of home-equity draws. Implementing a consumption tax model for home-equity draws will create tax-timing disincentives for individuals to borrow against home equity. It will also create a long-term repayment incentive. Ultimately, this model is intended to limit individuals' willingness to forego long-term savings for short-term consumption.

A. Income Tax Model v. Consumption Tax Model

America currently has an income-based tax system.[38] The Haig-Simmons equation is a prominent model used to detail the composition of income. This model helps illustrate the effects our current income-tax system has on savings as compared to a consumption-tax system. The Haig-Simmons equation for income is:

Income = Consumption + Δ Wealth[39]

This equation demonstrates that income is the sum of the source of funds used for consumption and the change in wealth (savings).[40] Conversely:

Consumption = Income - Δ Wealth[41]

A consumption tax "relies on taking a lifetime, rather than a current-year or snapshot, perspective in evaluating individuals' welfare and in predicting their behavior."[42] A notable component of consumption tax using the Haig-Simmons model is that an increase in savings would decrease the amount of tax liability under a consumption tax model. Conversely, an increase in savings under an income tax model would

37. Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745, 746–47 (2007).

38. *See id.*

39. Joseph Bankman & David Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1419 (2006).

40. *See id.*

41. *Id.*

42. *See* Shaviro, *supra* note 37, at 748.

increase an individual's tax liability.[43] The income-tax regime creates a significant savings disincentive.[44] Proponents of the consumption tax argue that "the income-tax burden on investments resulted in too little savings."[45] The implementation of a consumption-tax framework could incentivize savings.

B. Current Tax Treatment of Home Equity Draws

Currently, a mortgagor (a borrower who takes out a home loan) is not taxed on proceeds received from a loan.[46] This policy is rooted in the Internal Revenue Code's ("the Code's") presumption that a borrower will pay her loan back in full. Therefore, the borrower will not receive a net economic gain.[47] The Second Circuit determined that net refinancing proceeds are non-taxable even if these proceeds exceed the borrower's basis[48] in the property.[49] Conversely, a taxpayer does not receive a deduction upon repayment of principal on this debt.

Professor Mitchell Engler explained that the current income-tax code contains "realization defects."[50] The problem is that "income is reported only when 'realized' through a market transaction like the sale of an asset or payment of a salary."[51] This realization requirement describes the various tax-avoidance opportunities inherent in the income-tax code. Under our income-tax regime, if an individual sells her house for an amount greater than her basis, she would be required to pay taxes on the capital gains, which equals the selling price minus the individual's basis in the home. However, a borrower extracting these gains through a cash-out refinancing is not required to realize gains because borrowing against home equity is not a tax realization event.

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43. Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53, 55 (2003) (noting that "[t]he core difference between an income tax and a consumption tax is the tax treatment of the return from savings").

44. *See* Mitchell L. Engler, *Progressive Consumption Taxes*, 57 HASTINGS L.J. 55, 57 (2005).

45. *Id.*

46. Comm'r v. Indianapolis Power & Light Co., 493 U.S. 203, 207–08 (1990) ("[I]t is settled that receipt of a loan is not income to the borrower [because of the obligation to pay the loan back]."); *see also* Comm'r v. Tufts, 461 U.S. 300, 307 (1983); James v. United States, 366 U.S. 213, 219 (1961).

47. *See* James, 366 U.S. at 219 (discussing tax treatment of loans in dicta).

48. The "borrower's basis" is the amount the borrower paid for the property originally.

49. *See* Woodsam Associates, Inc. v. Comm'r, 16 T.C. 649 (T.C. 1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).

50. *See* Engler, *supra* note 44, at 64.

51. *Id*.

In theory, if a borrower pays her loan back in full, this tax treatment is logical because she truly does not have a net economic gain. However, if the borrower defaults on the loan, she benefits from tax-free gains extracted from her property. While forgiven debt is taxable,[52] it is unlikely that a borrower in financial distress has the means to satisfy the tax liability. At this point the home's equity has been depleted, and the lender is forced to engage in costly foreclosure proceedings. Meanwhile, the borrower benefited by extracting unrealized gains from her home tax free. Therefore, upon default, the borrower received a net economic gain. The current mortgage crisis has disproved the faulty assumption that a borrower will satisfy her loan obligations, and this theory must be reevaluated.

C. Transition to the Consumption Tax Model

1. Why use a consumption tax?

Tax policymakers debate whether a consumption-tax system would better support America's long-term economic growth than our current income tax system. A number of prominent scholars have concluded that a consumption tax system is superior to an income tax system.[53] Unlike an income-tax regime which "decreases the proportion of savings undertaken by individuals," a consumption tax "does not alter proportional savings or risk-taking from their no-tax levels so the regime is neutral with respect to savings and investment decisions."[54] Policymakers who advocate for a consumption tax seek to combat the current system's built-in savings disincentive.

2. How a consumption tax model would function

A consumption tax model would tax loan proceeds on a "cash flow basis."[55] Professor William Andrews postured, "[s]ubstantial loan proceeds would be includable in taxable income, and repayments would

52. *See generally,* Comm'r v. Tufts, 461 U.S. 300, 300 (1983) (holding that a taxpayer must include the value of any debt forgiveness, even from a nonrecourse obligation, in his amount realized when calculating gain on a sale of his property).

53. *See, e.g.*, Bankman & Weisbach, *supra* note 39, at 1414.

54. Janet A. Meade, *The Effects of Income and Consumption Tax Regimes on Proportional Savings and Risk-Taking,* 70 ACCT. REV. 635, 636 (1995).

55. William Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1137 (1974).

be deductible."[56] Professor Andrews favors consumption treatment as a means to, inter alia, "limit the abuse of tax shelters."[57] This proposal applies fundamental consumption tax principals to home equity extractions via HELOCs and cash-out refinancings.

Under the proposed system, the Code would tax all non-acquisition debt obtained through cash-out refinancing (or HELOCs) when received and would permit a recapture of the consumption tax as the loan is paid back.[58] The yearly recapture of consumption tax will result in a tax credit against the borrower's future tax liability, and would constitute a pro-rata share of the total amount repaid on a yearly basis over the total consumption tax paid. While this seems like a heavy burden for a cash-strapped taxpayer, there would be various exceptions to mitigate the seemingly harsh results imposed by a strict consumption tax.

