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PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF HOUSEHOLD DEBT

A REPORT TO THE
JOINT COMMITTEE ON TAXATION

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION AND SUMMARY

Introduction

This document[1] has been prepared by the staff of the Joint Committee on Taxation in response to the request of the Chairman and Vice Chairman of the Joint Committee on Taxation for a report of Federal income tax rules relating to the use of leverage by households and businesses in the United States.[2]

There has been concern about the level of debt in the U.S. economy. Below is a table illustrating corporate debt, household debt, and Federal debt as a percentage of gross national product (GNP), 1987-2010. This document relates to household debt, the data shown in column two of Table 1, below.

Table 1.−Corporate Debt, Household Debt, and Federal Debt, as a Percentage of Gross National Product (GNP), 1987-2010

Year	Corporate Debt[1] as a Percentage of GNP	Household Debt[2] as a Percentage of GNP	Federal Debt[3] as a Percentage of GNP
1987	42.8	57.9	41.0
1990	43.6	61.4	42.8
1995	39.5	65.0	48.9
2000	46.4	69.9	33.9
2005	43.0	92.4	36.9
2010	48.3	90.2	63.2

(1) Corporate debt of nonfinancial C corporations and S corporations excluding farms.

(2) Household debt includes debt of personal trusts, nonprofit organizations, partnerships and sole proprietorships.

(3) Federal debt excludes Federal debt held by Federal agency trust funds.

Sources: Debt levels from The Board of Governors of the Federal Reserve System *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 2011* Table D.3. GNP levels from the Federal Reserve Bank of St. Louis.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Household Debt* (JCX-40-11), July 11, 2011. This document can be found on our website at www.jct.gov.

[2] The request was made at the 112th Congress Organizational Meeting of the Joint Committee on Taxation on March 15, 2011.

The first part of this document provides economic data with respect to household debt. The second part provides a description of the major present-law Federal income tax rules governing household debt. The third part provides a discussion of the economic incentives created by the major present-law Federal income tax rules governing household debt. The last part provides a comparison of the tax treatment of common types of household debt in seven other countries: Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom.

A companion document[3] relates to business debt and provides a description of present-law Federal tax rules, economic data, and a discussion of business capital structures (without taking into account Federal tax rules) as well as of the economic incentives created by the present-law Federal income tax rules governing business debt.

Summary

Trends in household debt

Household debt principally consists of home mortgage debt and consumer credit (such as automobile loans, student loans and credit card debt).[4]

While debt as a percentage of disposable personal income has fallen below recent peak levels, it remains high by historical standards. The ratio of total credit market debt outstanding in the household sector to disposable personal income is roughly 20 percent higher in 2010 than it was in 2000, 40 percent higher than in 1990, and twice that of 1960. This growth is due largely to the growth in home mortgage debt.

Federal income tax rules for household debt

The central Federal income tax issues arising in connection with these types of household borrowings are whether interest paid on debt is deductible and whether the amount of a debt that has been forgiven must be included in income.

Deductibility of interest paid

A deduction generally is allowed under the Federal income tax law for interest paid or accrued in the course of a trade or business or with respect to investment.[5] In an income tax system, interest expense can be viewed as a cost of earning taxable business income or investment income. A deduction is allowed for this cost in order to measure the taxpayer's income accurately, net of expenses of earning the income. For example, the deduction for interest expense may be considered analogous to the business deduction for the cost of wages

[3] Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011 (hereinafter "*Tax Treatment of Business Debt*"). This document can be found on our website at www.jct.gov.

[4] See tables below illustrating categories of household debt.

[5] Sec. 163.

paid to workers or the cost of repairs and maintenance in a business because each of these expenditures is a cost of earning income of the business. Similarly, the cost of margin interest incurred in making an investment in stock may be considered a cost related to the income derived from earnings on, or sale of, the stock investment.

Interest expense on most types of household debt generally is either personal interest that is not deductible for Federal income tax purposes or investment interest that is deductible, but only to the extent of investment income. The general rule that a deduction is allowed for business interest and investment interest but not allowed for personal interest is subject to a variety of exceptions and special rules under present law. For example, home mortgage interest is deductible notwithstanding the fact that it is a form of personal interest and that the imputed rental value of the individual's home is excluded from income.[6] Interest on home equity debt of up to $100,000 is deductible even if the proceeds of the debt are used for consumer purchases. Interest deduction limitations apply to debt incurred with respect to insurance and tax-exempt bonds. These and other rules related to the deductibility of interest on debt of a type typically owed by households are described below.

Cancellation of indebtedness income

Households generally recognize income if debt is forgiven or cancelled, or if there is a foreclosure or default on the debt.[7] Economically, it is as if the debtor has received the money to pay the amount of debt forgiven, so that amount is considered income. The forgiveness of certain student loans, however, is excluded from income. Cancellation of indebtedness income is excluded from income in certain other circumstances, for example if the debt discharge occurs in a Title 11 bankruptcy proceeding, or to the extent a taxpayer is insolvent.[8] If cancellation of indebtedness income is excluded in these circumstances, the taxpayer generally reduces other tax attributes (such as the basis of property) by the amount excluded.[9]

Other tax issues related to household debt

Other Federal income tax rules governing household debt relate to less common types of household debt, to households as investors or lenders rather than as borrowers, or to both

[6] When mortgage interest is a cost of producing taxable income, such as income on rental property, for example, such interest is generally deductible against the rental income received.

[7] Sec. 61(a)(12).

[8] A temporary exclusion is provided for qualified principal residence indebtedness that is discharged before January 1, 2013.

[9] Secs. 108(b) and 1017.

households and businesses, and are not addressed in this document.[10] Federal tax issues relating to business debt are addressed in a companion document.[11]

Economic incentives for households under present law

The mortgage interest deduction, by subsidizing mortgage debt, may lead households to demand houses that are larger and more expensive than they would in the absence of the deduction or to finance their purchases more heavily with debt. Supporters of the home mortgage interest deduction believe that this policy has a positive effect on the U.S. economy, encouraging homeownership and accompanying positive spillover benefits. On the other hand, some research questions whether the home mortgage interest deduction serves its intended purpose of encouraging homeownership. The distributional impact of the mortgage interest deduction indicates that the largest tax expenditures accrue to those households with the highest incomes, who may have purchased homes even in the absence of the deduction. Because money is fungible, it is also possible that these taxpayers use mortgage loans to increase consumption rather than home purchases.

Deductions for interest on home equity loans, because the use of proceeds is not restricted, may create an incentive for households to borrow for any purpose, including for consumption or investment. For example, a home equity loan can be used to pay off other debt, purchase a car, or for medical or educational expenses. In fact, some researchers find a significant negative correlation between a household's stock of second mortgage debt and its net worth, consistent with the view that households primarily use home equity loans to increase consumption.