An individual could avoid current year taxation if non-acquisition funds are spent on "qualified expenditures." Qualified expenditures would reference various line-item deductions found in the current Code. In the event that an individual uses the proceeds obtained through a cash-out refinancing on qualified expenditures, those funds would be nontaxable in the current year. Therefore, an individual who uses equity proceeds on qualified expenditures would end up in a similar economic position as an individual who withdrew equity tax-free (under the current tax rules) and spent the borrowed money on certain deductible expenditures.[59]

Conversely, an individual who uses home-equity funds on unqualified expenditures must incur a consumption tax calculated as the amount of unqualified expenditures, from the loan proceeds, multiplied by their marginal tax rate in the year the proceeds are received. A new worksheet [that supports an additional line item in the "Other Taxes" section of Form 1040] would be added to the tax return to calculate a one-time consumption tax upon withdrawal. This worksheet would permit the taxpayer to track any consumption-tax recapture on a carry forward basis (similar to corporate net operating loss carryforwards) to account for future years' recapture of any consumption tax paid. As mentioned, the borrower would then receive a future recapture of the consumption tax paid as she repays the loan principal. The aggregate recapture could not exceed the amount of consumption tax incurred. The recapture is calculated by multiplying the marginal tax rate (fixed at the

56. *Id.*

57. *Id.*

58. This Article takes no position on eliminating the mortgage interest deduction.

59. *See, e.g.,* I.R.C. §213(a) (2009) (permitting deductibility for medical expenses that exceed 7.5% of the taxpayer's adjusted gross income).

marginal tax rate in the year the borrower extracted her home equity) by the repayments made over the repayment period. Thus, upon full repayment of the borrowed funds, the borrower would have recaptured her total tax outlay initially paid as a consumption tax. The long-term net affect would be $0 tax on the loan proceeds. The detrimental aspect of this tax regime rests in the time value of money, since the borrower has lost use of her funds for a substantial period of time.

Taxing loan proceeds upon receipt of the funds reflects the consumption-tax principal of taxing cash flow rather than income. This model is intended to create a disincentive for individuals to extract equity from their home. The qualified expenditure exceptions permit borrowers to use the loan proceeds on certain expenditures that Congress deems beneficial to public policy. Furthermore, the consumption tax model creates an incentive for borrowers to satisfy their loan obligations in order to benefit from the future recapture of the consumption tax paid that they receive upon repayment. To emphasize, the concept is only taxing the time value of the money received. The net effect is to recapture 100% (less the time-value of the money) of the consumption tax paid once the loan is repaid.

The following sections will analyze the various qualified expenditures and then present numerical illustrations of the proposed plan.

IV. QUALIFIED EXPENDITURES

This section will identify the qualified expenditures and illustrate how these expenditures provide an exception under this proposal.

A. What Are "Qualified Expenditures"?

The current Internal Revenue Code provides deductions for a variety of expenditures which Congress has deemed beneficial to the public good. Similarly, this proposal will treat as "qualified expenditures" certain itemized deductions permissible under the current tax code. These include, e.g., extraordinary medical expenditures and qualified educational expenditures. If a borrower uses the funds extracted from home equity on qualified expenditures, the borrower will not be subject to the consumption tax. Furthermore, the borrower would continue to benefit from any itemized deductions permitted under the current tax code if the borrower uses the loan proceeds towards a qualified expenditure.

B. What Will Be Treated As Qualified Expenditures?

1. Home improvement and repairs as qualified expenditures

Section 163(h) is a creation of the Tax Reform Act of 1986. It is often argued that this reform "fuel[ed]" the growth in non-purchase money lending.[60] Many borrowers recognize the mortgage interest deduction as "one of the most sacred parts of the Tax Code."[61] Under §163(h)(B)(i)(I), home improvement and repairs are considered acquisition indebtedness. This article proposes to exempt all loan proceeds deemed acquisition indebtedness from taxation.

Currently the Code distinguishes between acquisition debt and home-equity debt for the purposes of determining a borrower's allowable mortgage interest deduction.[62] Home acquisition debt is indebtedness which is "secured by such residence" and "incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer."[63] In contrast, home-equity indebtedness is "any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed" the difference between the fair market value of the "qualified residence" and the amount of acquisition indebtedness with respect to such residence.[64] The Code allows individuals to deduct interest paid on home acquisition loans of up to $1,000,000 and up to $100,000 of home-equity indebtedness.[65]

This proposal adopts the distinction set forth in § 163 and classifies expenditures defined as home-acquisition debt as qualified expenditures.

60. *See* Dickerson*, supra* note 1, at 27.

61. Julia Patterson Forrestor, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 397 (1994) (quoting 132 CONG. REC. 14,824 (1986) (statement of Sen. Pryor)).

62. *See* I.R.C. §163(h) (2009).

63. *Id.* at §163(h)(3)(B)(i) ("Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.").

64. *Id.* at §163(h)(3)(C)(i). [In essence the Code disallows deductions that exceed the fair market value of the home. Thus, if a borrower takes a $100,000 acquisition mortgage to purchase her property, the entire loan is considered home acquisition debt and the borrower can deduct the mortgage interest associated with this debt. If the home appreciates to $110,000 and the borrower takes a loan against the $10,000 of equity, this loan would be considered home equity indebtedness.]

65. *Id.* at §163(h)(3)(B)(ii), (h)(3)(C)(ii).

Allowing a borrower to withdraw home equity and reinvest in preserving, repairing, or modifying a home would be consistent with a policy of long-term wealth generation. Repairing or improving a home will preserve or increase the home's value. Also, the borrower may increase her tax basis in her property pursuant to § 263(a)(1).[66] Therefore, upon sale of the residence, she will recognize less taxable gain on the property, if she happens to exceed the qualified tax exceptions for gains on the sale of a personal residence.[67]

2. Expenditures related to production of income as qualified expenditures

Section 212 of the Code permits a deduction for "ordinary and necessary expenses paid or incurred during a taxable year for the production or collection of income."[68] Section 212 applies to expenses that involve a business origin.[69] The Supreme Court described this deduction in dicta:

For income tax purposes Congress has seen fit to regard an individual as having two personalities: "one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures."[70]

By enacting the §212 deduction, Congress sought to provide individuals with tax breaks to engage in certain profit-seeking activities. Congress deems such activities socially and economically beneficial. This deduction is intended to promote commerce and encourage entrepreneurial behavior.

Section 212 expenditures would be considered qualified expenditures. Therefore, home-equity proceeds used on a §212 expenditure would be nontaxable to the borrower during the year the proceeds are extracted. Moreover, the borrower will benefit from any corresponding §212 deduction in the year of extraction. Since the

66. I.R.C. §263(a)(1) (2009).

67. *See* I.R.C. §121(a), (b) (2009) (permitting up to a $250,000 ($500,000 for joint filers) deduction for capital gains derived from the sale of a home that a taxpayer has lived in for at least 2 out of 5 years preceding the sale).

68. Leigh v. United States, 611 F. Supp. 33, 36 (N.D. Ill. 1985) (citing I.R.C. §212 (1985)).

69. *See* United States v. Gilmore, 372 U.S. 39, 45 (1963) (noting that expenses deductible under §23(a)(2) [now §212] are those related to a profit-seeking purpose).

70. *See id.* at 44 (quoting *Surrey* and *Warren*, Cases on Federal Income Taxation, 272 (1960)).

borrower did not incur consumption tax in the year of extraction, there is no offsetting recapture over loan repayment period.

3. Extraordinary medical expenditures as qualified expenditures

The Code permits a deduction for "the expenses paid during the year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent . . . to the extent that such expenses exceed 7.5% of adjusted gross income."[71] Section 213 is intended to provide a deduction for "the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."[72] This deduction is intended to assist individuals with various catastrophic medical expenses.[73] Congress intended to provide a deduction for individuals when they suffer medical expenses that "are so great that they absorb a substantial portion of the taxpayer's income and hence substantially affect the taxpayer's ability to pay taxes."[74]

This article proposes to treat major medical expenses as defined under §213 as qualified expenditures. Therefore, a borrower would be relieved of tax liability on loan proceeds used for any expenditure which would qualify for the §213 deduction. Therefore, individuals would still be permitted to use their available financial resources on health-related expenses. Preserving an exception for health-related expenditures under this proposed modification to the law is in line with Congress's intent in promulgating §213 of the Code.

The 7.5% of adjusted gross income ("AGI") limitation would remain intact. The borrower would receive a deduction for qualified medical expenditures that exceed 7.5% of her AGI.[75] Therefore, if the borrower makes $100,000, she will be permitted a deduction for all medical expenditures, not covered by insurance, that exceed $7,500. Under this proposal, the borrower would take this deduction and reduce her consumption-tax liability by the amount of the qualified expenditures.

For example, assume in year 1 the borrower takes a loan, and in year 2,[76] she repays the loan. Under a consumption tax model, a

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71. I.R.C. §213(a) (2009).

72. *Id.* at §213(d)(1)(A).

73. James W. Colliton, *The Medical Expense Deduction*, 34 WAYNE L. REV. 1307, 1316 (1988).

74. *Id.* at 1317 (citing S. REP NO. 99-313, at 59 (1986)).

75. The loan proceeds would not be included in the borrower's consumption tax calculation.

76. Year 2 is used as a variable that represents the total repayment period of the loan.

borrower who drew $100,000 of home equity would incur a consumption tax on this amount in year 1 and would be permitted to recapture the year 1 consumption tax outlay in year 2 upon repayment of the debt. However, this proposal would not tax the borrower in year 1 if she spends the loan proceeds on qualified medical expenditures. Therefore, the borrower would not recognize consumption tax from the loan proceeds in year 1 and would receive a medical deduction in year 1. Since this is a qualified expenditure, the borrower was not subject to a consumption tax and there would be no consumption tax recapture in year 2.

Borrower Adjusted Gross Income	$100,000 (Assume the borrower spends 10% of the loan proceeds on Qualified Medical Expenditures.)
Home Equity Loan Amount	$100,000
Permitted Exclusion	$10,000 (10% is excluded from the Consumption Tax calculation)
Current Treatment Under § 213	Borrowers will receive a current year medical deduction of amounts spent above 7.5%AGI.
Tax Treatment Under Proposal Yr. 1: Marginal Tax Rate (25%)	**Yr. 1**: Year one consumption tax liability on the loan proceeds is $90,000 multiplied by the Yr 1 marginal tax rate (i.e. 25%) equals $22,500. This calculation does not include loan proceeds that were spent on qualified expenditures. **Yr. 2** (Full Repayment $100,000): Borrower would be entitled to a recapture of the $22,500 consumption tax paid in Yr 1. Total recapture is calculated by multiplying the full repayment amount ($100,000) by the Yr. 1 marginal tax rate which equals $25,000. However, the credit is limited to $22,500, which is 100% of the consumption tax paid in Yr. 1.

This scenario is illustrated below:

4. Tuition and related expenses as qualified expenditures

Society has an incentive to support those seeking higher education. One author noted, "The notion of improving access to–and affordability of–higher education is a theory long transfused into American politics and social policy."[77] Currently, taxpayers are permitted to deduct or claim a credit for a limited amount of education related expenses.[78] The tuition deduction is up to $4,000 for individuals making under $65,000 a year ($130,000 a year if filing jointly).[79] The deduction is currently set at $2,000 dollars for individuals making more than $65,000 but less than $80,000 ($160,000 a year if filing jointly).[80] Taxpayers are not permitted to get a double benefit through other assistance such as the Lifetime Learning Credit.[81]

This proposal recognizes tuition and related expenses as qualified expenditures. Under the proposal outlined in this article, an individual who uses home equity funds on a §222 educational expenditure will be exempt from tax on the amount applied to that expenditure. If borrowers are forced to include the funds received from their HELOC or cash-out refinancing in the consumption-tax calculation it would jeopardize their ability to fund their education. An example will illustrate the effects of a hypothetical application of this exception.

Assume in year 1 a borrower (files a joint return, earns $60,000 per year and has a marginal tax rate of 25%) refinanced and received $10,000 which she used to pay for a master's degree. Assume in year 2 the individual pays the loan back in full. Under the consumption tax model, the general assumption is that the borrower would incur a consumption tax of $2,500 in year 1 based on $10,000 of loan proceeds at her marginal tax rate. However, because she spent these funds on qualified tuition per §222 of the Code, she will be deemed to have used the funds for "qualified expenditures." In year 1 she will not be taxed on the loan proceeds used on qualified educational expenses. Since the borrower earns $60,000, and is married filing jointly, she is entitled to a $4,000 deduction in year 1 when she incurs the expenses.[82] The net effect is the same as if the borrower withdrew home equity under the current tax regime to fund her educational expenses.

5. Limited living expenditures as qualified expenditures

Some borrowers accessed home equity as a means to support a family through rough economic times. While the goal of introducing a

77. Sean M. Stegmaier, *Tax Incentives for Higher Education in the Internal Revenue Code: Education Tax Expenditure Reform and the Inclusion of Refundable Tax Credits*, 37 SW. U. L. REV. 135, 139 (2008).

78. I.R.C. §222(a), (b) (2009).

79. *Id.* at §222(b)(2)(B)(i).

80. *Id.* at §222(b)(2)(B)(ii).

81. *See* Stegmaier, *supra* note 77, at 143–44 (citing I.R.C. §222(c)).

82. *See* I.R.C. §222(b)(2)(B)(i) (2009).

consumption tax model to home equity draws is to limit the incentive to rely on home equity to finance personal living expenses, there may be a need for lower income individuals to access home equity to survive. Providing a living expenditure allowance would not be administratively difficult. It would provide a certain yearly "allowance" which individuals will be permitted to access tax free. To qualify for the living expenditure carve out, taxpayers would have to show proof to the Internal Revenue Service (IRS) that they receive state unemployment or social security assistance. The amount of the allowance could be determined by referencing the IRS "National Standards: Food, Clothing and Other Items."[83] The National Standards currently indicate the yearly allowance for delinquent taxpayers who are currently paying back taxes to the IRS.

The downside to providing this allowance is the potential for taxpayer abuse. Therefore, a single borrower would need to make $50,000 or less per year to qualify for this exemption and a family would need to make less than a combined income of $100,000 to qualify. This provision is intended to limit this loophole to benefit only individuals who may have legitimate needs to supplement their income. This exemption from the proposed code would provide for yearly allowances for food, clothing, and transportation only. It would not take into account the housing allowance because the borrower will be required to continue to pay their mortgage obligations.