There are three main arguments in favor of tax benefits for student loans. First, there may be positive spillover effects associated with education. For example, higher education levels are associated with increased average productivity and wages, lower crime rates, increased civic participation, and improved health. Second, there may be failures in the market for student loans that result in less borrowing than there otherwise would be. Finally, government intervention may alleviate inequalities in access to higher education between low-income and high-income students to the extent that they exist. On the other hand, critics point out that the positive spillover effects associated with education are large for elementary and secondary education, but small for post-secondary education where most of the returns are private. Furthermore, even if the spillover effects were larger, this would not necessarily imply that the government should choose policies that subsidize debt-financed higher-education over other types of policies that also alleviate under-provision.

Under the investment interest deduction limitation, tracing rules determine whether interest is associated with tax-exempt income and therefore not deductible. By contrast, some

[10] For example, section 7872 treats below-market interest rate loans between family members as loans that bear interest at a market rate accompanied by a payment from the lender to the borrower, which may be a gift subject to the gift tax.

[11] See *Tax Treatment of Business Debt*.

business taxpayers are subject to a pro rata rule for making this determination. The tracing rules applicable to households may be less effective at preventing tax arbitrage than the pro rata method applicable to businesses, resulting in more portfolio leverage than there otherwise would be.

Taxation of income from the discharge of indebtedness may affect the incentives of households to borrow. In principle, taxation of this income reduces the net benefit of filing for bankruptcy and reduces incentives to borrow. On the other hand, exceptions to the income inclusion rules reduce the cost of borrowing in certain circumstances.

I. REASONS HOUSEHOLDS INCUR DEBT

In general

Households have many reasons to incur debt. A disparity between the timing of income and desired consumption is a principal reason that households incur debt. Consumers may borrow to smooth their consumption over time rather than subject their consumption to fluctuations in their current income.[12] That is, consumers may want to buy more goods and services in a given period than their income in that period would allow. To have the funds available to purchase those goods and services, consumers may choose to save, reducing consumption now to fund consumption later in excess of future income, or they may choose to borrow to fund consumption now in excess of current income.

Borrowing to fund an increase in consumption in the current period requires a greater reduction in future consumption as the borrower repays not only the principal amount borrowed but also interest. Households that wish to increase their consumption in a particular period can only borrow if others (savers) are willing to lend by reducing their consumption in the same period below their income in that period. Interest rates represent the price borrowers are willing to pay and savers are willing to accept to achieve the intertemporal substitution.

This smoothing of consumption over time is referred to as the "life cycle" theory of savings. Suppose that an individual expects to have low earnings while young, higher earnings as his productivity rises with more experience and more education, and lower earnings as he reduces hours worked in anticipation of retirement. Rather than subject his consumption to fluctuations in his earnings, the individual may wish to smooth out these fluctuations to have either a steady level of consumption or perhaps a constantly rising level of consumption throughout his life cycle. This smoothing may be accomplished in part by saving to fund consumption during retirement and in part by borrowing to finance consumption early in his working career. Interest payments are the price the borrower is willing to pay to experience his preferred pattern of consumption.

Consumers may also wish to align the timing of income and payment for consumption over a short time horizon. For example, a worker who is paid on a monthly basis may use a charge card or credit card to make purchases between paychecks and pay the bill in full when it is due each month after receiving the paycheck for that month. Credit cards may also serve as a convenience mechanism, for example, for payment for items purchased via the internet or otherwise, or in lieu of carrying around large amounts of cash. Beyond serving as a convenient payment mechanism, credit cards may also allow individuals to maintain a level of consumption following the loss of a job or the depletion of any savings.

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[12] Milton Friedman. *A Theory of the Consumption Function*, Princeton University Press, 1957. Alberto Ando and Franco Modigliani, "The 'Life Cycle' Hypothesis of Saving: Aggregate Implications and Tests," *American Economic Review*, 53:1, March 1963, pp. 55-84.

Durable goods

Borrowing is often associated with the purchase of durable goods.[13] Examples of durable goods include motor vehicles, furniture, and appliances. These items may be too expensive for some consumers to purchase out of their current income. Consumers must then choose either to reduce current consumption to save for the purchase of the desired good in the future or to borrow the funds necessary to make the purchase now and reduce future consumption.

By their very nature, durable goods provide consumption benefits over a period of years. By borrowing, a household can purchase durable goods and align the period during which they pay for them with the useful life in which they provide consumption benefits. For example, consider the purchase of a washing machine that has a price of $1,000 and a useful life of 10 years. Alternatively, a consumer could wash clothes at the local laundromat for $208 per year ($2 per load at two loads of laundry per week). Buying the washer yields benefits of $208 per year to the consumer. If the consumer borrows the $1,000 payable over ten years at 10 percent interest, the payments are only $158.64 per year, and the timing of the payments more closely matches the timing of the benefits of the washing machine. In the absence of borrowing, the individual would be worse off.

For many consumers, their most significant borrowing finances the purchase of a home. Analogous to other durable goods, a home yields a stream of benefits over time. Borrowing allows a consumer to pay for those benefits over a time horizon that more closely matches the timing of the benefits. Even for a buyer with sufficient assets to purchase a home (or other durable goods) with cash, borrowing may make sense if the after-tax interest rate on the loan is below the after-tax rate of return the buyer could earn by investing the cash in some other asset. Even if the interest rate on the loan is above the rate of return on the alternative investment, an individual may borrow to maintain sufficient liquid assets as a precaution to fund emergencies.

Education

In addition to borrowing to smooth consumption over one's lifetime, individuals may borrow to make investments in education (human capital) to increase their future earnings and consumption possibilities.[14] An investment in education often involves both direct expenses such as tuition and the cost of forgone current earnings when individuals devote themselves to full-time study. Accordingly, individuals often need to borrow to cover living expenses as well as tuition and fees for education. Borrowing for education is analogous to borrowing for durable goods or for investment. Education may increase an individual's productivity and therefore an individual's earning potential, thus yielding a stream of benefits over an entire working career.

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[13] In economic data, durable goods are defined as those items that have an average useful life of at least three years. Bureau of Economic Analysis, U.S. Department of Commerce, NIPA Handbook: Concept and Methods of the U.S. National Income and Product Accounts, November 2010, available at http://www.bea.gov/national/pdf/NIPAhandbookch1-7.pdf.

[14] An additional year of education can increase earnings by between six and thirteen percent. David Card, "Estimating the Return to Schooling: Progress on Some Persistent Econometric Problems," *Econometrica*, 69(5): 1127-1160 (2001).

Borrowing to finance education can serve to align the payment for education with the benefits in terms of this increased earning potential.