To exemplify the extent of the Internal Revenue Code allowance, assume a single borrower takes out a $10,000 loan and makes $39,000 per year as a teacher in Los Angeles, California. Here is the National Standards for 2008 monthly expenses:[84]

Expense	**One Person**	**Two Persons**	**Three Persons**	**Four Persons**
Food	$277	$528	$626	$752
Housekeeping supplies	$28	$60	$61	$74
Apparel & services	$85	$155	$209	$244

83. IRS, NATIONAL STANDARDS: FOOD, CLOTHING, AND OTHER ITEMS, *available at* http://www.irs.gov/businesses/small/article/0,,id=104627,00.html.

84. *Id.*

Expense	**One Person**	**Two Persons**	**Three Persons**	**Four Persons**
Personal care products & services	$30	$53	$58	$65
Miscellaneous	$87	$165	$197	$235
Total	**$507**	**$961**	**$1,151**	**$1,370**

Additionally, there is a $261 monthly transportation allowance for Los Angles and a $489 a month allowance for a car lease or purchase. Therefore, the borrower would be permitted a monthly allowance of $1,257 per month or $15,084 per year that she could access tax free. The borrower would have to provide proof of payment for any car payments. However, she would not be required to substantiate the $507 per month for food and other personal items or the transportation allowance.

6. What about credit card debt repayment?

Currently the Code does not provide a deduction for credit-card interest as it is not a socially favored expense. As discussed in Part II, a high percentage of the funds derived from home equity are used to pay down credit-card debt.[85] This is a poor use of home equity for numerous reasons and should not be considered a "qualified expenditure." Therefore, if an individual refinances and uses equity to pay down credit card debt, she will be subject to current year taxation on the borrowed funds. The consumption tax acts as a deterrent due to the time value of money. Essentially, $100,000 of tax liability in year 1 is more costly than $100,000 of tax liability in year 2, or any later repayment year. Borrowing home equity to pay down credit card debt shifts the risk of loss from a credit card company to the borrower. This risk is inherent in the distinct treatment of mortgage debt versus consumer debt under the United States Bankruptcy Code. Bankruptcy laws protect mortgage lenders "from lien avoidance in bankruptcy" which "encourage[s] (and often subsidize[s]) homeownership."[86] The Bankruptcy Code disallows "stripping" any portion of debt that is not secured by the value of the home.[87] Therefore, even the unsecured or under secured portion of the mortgagees' lien will survive bankruptcy. Thus, a borrower in financial

85. Greenspan & Kennedy, *supra* note 15, at 122.
86. Dickerson, *supra* note 1, at 50.
87. *Id.* at 51.

distress is still at high risk to lose their home, even under the shelter of bankruptcy protection.[88]

However, unsecured creditors, like credit card companies, are not treated as favorably under the bankruptcy laws. Unsecured credit-card debt is presumptively dischargeable.[89] Therefore, in the absence of fraud on the creditor, the borrower will be able to shed off the credit-card debt, where the mortgage debt may still linger. Therefore, there is an inherent risk-shifting from the unsecured creditor to the mortgagor. If an individual pays off a credit card company through mortgage loan proceeds, she assumes the risk of a non-dischargeable lien. For many, this leads to foreclosure.[90] If the borrower does not take on high-rate HELOCs and second mortgages, the credit-card company bears the risk of loss in subsequent bankruptcy proceedings. A borrower may still choose to take a high-rate secured second mortgage to pay off consumer debt. However, under a consumption tax regime, the borrower must keep in mind that the loan proceeds are taxable.

7. Carve out provision for reverse mortgages

Senior homeowners over the age of sixty-two may convert equity in their home into an income stream by taking a reverse mortgage.[91] The borrower qualifies if she owns her property and occupies the property as a primary residence.[92] Reverse mortgages are federally backed by the Federal Housing Administration; therefore, recipients will receive "[their] money even if the lender goes under."[93] For many seniors, this is a viable option to supply an additional income stream to supplement their social security income.

Though this unique mortgage tool extracts home equity, this article proposes a carve-out provision for seniors opting to supplement their

88. *Id.*

89. *Id.* at 53 (citing 11 U.S.C. §523(a)(2)).

90. *Id.* at 56 (noting the high rates of foreclosure and default indicate that many borrowers cannot afford to pay refinanced debt and proposes a bankruptcy reform to provide a rebuttable presumption of dischargeability for unsecured home debt).

91. *See* US Dept. of Housing and Urban Dev., FHA Reverse Mortgages (HECMs) for Consumers, http://www.hud.gov/offices/hsg/sfh/hecm/hecmabou.cfm. (setting forth the requirements needed to qualify for a reverse mortgage including "not be delinquent on any federal debt" and "participate in a consumer information session given by an approved HECM counselor").

92. *Id.*

93. Emily Brandon, *How the Housing Law Affects Reverse Mortgages*, U.S. NEWS & WORLD REP., Aug. 18, 2008, *available at* http://www.usnews.com/money/personal-finance/retirement/articles/2008/08/18/how-the-housing-law-affects-reverse-mortgages.html.

income via a reverse mortgage. Seniors that have purchased their home outright have overcome a significant hurdle in today's markets. A senior citizen who has paid off her mortgage debt has achieved the primary objective of this proposed policy, which is preserving adequate savings for retirement. These seniors should have unabridged access to a reverse mortgage to supplement their retirement income.

As long as the homeowner continues to live in the home, she will not have to repay the funds received from a reverse mortgage. Under a reverse mortgage, the risk of foreclosure is abated because the borrower has satisfied her mortgage obligations and owns her home outright. Recipients of reverse mortgages are usually retirees using the value in their home as a source of income during retirement. Therefore, there is less concern regarding depleting equity in the home and the homeowner is not liable to repay cash received from the reverse mortgage.[94] The individual is merely reaping the benefits of the accumulated equity through an additional income stream. While there are other concerns related to the reverse mortgage that go beyond the scope of this article, it can be a valuable tool to assist in financing a retirement. Overall, funds received through a reverse mortgage would not be subject to this proposed tax code.

8. *Temporary safe-harbor provision through qualified accounts*

Individuals may extract equity through a cash-out refinancing and not use all of the money extracted immediately. A safe harbor will permit the individual to deposit extracted funds into a qualified Home Equity Savings Account (HESA) which will be discussed in depth in Part V.

V. ADMINISTRATION

The changes set forth in this article would require an extensive administrative infrastructure in order to successfully support the proposed changes to the Code. Administering the previously introduced HESA program would require a system to monitor the borrower's use of her loan proceeds. The first part of this section introduces Health Savings and Flexible Spending Account models. The second part of this section sets forth a proposal to integrate characteristics of these models to administer the proposed plan.

94. *But see, id.* (noting that there are some instances, such as if the homeowner no longer uses the home as her primary residence for longer than 12 months, where the individual will have to pay back the amount received plus interest).

A. An Introduction to Health Savings Accounts and Flexible Spending Accounts

Health Savings Accounts (HSA) arising as a component of Medicare legislation began on January 1, 2004.[95] HSAs are tax-exempt accounts that permit individuals with high deductible health plans to pay for qualified medical expenses. Section 223 of the Code provides that contributions by eligible individuals are permitted to make "above-the-line" adjustments to gross income for income tax purposes.[96] The Code requires that a health savings account be created as a "trust created or organized in the United States as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary."[97] A trustee includes a bank as defined under I.R.C. §408.[98] HSA trustees are not required to substantiate distributions from an HSA.[99]

Flexible Spending Accounts (FSA) are employee tax shelters created under §125 of the Code.[100] Employees participating in employer FSA programs are permitted to select a specific amount of money that is deducted from their pre-tax wages. The funds contributed to an FSA are used to reimburse employees for out-of-pocket medical expenditures that are not covered by their insurance.[101] At the end of the year, an employee must use the contributed funds or the money goes back to the employer. Employers must comply with a number of legal mandates when administering FSAs. For instance, an FSA requires substantiation of all expenditures that the employee makes prior to disbursing funds. Any unqualified expenditure will not be reimbursed.[102] Substantiation includes independent third-party documentation (i.e. a receipt) that

95. PUB. L. NO. 108-173 (2003).

96. I.R.C. §223(a) (2009) (An employer may make contributions to HSAs for employees and exclude from gross income and wages for employment tax purposes).

97. *Id.* §223(d)(1).

98. I.R.C. §408(n)(1) (2009). Includes "any bank as defined under I.R.C. §581, which is a bank or trust company incorporated and doing business under the laws of the United States . . . which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions." *Id.; See also* I.R.C. §581.

99. IRS, INTERNAL REVENUE BULLETIN 2004-2, (Jan. 12, 2004) *available at http://www.irs.gov/irb/2004-02_IRB/ar09.html*.

100. Roger Feldman and Jennifer Schultz, *Who Uses Flexible Spending Accounts: Effects of Employee Characteristics and Strategies*, 39 MED CARE 661, 661 (2001).

101. *Id.*

102. 2007 Prop. Regs. §1.125-6(a)(1).

verifies the purchase.[103] A number of employers hire third party administrators such as “myCAFETERIAPLAN.com” or AFLAC. These administrators assist companies with the implementation, maintenance, and distribution of cafeteria plans. Many companies issue FSA debit cards. Most of these debit cards determine the nature of the purchase based on the stock keeping unit (SKU) and decline transactions that are unauthorized. Major credit card companies such as VISA and MasterCard offer these cards. FSAs possess a number of differences from HSAs, but the substantiation requirement is the most significant difference.[104]

B. Expanding HSA and FSA Models into the Mortgage Market

This article proposes integrating characteristics found under the HSA and FSA regimes to administrate this consumption tax model. To avoid current year taxation on HELOC or cash-out refinancing proceeds, the borrower could open a Home-Equity Savings Account (HESA) and deposit the funds into this account. These accounts would be similar to the widely used Health Savings Accounts. HESAs would be interest bearing accounts at qualified banks.[105] Banks will have access to the deposits for purposes of lending. Therefore, banks have a commercial incentive in creating HESAs. Funds deposited in HESA accounts act as a safe-harbor to shield borrowers who extract cash from having to include this cash in taxable income during the year of extraction. Essentially, if the borrower contributes funds derived from a refinancing or HELOC, and places these funds into a HESA account, the taxpayer will not have to include the cash received in income until it is accessed.

Unlike a Health Savings Account, substantiation would be mandatory. Many banks would hire third party administrators for efficiency and cost savings.[106] The costs for hiring outside administrators would be satisfied via a small monthly service fee charged to each HESA client account.

Failure to substantiate expenditures would subject an individual to consumption tax on the unsubstantiated funds. Substantiation will mirror the FSA system. A HESA holder would submit a form similar to a

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103. 2007 Prop. Regs. §1.125-6(b)(3)(i).

104. *See* H.R. 5719, 110th Cong. (2008) (approved by Congress in 2008, would require HSA’s to implement substantiation prior to payouts).

105. *See supra,* note 98 and accompanying text.

106. Third party administrators such as AFLAC and myCAFETERIAPLAN.com provide administrative services for flexible spending accounts. These companies would have the expertise to administer a HESA.

Flexible Benefit Plan Expense Reimbursement form to the plan administrator.[107] The account holder would detail her expenditures and include receipts or other documentation for all purchases listed. In some situations, such as situations with significant home-repair projects, a borrower may seek preapproval from the fund administrator by submission of a proposal and estimate of required funding. This would assist in eliminating the uncertainty that borrowers may face in situations where they would have to spend a substantial amount of money by alerting the borrower, in advance, that her expenditure is qualified (or not qualified) under this proposed tax code modification. Funds would be remitted to the account holder upon the administrator's verification that the expenditure is qualified. If the expenditure is deemed unqualified, the administrator will notify the account holder that the expenditure is not qualified and the taxpayer may be subject to income tax on funds dispersed. The taxpayer could appeal to a more senior member of the bank or challenge the determination in court if she believes that the administrator erred in her determination. Also, there will be a safeguard for a borrower who used loan proceeds from a HESA because of a mistaken belief that the expenditure was qualified. Similar to the IRS rules regarding HSAs, the account beneficiary should be permitted to repay these funds to her HESA account by April 15 "following the first year the account beneficiary knew or should have known the distribution was a mistake."[108]

C. Reporting Under a Modified Tax System

For tax reporting purposes, a line item would be added to the form the lenders send to the borrowers, Form 1099-HE, (see below) when the funds are disbursed. On the Form 1040 and 1040NR,[109] a new worksheet would be added in the "Other Taxes" section (similar to additional tax penalty on early withdrawal of retirement funds). The worksheet would become a carryforward worksheet (similar to a net operating loss (NOL) carry forward) and require the date her loan was funded and the total cash value of her refinance. The borrower would then report the amount

107. *See* Exhibit 1, *infra* p. 35.

108. *See* 2008 Instructions for IRS Forms 1099-SA and 5498-SA *available* at http://www.irs.ustreas.gov/pub/irs-prior/il099sa—2008.pdf (last visited Mar. 12, 2010).

109. The line item would also be added to any other IRS forms that a taxpayer uses or may use in the future to report her income.

of the loan that represents equity extracted from the home.[110] This amount becomes the loan proceeds subject to consumption tax. If the borrower reports any equity received, she will be required to use the consumption-tax supplemental worksheet to determine the amount of consumption tax due. This form would be modeled after Form 8889, which is used for reporting contributions and distributions from HSA accounts.[111] Form 8889 has three parts. Part I asks the individual to describe contributions and deductions. Part II asks the individual details on any distributions made from the HSA. Part III requires the borrower to report any "additional tax" liability from unqualified expenditures.