Evaluated purely as an economic investment,[15] an individual should invest in education if the present discounted value of the expected future increase in income attributable to education exceeds the present discounted value of the individual's immediately forgone earnings (from going to school instead of working) plus the present discounted value of future payments of principal and interest on the loans (or forgone earnings on savings). An individual should finance the education with borrowing if the present discounted value of payments on the loans is less than the present discounted value of education expenses and forgone earnings on savings. Like the homebuyer discussed above, an individual with sufficient savings to fund his education and to support current desired consumption without loans might still wish to borrow if the borrowing terms are sufficiently favorable.[16]

Portfolio leverage

Another form of leverage households may undertake is portfolio leverage, that is, individuals may borrow to finance the purchase of other portfolio assets, such as stocks or bonds. Portfolio leverage may make sense if the expected after-tax rate of return exceeds the after-tax cost of borrowing. Modern portfolio theory and the capital asset pricing model suggest investors should diversify and hold portfolios that achieve the highest rate of return for a given level of risk or minimize the amount of risk for a given rate of return.[17] Portfolios that maximize return for a given level of risk or minimize risk for a given rate of return are described as efficient portfolios. Investors would hold different efficient portfolios of risky assets depending on the tradeoff between risk and return that each investor desires. However, when investors may invest in a risk-free asset, such as a short-term U.S. Treasury bill, all investors can do better in terms of the risk-return tradeoff than before the introduction of the risk-free asset.

In fact, the theory implies that any investor seeking risk should hold the same diversified market portfolio of all *risky* assets (that is, all assets other than the risk-free asset),

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[15] Education may contain elements of consumption as well as investment. See, e.g., Joint Committee on Taxation, *Overview of Present Law and Issues Relating to Tax and Savings Incentives For Education* (JCX-12-99), March 2, 1999.

[16] Various government and private loan programs exist that may subsidize an individual's borrowing costs while pursuing an education, or forgive debt if the individual pursues specified careers or has income below specified levels. Employers may also offer additional compensation in the form of student loan repayments, subsidies that may not be available for education financed without borrowing, that further reduce the cost of borrowing relative to not borrowing.

[17] Harry Markowitz, "Portfolio Selection," *Journal of Finance*, vol. 7, no. 1, March 1952, pp. 71-91. William F. Sharpe, "Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk," *Journal of Finance*, September 1964, pp. 425-442. John Litner, "The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets," *Review of Economics and Statistics*, vol. 47, no. 1, 1965, pp. 13-37. Andre F. Perold, "The Capital Asset Pricing Model," *Journal of Economic Perspectives*, vol. 18, no. 3, Summer 2004, pp. 3-24. Eugene F. Fama and Kenneth R. French, "The Capital Asset Pricing Model: Theory and Evidence," *Journal of Economic Perspectives*, vol. 18, no. 3, Summer 2004, pp. 25-46.

because the market portfolio of risky assets is an efficient portfolio that achieves the highest rate of return for the given level of risk.[18] Combinations of the risk-free asset and the market portfolio can be found that dominate any previous combination of risky assets that investors held before the introduction of the risk-free asset. That is, any prior portfolio of risky assets other than the market portfolio is no longer efficient. An investor can now hold a portfolio that achieves a higher rate of return for the given level of risk or the same level of return for a lower level of risk.

Investors who desire a different combination of risk and return than the market portfolio can achieve the desired combination either by investing some money in the risk-free asset rather than in the market portfolio or by borrowing to invest more in the market portfolio.[19] A more conservative investor willing to accept a lower rate of return with less risk effectively lends money by investing in the risk-free asset. Some extremely risk adverse investors may hold only the risk-free asset. An individual who desires more exposure to the market borrows to purchase more of the market portfolio. For example, an individual could achieve this result by investing $10,000 in one of several leveraged mutual funds or exchange traded funds that borrows an additional $10,000 at the fund level to invest $20,000 in the market portfolio, thereby magnifying market movements. Such leverage combined with holding the market portfolio of all assets allows the investor to achieve a higher rate of return for a given level of risk than would be available in the absence of a risk-free asset.

Business leverage

Households may also borrow to finance business operations. For example, they may do so as sole proprietors or when borrowing in their own name is less expensive than borrowing in the name of a business entity that they own. Borrowing can make sense in this context if the discounted present value of expected cash flows from the investment in the business is positive, that is, if the risk-adjusted expected returns from the capital investment in the business exceed the costs of the loan. Business leverage is the subject of a companion report.[20]

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[18] James Tobin, "Liquidity Preference as Behavior towards Risk," *Review of Economic Studies*, February 1958, pp. 68-85. The market portfolio may be effectively replicated by multiple different portfolios.

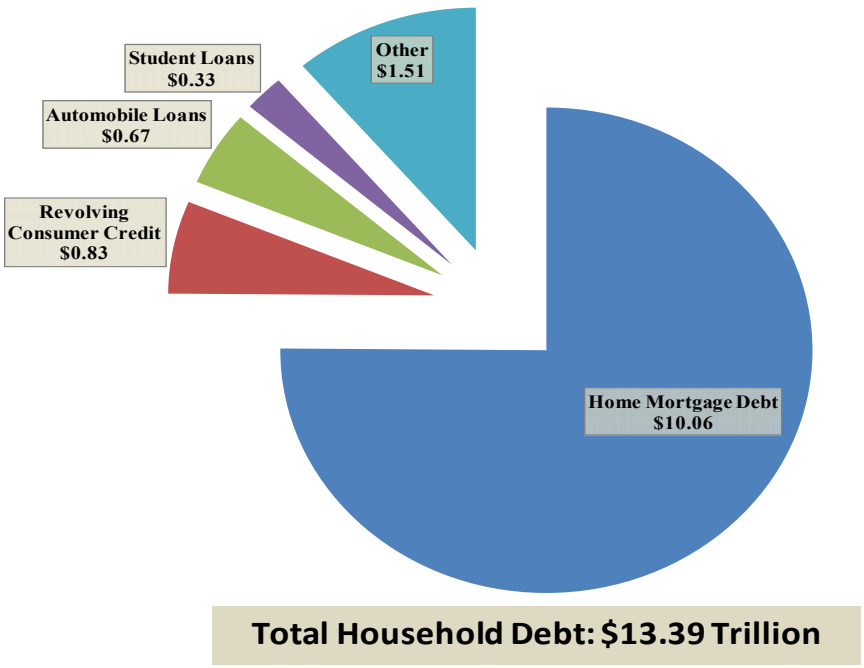
[19] The original formulation of the theory has investors borrowing at the risk-free rate so that the rate on borrowing and lending (by investing in the risk-free asset) were the same. However, for the market portfolio to be efficient, it is not necessary that investors be able to borrow at the risk-free rate. See, e.g., Fischer Black, "Capital Market Equilibrium with Restricted Borrowing," *Journal of Business*, July 1972, pp. 444-454.

[20] See *Tax Treatment of Business Debt*.

II. DATA ON HOUSEHOLD DEBT

Total credit market debt outstanding in the household sector at the end of 2010 was $13.386 trillion.[21] Of this amount, by far the largest category was home mortgage debt totaling $10.055 trillion. Total consumer credit liabilities, consisting of revolving and non-revolving credit were $2.435 trillion. Revolving credit (for example, credit cards) is credit that is extended up to pre-approved limits and may be used repeatedly, with the amount of available credit decreasing as borrowing increases and increasing as borrowed funds are repaid. Non-revolving credit (for example, auto loans) is credit that cannot be used again once repayment is made, and is usually repaid in predetermined installments. Of the consumer credit liabilities, non-revolving credit was $1.608 trillion, and revolving credit was $827 billion. Non-revolving credit liabilities consisted of, in part, automobile loans of $668 billion and student loans of $326 billion. The bulk of the revolving credit liabilities were credit card liabilities of $760 billion. For comparison, household sector financial assets in 2010 were $47.683 trillion. Figure 1 shows selected categories of household credit market debt for 2010.

Figure 1.—Outstanding Credit Market Debt, Household Sector, 2010 (Dollar Figures in Trillions)



Source: Board of Governors of the Federal Reserve System. Other category includes security credit, personal bank loans, commercial mortgages, and policy loans.

[21] The data reported in this section are from the Board of Governors of the Federal Reserve System and are available through the Board of Governors of the Federal Reserve System's data download program at http://www.federalreserve.gov/datadownload/. The reported data for the household sector includes nonprofit organizations. Calculations relating to the data, such as the ratios of the credit market debt to personal income, were made by the staff of the Joint Committee on Taxation.

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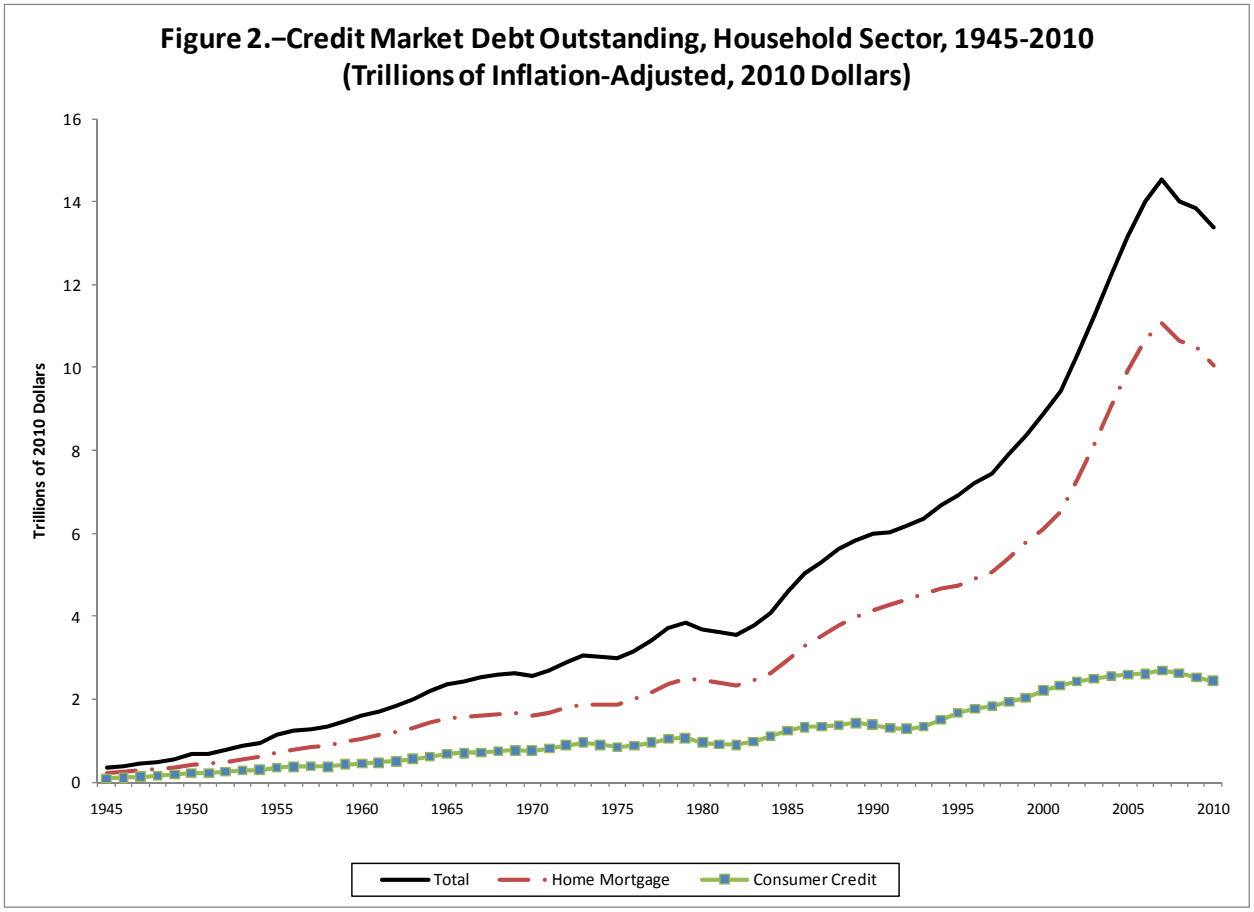
Table 2.–Credit Market Debt Outstanding, Household Sector