The Consumption Tax Supplemental Worksheet used to account for the HESAs would also contain three main parts. Part I would require the taxpayer to indicate the type of refinancing (HELOC or cash-out) and the amount of the loan proceeds attributed to equity. Part I will also ask the borrower to indicate if she has a qualified account and how much of the loan proceeds she deposited into this account. Part II will inquire about the amount of distributions from the account. It will require the borrower to report the amount of qualified and unqualified expenditures. Part II will also ask the buyer to report qualified expenditures from any undeposited funds. If the borrower does not deposit a portion of the funds, the IRS will require the borrower to attach substantiating documentation to the supplemental form. In Part III, the borrower would detail the amount spent on qualified and unqualified expenditures. The borrower will then identify any free cash remaining in her qualified HESA. The final calculation will indicate the amount of equity proceeds subject to the consumption tax in the current year. This number will be input on the corresponding line item (such as Line 59 "Other Taxes") on the 1040.[112]

The bank (or third-party administrator) and the mortgage company will be required to file a Form "1099-HE."[113] This form will mimic the current 1099-SA for reporting distributions from an HSA, Archer MSA, or Medicare Advantage MSA. This form would allow the IRS to verify the accuracy of the taxpayer's reported contributions and distributions to their HESA accounts.[114] Therefore, if individuals withdraw

110. As discussed earlier, this is the cash remaining after the borrower pays down her first mortgage and any fees associated with the refinancing.

111. *See* Exhibit 2, *infra* pp 36–37.

112. On the Form 8899, the borrower reports the calculated values from line 16 and 17(a) on the 1040.

113. The 1099-HE is not a current IRS form. The 1099-HE is used for illustrative purposes and simply suggests a designation for the 1099 associated with the HESA account. "HE" is used to indicate that the 1099 is for "Home Equity."

114. *See* Exhibit 3, *infra* p. 38.

unsubstantiated funds from the account, these withdrawals will be reported by the account administrator via the 1099-HE as an unsubstantiated withdrawal and the individual will be subject to consumption tax on that amount.

Lastly, the mortgage company would have a duty to inform a borrower of the potential tax implications before taking a cash-out refinancing or HELOC.[115] This duty would include oral notification and provide a written description of any potential tax liability the borrower may incur. This written disclosure would be a uniform federal document modeled after the instructions that would accompany the tax addendum described above. Essentially, this form would detail the potential tax consequences of refinancing and advise the borrower to seek further assistance from a tax professional. This form would be signed by the borrower and filed along with the deed of trust.

VI. HYPOTHETICAL CALCULATIONS

This section illustrates this proposal via hypothetical transactions. To simplify these illustrations, year 1 will represent the year the borrower refinances and withdraws cash from a HELOC. Year 2 will represent the span of years that the borrower repays the loan. Moreover, these examples give the total amount of permitted deductions. If not indicated in the examples, consumption tax is limited to the amount of the unqualified withdrawals multiplied by the borrower's marginal tax rate in the year of withdrawal.

115. Professor Lauren Willis noted that placing a duty on brokers or originating lenders is a difficult task because the ease in which these entities are able to exit the market and set up shop under another identity. There are also significant complications in enforcing these duties. *See* Willis, *supra* note 20, at 820. Imposing a duty on the broker or originator must be explored in more depth in a subsequent proposal. However, for the sake of this proposal, a failure to disclose would have to subject the lender to harsh penalties, e.g., voiding the deed of trust. Another remedy could be to allow a taxpayer to assert a failure to disclose as a defense in an IRS delinquency action. In this action, a borrower could have the right to join the lender as a third-party defendant. If the borrower proves that the lender failed to disclose the tax implications of refinancing, the lender would be liable for the delinquent taxes.

A. Current Method

Hypothetical 1: *A Cash Out Refinance Under Our Current Income Tax System*		
Year 1	**Borrows**: $100,000 in cash out refinancing **Marginal Tax Rate**: 30% **Tax Liability for Loan**: $0 in Year 1	Assume the borrower refinances and after paying down her acquisition mortgage, she has $100,000 equity-derived free cash.
Year 2	Borrower pays down the $100,000 principal plus interest.	Interest deductible pursuant to section 163(h) of the Code. Principal would not be deductible.
Comment	Under the current method the borrower is not taxed on the loan proceeds and would not receive a deduction upon repayment. Contrary to the proposed system, there is no tax realization event. She would receive a current-year itemized deduction if she incurs a deductible interest expense. Under our current system, the borrower is indifferent as to how she utilizes her loan proceeds and there is no added tax incentive to repay the loan.	

B. Proposed Method

Hypothetical 2: *A Cash Out Refinance Without Qualified Expenditures*		
Year 1	**Borrows**: $100,000 **Marginal Tax Rate**: 30% **Presumptive Tax Liability**: $30,000	Assume the borrower refinances and after paying down her acquisition mortgage, she has $100,000 equity-derived free cash. The $100,000 is subject to consumption tax of $30,000. Interest is deductible pursuant to section 163(h) of the Code.
Year 2	Borrower pays down the $100,000 principal plus interest.	Interest deductible pursuant to section 163(h) of the Code. The borrower recaptures the $30,000 of consumption tax paid in Year 1 reducing her tax liability in Year 2.
Comment	Most likely, the borrower will only pay back a certain portion of the loan each year. The amount repaid will determine the borrower’s yearly recapture. Therefore, if the borrower pays down $10,000 per year in principal, she will receive a recapture of $3,000 per year for 10 years. This consumption-tax recapture is a tax credit which reduces the borrower’s tax liability during the repayment period. Under this proposal, the borrower has an incentive to avoid extracting equity from her home. Also, a borrower has an incentive to spend home-equity proceeds more carefully (which will be demonstrated in the examples presented below). This also creates an incentive to preserve home equity. Furthermore, if the borrower recognizes tax liability in year 1, there is an incentive to repay the loan to benefit from future recapture of the consumption tax.	

<table>
<tr><td colspan="3">Hypothetical 3: A Cash Out Refinance When All Loan Proceeds Are Spent on Qualified Medical Expenditures</td></tr>
<tr><td>Year 1</td><td>Borrows: $100,000
Marginal Tax Rate: 30%
Presumed Tax Liability: $30,000 in Year 1
Spends: $100,000 on Emergency Surgery

AGI of Borrower: $100,000</td><td>Again, assume the borrower refinances and after paying acquisition mortgage, she has $100,000 equity-derived free cash.