Millions of Current $

Year	Total	Home Mortgage	Consumer Credit		
			Total	Non-Revolving	Revolving
1945	27,958	18,596	6,774	6,774	-
1946	35,356	23,074	9,777	9,777	-
1947	44,147	28,239	13,298	13,298	-
1948	52,684	33,388	16,332	16,332	-
1949	60,514	37,717	19,374	19,374	-
1950	73,263	45,304	23,947	23,947	-
1951	81,781	51,745	25,350	25,350	-
1952	93,888	58,433	30,522	30,522	-
1953	106,085	65,950	34,614	34,614	-
1954	117,414	75,300	35,963	35,963	-
1955	137,953	87,878	42,949	42,949	-
1956	152,872	98,686	46,580	46,580	-
1957	165,306	107,317	49,217	49,217	-
1958	176,135	117,124	49,490	49,490	-
1959	198,076	130,044	57,213	57,213	-
1960	215,586	141,324	61,248	61,248	-
1961	232,277	153,976	63,435	63,435	-
1962	254,244	168,256	69,344	69,344	-
1963	281,148	185,054	77,870	77,870	-
1964	310,290	202,282	87,352	87,352	-
1965	338,732	219,397	97,489	97,489	-
1966	361,222	232,689	103,422	103,422	-
1967	384,167	245,857	108,567	108,567	-
1968	412,857	262,817	119,324	117,219	2,105
1969	442,680	278,575	129,231	125,511	3,720
1970	457,346	285,897	133,660	128,530	5,130
1971	499,394	309,404	149,243	140,714	8,529
1972	555,351	343,490	168,757	159,056	9,701
1973	624,790	382,154	192,980	181,270	11,710
1974	680,168	419,277	201,926	188,244	13,682
1975	734,128	459,028	206,996	191,976	15,020
1976	818,769	517,013	228,961	211,771	17,190
1977	946,680	602,953	264,892	225,618	39,274
1978	1,105,337	708,593	311,305	262,996	48,309
1979	1,275,273	826,675	354,616	297,679	56,937
1980	1,394,408	926,486	358,044	299,538	58,506
1981	1,504,674	998,221	377,882	313,075	64,807
1982	1,573,975	1,031,147	396,718	326,257	70,461
1983	1,728,508	1,116,227	444,878	361,076	83,802
1984	1,943,786	1,242,830	526,584	420,328	106,256
1985	2,277,702	1,449,561	610,574	479,021	131,553
1986	2,536,695	1,648,339	666,355	517,453	148,902
1987	2,754,552	1,827,851	698,640	529,001	169,639
1988	3,044,123	2,054,156	745,206	550,746	194,460
1989	3,319,091	2,259,465	809,285	586,990	222,295
1990	3,581,122	2,488,755	824,391	573,482	250,909
1991	3,769,529	2,666,968	815,581	538,492	277,089
1992	3,970,427	2,840,032	824,769	532,511	292,258
1993	4,210,459	2,998,729	886,169	561,158	325,011
1994	4,531,661	3,165,254	1,021,168	637,981	383,187
1995	4,841,248	3,318,894	1,168,160	703,213	464,947
1996	5,176,976	3,523,783	1,273,878	749,461	524,417
1997	5,478,392	3,739,252	1,344,165	788,632	555,533
1998	5,902,723	4,040,620	1,441,272	843,612	597,660
1999	6,394,789	4,416,260	1,553,622	926,155	627,467
2000	6,985,768	4,798,350	1,741,267	1,039,020	702,247
2001	7,657,593	5,305,406	1,891,827	1,156,734	735,093
2002	8,482,359	6,009,938	1,997,008	1,224,885	772,123
2003	9,508,862	6,894,521	2,102,932	1,312,544	790,388
2004	10,575,877	7,838,232	2,220,119	1,395,698	824,421
2005	11,763,740	8,877,272	2,320,555	1,463,872	856,683
2006	12,943,204	9,866,529	2,415,971	1,515,817	900,154
2007	13,805,640	10,540,176	2,555,304	1,582,069	973,235
2008	13,843,759	10,495,739	2,594,109	1,605,052	989,057
2009	13,611,187	10,342,073	2,478,855	1,584,859	893,996
2010	13,386,220	10,055,358	2,434,692	1,608,016	826,676

Source: Board of Governors of the Federal Reserve System.

Figure 2, below, shows total credit market debt outstanding, as well as the subcategories of mortgage debt and consumer debt, from 1945 to 2010, in inflation-adjusted 2010 dollars. Table 2 shows the data behind Figure 2 in current dollars, and also shows the breakdown of consumer credit into revolving and non-revolving credit.



Source: Board of Governors of the Federal Reserve System and JCT Staff calculations.

The 2010 debt figures have fallen below the peak levels achieved in the middle of the decade. Total credit market debt outstanding in the household sector peaked at $13.844 trillion in 2008. Total consumer credit liabilities also peaked in 2008 at $2.594 trillion.[22] Home mortgage debt peaked a year earlier, in 2007, at $10.540 trillion.

The growth in credit market debt by itself does not give a sense of the growth of household debt relative to the size of the economy. To give a sense of the size of household debt in relation to the economy, it is common to express household debt in relation to annual disposable personal income, as is shown in Figure 3 and Table 3 below. Total disposable personal income in 2010 was $11.375 trillion. In 2010, total credit market debt outstanding in

[22] For comparison, total household sector financial assets peaked in 2007 at $50.6 trillion.

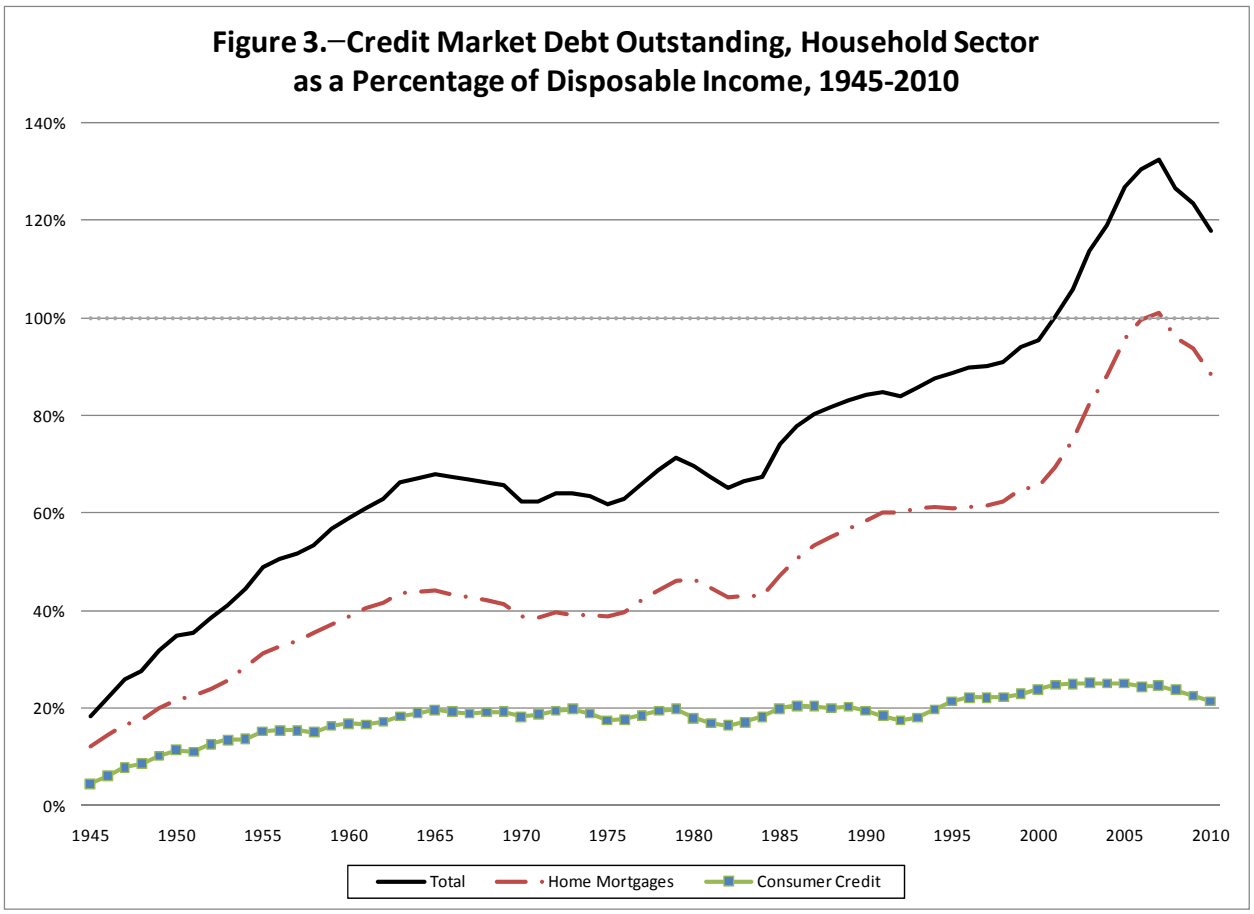
the household sector equaled 117.7 percent of disposable personal income. Home mortgage debt alone was 88.4 percent of disposable personal income, while total consumer credit was 21.4 percent. Expressed as a percentage of disposable personal income, 2007 was the peak year for total credit market debt outstanding at 132.4 percent of disposable personal income, while home mortgage debt was 101.1 percent of disposable personal income. In contrast, total consumer credit liabilities peaked in 2003 at 25.1 percent of disposable personal income.