This time she spends the funds on a qualified medical expenditure. The consumption tax liability is reduced to $0 in Year 1 because the full amount was spent on a qualified expenditure.
Permitted itemized deduction is the medical expenditures amount exceeding 7.5% of the taxpayer's AGI.</td></tr>
<tr><td>Year 2</td><td>Borrower pays down the $100,000 loan.</td><td>Since no consumption tax was paid, no recapture is available.</td></tr>
<tr><td>Comment</td><td colspan="2">Notice the borrower receives the same deduction she would have received under an income tax. Since the borrower spent the home equity-derived cash on a qualified expenditure, she does not recognize any tax in year 1.</td></tr>
</table>

<table>
<tr><td colspan="3">Hypothetical 4: A Cash Out Refinance With Half Spent on Qualified Medical Expenditures</td></tr>
<tr><td>Year 1</td><td>Borrows $100,000
Marginal Tax Rate: 30%
Presumed Tax Liability: $30,000 in Year 1

Spends $50,000 on Emergency Surgery and $50,000 on a BMW 545i

AGI of Borrower: $100,000</td><td>Again, assume the borrower refinances and after paying down her acquisition mortgage, she has $100,000 equity-derived free cash.

This time she spends half of the funds on qualified medical expenditures and half of the funds on unqualified expenditures.

Consumption Tax Liability in Year 1: $15,000 ($50,000 x 30%) because ½ of loan proceeds on non-qualified expenditure. The itemized deduction is limited to the medical expenditures that exceed 7.5% of the taxpayer's AGI.</td></tr>
<tr><td>Year 2</td><td>Borrower pays down the $100,000 loan.</td><td>The borrower recaptures the full $15,000 consumption tax paid in year 1. Consumption tax theory provides the recapture upon repayment of the loan.</td></tr>
<tr><td>Comment</td><td colspan="2">The borrower would be deterred from buying the car in year 1 because she would have to incur $15,000 of consumption tax.</td></tr>
</table>

VII. CONCERNS AND RESPONSES

Significant overhauls in the tax code may require significant time and careful planning. This proposal requires numerous modifications to the current tax code and may be a challenging legislative feat. However, this proposal taps in to current tax law to maximize legislative feasibility.

Administration may pose a significant challenge. While this proposal uses the HSA and FSA models as a basis, the types of expenditures involved with free cash from home equity draws will include a wider variety of goods and services. This is an obstacle that would require a steep learning curve for administrators and the IRS. However, relying on the current Code's recognition of various itemized deductions as the basis of "qualified expenditures," provides a degree of certainty. A borrower, attorney, or administrator will rely on currently published cases and rulings when determining what constitutes a "qualified expenditure." For example, §213 of the Code provides a deduction for qualified medical expenditures. There is a plethora of case law interpreting what constitutes qualified deductions under this section of the Code.[116]

Lastly, the proposed system would revolutionize the current tax system relating to home equity debt. Many individuals will oppose this legislation as a highly restrictive measure. During tough economic times, many families have relied on home equity as a means of sustenance. While these are valid concerns, this proposal seeks to prevent another massive economic shock due to unchecked borrowing and lending. Moreover, home equity is volatile as it is based on capricious economic conditions. Borrowing against home equity is borrowing against unrealized gains in one's home value. This speculative practice is dangerous because it leads to increased defaults as individuals are unable to satisfy loan debts. Also, borrowers exhaust any potential for long-run economic gains by prematurely withdrawing these gains. This plan may provide incentives for Americans to increase savings. There is a significant need for legislative attention in this field, and this proposal offers a step in the right direction.

116. *See, e.g.*, Mattes v. Comm'r, 77 T.C. 650 (1981) (holding that cosmetic hair transplants constituted a treatment that was medical in nature and therefore deductible); *see also* Altman v. Comm'r, 53 T.C. 487 (1969) (denying a taxpayer who suffered from pulmonary emphysema a deduction for expenses for a golf game even though his physicians recommended he play golf).

VIII. CONCLUSION

Many Americans have recently turned to their homes to extract cash for personal consumption and to pay off their credit-card debt. As a result, many hard-working Americans lost their safest investment vehicle and the comfort of a roof over their heads. Further, mortgage lenders suffered substantial economic losses. For some, borrowing was necessary to save a family member's life or to send a child to college. However, studies show that a significant portion of the funds that individuals received during the surge of home-equity draws in the United States were used for personal consumption and credit-card debt satisfaction.

This article has outlined a proposal that offers a framework to curb individuals' propensity to extract equity from their homes for socially disfavored reasons. Implementing this change to the Code's treatment of home-equity debt has the potential of deterring the practice of extracting home equity to finance consumption spending. This deterrence is rooted in consumption tax policy which creates a tax-timing disincentive to extract home equity. However, the flexibility in this policy allows individuals to escape costly tax liability if the extracted funds are used on "qualified expenditures." Qualified expenditures are anchored in line-item deductions contained in the Code. Moreover, this policy creates an incentive for individuals to repay their mortgage debt. Any deductions allotted would offset ordinary income on a pro-rata basis over the life of loan repayment.

Borrowers could set up HESAs to deposit the funds received from their HELOC or cash-out refinancing and postpone taxation until the funds are withdrawn. As discussed in Part V, HESAs borrow their structure from a hybrid of a Health Savings Account and Flexible Savings Account. HESAs would use FSA substantiation methods to account for the use of the loan proceeds and provide a temporary tax safe-harbor for any unused loan proceeds.

Overall, this proposal focuses on minimizing loan defaults by creating a disincentive for borrowers to withdraw equity from their homes. While significant changes must be implemented throughout the mortgage market, this article offers one approach to prevent excessive extraction of home equity. By implementing careful and well-planned reform, we may be able to circumvent another debacle in America's mortgage markets.

EXHIBITS

EXHIBIT #1

SECTION 125 FLEXIBLE BENEFIT PLAN
EXPENSE REIMBURSEMENT VOUCHER

Name of Employer:		Daytime Phone (with area code):
Name of Employee (Last, First, M.I.):		Social Security #:
Mailing Address (where reimbursement is to be sent):	City & State:	Zip Code:
Is this a New Address? Yes ☐ No ☐		
*E-mail Address (please print clearly):		

*** You will receive notification by e-mail when your claim is received and another when a payment is sent. You will also receive e-mail notification of direct deposits. Please be sure your e-mail address is legible.***

Date of Service	Description of Expense	Family Member for Whom Expense Was Incurred	Amount of Expense: Medical Expense	Dependent Day Care
TOTAL			0	0

UNREIMBURSED MEDICAL (URM) EXPENSE GUIDELINES: With the expense voucher, you will need to submit a professional bill or receipt that includes the following: 1) Service provider's name; 2) Type of service rendered; 3) Charge for service; and 4) Original date of service. Note: the date of service, NOT the date of payment, must fall within the dates of the Section 125 plan year (or grace period, if applicable) for which you are enrolled. When submitting a claim for orthodontia, you must provide a copy of the service contract with your first reimbursement request. Only pre-paid expenses for orthodontia treatments can be reimbursed in advance. Receipts for all services should include a detailed description of the service. Acceptable documentation of an expense includes an insurance company's explanation of benefits or a pharmacy statement with an Rx number and name of prescription. Unacceptable documentation includes cancelled checks, credit card receipts or a statement or bill that shows a balance forward, previous balance or payment due.

DEPENDENT DAY CARE (DDC) EXPENSE GUIDELINES: You must submit a completed Dependent Day Care Acknowledgment Form with this expense voucher for reimbursement.

*****INCOMPLETE VOUCHER OR ACKNOWLEDGMENT FORMS MAY DELAY PROCESSING OR RESULT IN A DENIED CLAIM*****

I authorize the above expense(s) to be reimbursed from my medical expense and/or dependent day care reimbursement account(s), whichever applies. To the best of my knowledge, my statements on this form are true and complete. I certify all of the following: Either I, my Spouse, or my Dependent has received the services described above on the dates indicated and the expenses qualify as valid medical care expenses under Code Section 213(d) . If I am a participant of a Health Savings Account and am also covered under a Limited Purpose medical expense account, the above expenses qualify as being services that are eligible under the account. These expenses have not previously been reimbursed under the medical expense or dependent care reimbursement account or any other health plan and I will not seek reimbursement for them under my medical insurance or any other health plan. I understand that expenses for cosmetic purposes, toiletries or for general good health do not constitute an eligible expense. I understand that expenses reimbursed may not be used to claim any federal income tax deductions or credit. I also understand that I may be asked to provide further details about some expenses, such as a statement from a medical practitioner that the expense is to treat a specific medical condition or a more detailed certification from me.

________________ Date Signed ________________________ Signature of Employee

Mailing Address: American Fidelity Assurance, Flex Account Administration, P. O. Box 25510, Oklahoma City, OK 73125

Fax Number: (800) 543-3539. American Fidelity will not be responsible for faxes not received. **Average processing time is 5 to 7 working days from receipt of a completed voucher. Processing times may vary throughout the year.** Additional Forms and Account Information are available on our website at: **www.afadvantage.com®**

FlexConnection® Interactive Phone Response Number: (800) 325-0654

VOUCHER AFES 03/08

EXHIBIT #2

Version A, Cycle 4

Form **8889**

Department of the Treasury
Internal Revenue Service

Health Savings Accounts (HSAs)

► **Attach to Form 1040 or Form 1040NR.** ► **See separate instructions.**

OMB No. 1545-0074
2009
Attachment
Sequence No. **53**

Name(s) shown on Form 1040 or Form 1040NR

Social security number of HSA beneficiary. If both spouses have HSAs, see page 3 of the instructions ►

Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

Part I **HSA Contributions and Deduction.** See page 3 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse.

1 Check the box to indicate your coverage under a high-deductible health plan (HDHP) during 2009 (see page 4 of the instructions) ► ☐ Self-only ☐ Family

2 HSA contributions you made for 2009 (or those made on your behalf), including those made from January 1, 2010, through April 15, 2010, that were for 2009. **Do not** include employer contributions, contributions through a cafeteria plan, or rollovers (see page 4 of the instructions) **2**

3 If you were under age 55 at the end of 2009, and on the first day of **every** month during 2009, you were, or were considered, an eligible individual with the **same** coverage, enter $3,000 ($5,950 for family coverage). All others, see page 4 of the instructions for the amount to enter **3**

4 Enter the amount you and your employer contributed to your Archer MSAs for 2009 from Form 8853, lines 3 and 4. If you or your spouse had family coverage under an HDHP at any time during 2009, also include any amount contributed to your spouse's Archer MSAs **4**

5 Subtract line 4 from line 3. If zero or less, enter -0- **5**

6 Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2009, see the instructions on page 4 for the amount to enter **6**

7 If you were age 55 or older at the end of 2009, married, and you or your spouse had family coverage under an HDHP at any time during 2009, enter your additional contribution amount (see page 5 of the instructions) **7**

8 Add lines 6 and 7 **8**

9 Employer contributions made to your HSAs for 2009 **9**

10 Qualified HSA funding distributions **10**

11 Add lines 9 and 10 **11**

12 Subtract line 11 from line 8. If zero or less, enter -0- **12**

13 **HSA deduction.** Enter the **smaller** of line 2 or line 12 here and on Form 1040, line 25, or Form 1040NR, line 25 **13**

Caution: *If line 2 is more than line 13, you may have to pay an additional tax (see page 5 of the instructions).*

Part II **HSA Distributions.** If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part II for each spouse.

14a Total distributions you received in 2009 from all HSAs (see page 6 of the instructions) **14a**

b Distributions included on line 14a that you rolled over to another HSA. Also include any excess contributions (and the earnings on those excess contributions) included on line 14a that were withdrawn by the due date of your return (see page 6 of the instructions) **14b**

c Subtract line 14b from line 14a **14c**

15 Unreimbursed qualified medical expenses (see page 6 of the instructions) **15**

16 **Taxable HSA distributions.** Subtract line 15 from line 14c. If zero or less, enter -0-. Also, include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. On the dotted line next to line 21, enter "HSA" and the amount **16**

17a If any of the distributions included on line 16 meet any of the **Exceptions to the Additional 10% Tax** (see page 6 of the instructions), check here ► ☐

b **Additional 10% tax** (see page 6 of the instructions). Enter 10% (.10) of the distributions included on line 16 that are subject to the additional 10% tax. Also include this amount in the total on Form 1040, line 60, or Form 1040NR, line 57. On the dotted line next to Form 1040, line 60, or Form 1040NR, line 57, enter "HSA" and the amount **17b**

For Paperwork Reduction Act Notice, see page 5 of the instructions. Cat. No. 37621P Form **8889** (2009)

Form 8889 (2009) Page **2**

Part III **Income and Additional Tax for Failure To Maintain HDHP Coverage.** See page 6 of the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part III for each spouse.

18 Qualified HSA distribution **18**

19 Last-month rule **19**

20 Qualified HSA funding distribution **20**

21 **Total income.** Add lines 18, 19, and 20. Include this amount on Form 1040, line 21, or Form 1040NR, line 21. On the dotted line next to Form 1040, line 21, or Form 1040NR, line 21, enter "HSA" and the amount **21**

22 **Additional tax.** Multiply line 21 by 10% (.10). Include this amount in the total on Form 1040, line 60, or Form 1040NR, line 57. On the dotted line next to Form 1040, line 60, or Form 1040NR, line 57, enter "HDHP" and the amount **22**

Form **8889** (2009)

EXHIBIT #3

☐ VOID ☐ CORRECTED

TRUSTEE'S/PAYER'S name, street address, city, state, and ZIP code

OMB No. 1545-1517

2009

Form 1099-SA

Distributions From an HSA, Archer MSA, or Medicare Advantage MSA

PAYER'S federal identification number	RECIPIENT'S identification number	1 Gross distribution	2 Earnings on excess cont.
		$	$

RECIPIENT'S name

3 Distribution code

4 FMV on date of death

$

Street address (including apt. no.)

City, state, and ZIP code

5 HSA ☐ Archer MSA ☐ MA MSA ☐

Account number (see instructions)

Copy C For Payer

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Form **1099-SA** Department of the Treasury - Internal Revenue Service