Table 3.−Credit Market Debt Outstanding, Household Sector, as Percentage of Disposable Personal Income

Year	Total	Home Mortgages	Consumer Debt
1945	18.4%	12.2%	4.5%
1946	21.9%	14.3%	6.1%
1947	25.8%	16.5%	7.8%
1948	27.7%	17.5%	8.6%
1949	31.8%	19.8%	10.2%
1950	34.9%	21.6%	11.4%
1951	35.4%	22.4%	11.0%
1952	38.6%	24.0%	12.6%
1953	41.1%	25.5%	13.4%
1954	44.5%	28.5%	13.6%
1955	48.7%	31.0%	15.2%
1956	50.5%	32.6%	15.4%
1957	51.7%	33.6%	15.4%
1958	53.3%	35.4%	15.0%
1959	56.6%	37.1%	16.3%
1960	59.0%	38.7%	16.8%
1961	60.9%	40.4%	16.6%
1962	62.8%	41.6%	17.1%
1963	66.2%	43.5%	18.3%
1964	67.1%	43.8%	18.9%
1965	68.0%	44.1%	19.6%
1966	67.2%	43.3%	19.2%
1967	66.8%	42.8%	18.9%
1968	66.1%	42.1%	19.1%
1969	65.7%	41.3%	19.2%
1970	62.2%	38.9%	18.2%
1971	62.3%	38.6%	18.6%
1972	63.9%	39.5%	19.4%
1973	63.9%	39.1%	19.7%
1974	63.5%	39.1%	18.8%
1975	61.8%	38.7%	17.4%

Year	Total	Home Mortgages	Consumer Debt
1976	62.9%	39.7%	17.6%
1977	66.0%	42.0%	18.5%
1978	68.8%	44.1%	19.4%
1979	71.2%	46.2%	19.8%
1980	69.6%	46.3%	17.9%
1981	67.3%	44.6%	16.9%
1982	65.2%	42.7%	16.4%
1983	66.5%	42.9%	17.1%
1984	67.2%	43.0%	18.2%
1985	74.0%	47.1%	19.8%
1986	77.8%	50.6%	20.4%
1987	80.2%	53.2%	20.3%
1988	81.7%	55.1%	20.0%
1989	83.2%	56.6%	20.3%
1990	84.2%	58.5%	19.4%
1991	84.8%	60.0%	18.3%
1992	83.8%	60.0%	17.4%
1993	85.6%	60.9%	18.0%
1994	87.4%	61.1%	19.7%
1995	88.7%	60.8%	21.4%
1996	89.9%	61.2%	22.1%
1997	90.2%	61.6%	22.1%
1998	90.8%	62.2%	22.2%
1999	94.0%	64.9%	22.8%
2000	95.3%	65.5%	23.8%
2001	100.1%	69.4%	24.7%
2002	105.9%	75.0%	24.9%
2003	113.5%	82.3%	25.1%
2004	119.0%	88.2%	25.0%
2005	126.8%	95.7%	25.0%
2006	130.5%	99.5%	24.4%
2007	132.4%	101.1%	24.5%
2008	126.4%	95.8%	23.7%
2009	123.3%	93.7%	22.5%
2010	117.7%	88.4%	21.4%

Source: Board of Governors of the Federal Reserve System.



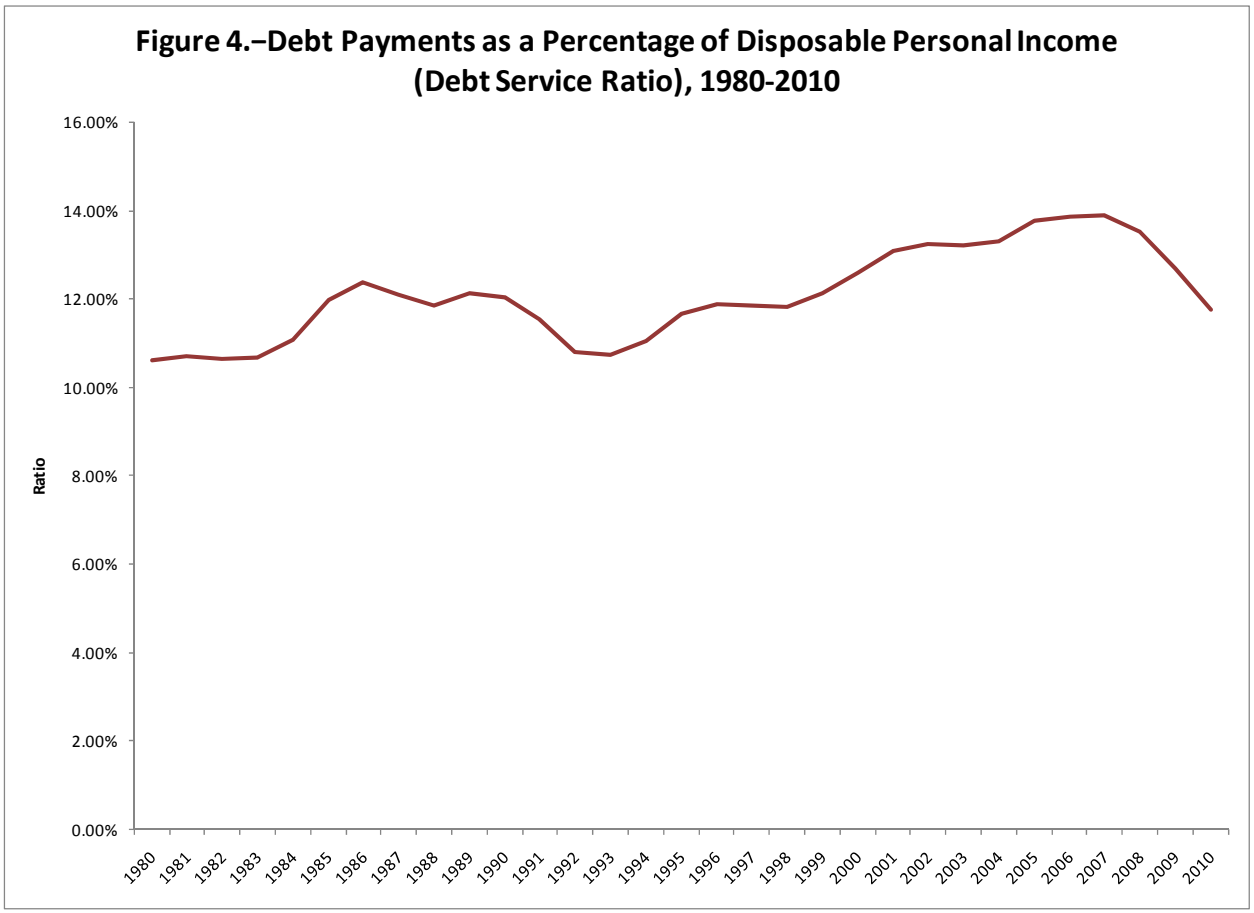
Source: Board of Governors of the Federal Reserve System.

While debt as a percentage of disposable personal income has fallen below recent peak levels, it remains high by historical standards. The ratio of total credit market debt outstanding in the household sector to disposable personal income is roughly 20 percent higher in 2010 than it was in 2000, 40 percent higher than in 1990, and twice that of 1960. This growth is due largely to the growth in home mortgage debt. Corresponding figures for home mortgage debt are roughly 40 percent higher than 2000, 50 percent higher than 1990, and 230 percent higher than 1960. Growth in total consumer debt has been more modest, and as a percent of disposable personal income is today only 90 percent of what it was in 2000. However, the ratio of total consumer debt to disposable personal income in 2010 is still approximately 10 percent higher than in 1990 and 30 percent higher than in 1960.

While credit market debt outstanding has grown considerably over the past decades, the cost of servicing such debt has grown less dramatically as a result of generally declining interest rates. The Board of Governors of the Federal Reserve System calculates a measure of the cost of debt service equaling the ratio of the estimated required debt payments to disposable personal income.[23] The debt payments considered for this estimate consist of the estimated required

[23] For revolving consumer debt, the Board of Governors of the Federal Reserve System uses an estimate of the required minimum payment on balances as the estimated required debt payment.

payments on outstanding mortgage and consumer debt. Figure 4, below, shows this debt service ratio from 1980 to 2010.



Source: Board of Governors of the Federal Reserve System. The data shown are for the fourth quarter of the relevant year.

The debt service ratio fluctuates with the aggregate amount of debt, changes in interest rates, and changes in disposable personal income. In the first half of the 1980s, the debt service ratio was generally between 10 and 11 percent. That is, approximately 10 percent of disposable personal income was required to cover the debt payments on mortgage and consumer debt. In the latter half of the 1980s and throughout the 1990s, the ratio was generally between 11 and 12 percent. The ratio rose through the 2000s from 12 percent to a peak of 13.95 percent in the third quarter of 2007. The ratio fell to 11.75 percent by the fourth quarter of 2010 as consumer and mortgage debt outstanding fell, mortgage rates declined, and aggregate disposable personal income continued to rise.[24]

[24] The Board of Governors of the Federal Reserve System also calculates a financial obligations ratio. For homeowners, the financial obligations ratio adds automobile lease payments, homeowners' insurance, and property tax payments to the debt service ratio. The financial obligations ratio follows a pattern similar to the debt service ratio, rising from 15 to 16 percent in the early 1980s to a peak, also in the third quarter of 2007 as for the debt service ratio, of 18.85 percent, and subsequently falling to 16.64 percent by the fourth quarter of 2010. The Board of

A complete picture of the finances of the household sector needs to reflect the full balance sheet of households and consider assets as well as liabilities. Table 4, below, shows the balance sheet for the household sector. The net worth of the household sector in 2010 was $57.1 billion. The peak level of household net worth was $64.2 trillion in 2007.

Table 4.−Household Sector Balance Sheet: Selected Years 1980, 1990, 2000, and 2010 ($ in billions)[1]

Item	1980	1990	2000	2010
Assets	11,000	24,219	50,063	71,063
Tangible assets	4,442	9,722	16,782	23,380
Real estate	3,414	7,605	13,448	18,466
Households[2,3]	2,943	6,800	12,201	16,451
Consumer durable goods[4]	991	2,039	3196	4,618
Financial assets	6,558	14,497	33,280	47,683
Deposits	1,534	3,325	4,376	7,934
Credit market instruments	521	1,741	2,458	4,255
Corporate equities[2]	1,010	1,961	8,147	8,240
Mutual fund shares[5]	52	512	2,704	4,717
Security credit	16	62	412	694
Life insurance reserves	221	392	819	1,278
Pension fund reserves	970	3,310	9,171	13,092
Equity in noncorporate business[6]	2,154	2,939	4,813	6,642
Liabilities	1,446	3,703	7,375	13,948
Home Mortgage[7]	926	2,489	4,798	10,055
Consumer credit	358	824	1,741	2,435
Net Worth	**9,554**	**20,516**	**42,688**	**57,114**

(1) Includes farm households, domestic hedge funds, and nonprofit organizations.
(2) At market value.
(3) All types of owner-occupied housing including farm houses and mobile homes, as well as second homes that are not rented, vacant homes for sale, and vacant land.
(4) At replacement (current) cost.
(5) Value based on the market values of equities held and the book value of other assets held by mutual funds.
(6) Net worth of noncorporate business and owners' equity in farm business and unincorporated security brokers and dealers.
(7) Includes loans made under home equity lines of credit and home equity loans secured by junior liens.

Source: Board of Governors of the Federal Reserve System.

Governors of the Federal Reserve System also calculates a financial obligation ratio for renters by including rental payments on tenant-occupied property.

Table 5, below, shows, for the same years as Table 4, the real value (in 2010 dollars) of assets, liabilities, and net worth, as well real per capita net worth and the ratio of liabilities to assets, or leverage ratio. While net worth has risen in the aggregate over this period, real per capita net worth has declined somewhat since 2000. Leverage ratios have increased over this period, especially over the past decade, as the real value of liabilities has grown faster than the real value of assets.

Table 5.−Assets, Liabilities, Net Worth, and Per Capita Net Worth, in 2010 Dollars; and Leverage Ratios

	1980	1990	2000	2010
Assets (billions of dollars)	29,108	40,406	63,394	71,063
Liabilities (billions of dollars)	3,826	6,178	9,339	13,948
Net Worth (billions of dollars)	25,282	34,227	54,055	57,114
Per Capita Net Worth (thousands)	111	137	192	185
Ratio of Liabilities to Assets	0.13	0.15	0.15	0.20

Source: Board of Governors of the Federal Reserve Board; U.S. Census Bureau, and JCT staff calculations.

These aggregate level data on household assets and liabilities may obscure differences across segments of the population. The top panel of table 6 reports the leverage ratio for households by income and by age of the head of the household.[25] The bottom panel of Table 6 reports the income thresholds associated with the percentiles used to define the income groups in the table. The overall pattern of leverage ratios is stable across time, though it exhibits substantial variation across families. Leverage ratios rise and then fall as income increases. The ratio declines uniformly with age. This age pattern is consistent with the life-cycle hypothesis of savings discussed earlier in this document.

[25] Data come from Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 95, February 2009, pp. A1-A56.

Table 6.-Leverage Ratio by Income and Age

	Survey Year			
	1998	**2001**	**2004**	**2007**
All Families	14.2	12.1	15.0	14.9
Percentile of income				
Less than 20	12.7	13.5	15.1	13.5
20–39.9	14.4	14.5	19.4	18.5
40–59.9	20.6	19.2	23.2	24.3
60–79.9	23.1	18.0	21.7	25.3
80–89.9	20.1	18.1	22.8	23.4
90–100	8.9	7.4	9.2	8.4
Age of head of family (years)				
Less than 35	36.6	33.5	46.4	44.3
35-44	25.1	22.6	26.0	28.2
45-54	15.7	13.5	17.3	16.3
55-64	9.0	7.2	9.3	10.3
65-74	4.7	4.2	5.2	6.5
75 or more	2.2	1.8	4.0	2.2

Income Thresholds (nominal dollars)				
	Survey Year			
Percentile of Income	**1998**	**2001**	**2004**	**2007**
20	17,700	19,700	20,800	20,600
40	33,600	36,100	37,200	36,500
60	54,200	60,100	58,900	59,600
80	86,900	96,200	98,100	98,200
90	119,600	139,000	142,100	140,900

Source: Board of Governors of the Federal Reserve System, Survey of Consumer Finances.

III. PRESENT LAW AND LEGISLATIVE BACKGROUND

The description below focuses on the Federal income tax rules applicable to households, which consist of individuals, apart from any business activities.[26]

A. Deductibility of Interest Expense of Households

1. Disallowance of deduction for personal interest

Present Law

Unlike business interest and investment interest, the personal interest of an individual taxpayer is not deductible. Personal interest includes all interest other than interest properly allocable to a trade or business (other than the trade or business of performing services as an employee), investment interest, certain home mortgage interest and education loan interest, and other types of interest.[27] For example, personal interest includes interest on a loan to purchase an automobile and credit card interest incurred, if such interest is not incurred or continued in connection with the conduct of a trade or business. Personal interest also includes interest on certain underpayments of individual Federal, State or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from the conduct of a trade or business.[28]

Because personal interest generally is not a cost associated with the production of income that is subject to tax, a deduction for personal interest would not accurately measure the taxpayer's income. The Federal income tax system generally does not include the economic income taxpayers receive from personal assets, even though the individual taxpayer may be considered as having received a measurable economic benefit from the personal asset.[29] Because

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[26] A sole proprietorship is a form of business entity that is disregarded as separate from its owner for Federal tax purposes. Taxpayers report income or loss from a business operated or a profession practiced as a sole proprietor on Schedule C of the taxpayer's Form 1040. The Federal income tax rules relating to business debt are discussed in *Tax Treatment of Business Debt*.

[27] Sec. 163(h)(2). This rule applies to taxpayers other than corporations. The other types of interest are: interest taken into account under section 469 in computing income or loss from a passive activity; and certain interest payable under an extension of time to pay estate tax.

[28] Temp. Treas. Reg. sec. 1.163-9T(b)(2)(i)(A). See *Allen v. U.S.*, 173 F.3d 533, 537 (4th Cir. 1999), in which the court stated, "[i]n plain English, interest on an unpaid income tax debt is never a cost of doing business, because no taxpayer may claim that he or she is in the business of not paying taxes"; *Alfaro v. Commissioner*, 349 F.3d 225 (5th Cir. 2003); *McDonnell v. U.S.*, 180 F.3d 721 (6th Cir. 1999); *Redlark v. Commissioner*, 141 F.3d 936 (9th Cir. 1998); *Kikalos v. Commissioner*, 190 F.3d 791 (7th Cir. 1998); *Miller v. U.S.*, 65 F.3d 687 (8th Cir. 1995). In the case of property tax, however, personal interest includes interest on underpayments of individual Federal, State, or local property taxes not properly allocable to a trade or business (other than the trade or business of performing services as an employee). With respect to interest on property tax, it can be ascertained whether the property subject to property tax is trade or business property or not.

[29] For example, the economic benefit of living in a home an individual owns, or of personal use of a car the individual owns, is not included in the individual's income. Nonetheless, the amount of the economic benefit the individual receives from living in his home, or using his car, can be measured: it is generally the rental value of a

imputed personal income is excluded from the income tax, interest expense associated with the excluded income is not deductible as a general rule.[30]

Legislative Background

Prior to the Tax Reform Act of 1986 ("1986 Act"),[31] no limitation was imposed on the deductibility of interest on indebtedness of households. Interest incurred to purchase or carry consumption goods was deductible. For example, households could deduct interest on auto loans and credit cards as itemized deductions.

In 1985, a total of 101.7 million returns were filed. Among the returns filed, 39.8 million claimed itemized deductions of $405 billion in aggregate. Of the returns claiming itemized deductions, 36.3 million claimed $180 billion of itemized deductions for interest paid, of which 28.1 million claimed $115 billion of mortgage interest, 26 million claimed $12.2 billion of credit card interest, and 29 million claimed $52.8 billion of other interest (including mortgage points and investment interest).[32] By 1991, when the deduction for personal interest was completely phased out, of the 114.7 million returns filed for that year, 32.5 million claimed itemized deductions of $467.7 billion. Only 27.4 million claimed a deduction for any interest paid for total interest paid deductions of $213.7 billion. Of these 27.4 million returns, 27 million claimed $201 billion of mortgage interest, just under 2 million claimed $2.2 billion of deductible mortgage points, while 1.6 million claimed $10.3 billion of investment interest.[33]

The 1986 Act phased out the deductibility of consumer interest generally, while providing specified exceptions.[34] In enacting the personal interest limitation, Congress described a principal rationale as eliminating a disincentive to saving:

> Prior to the 1986 Act, the tax law excluded or mismeasured income arising from the ownership of housing and other consumer durables. Investment in such goods allowed consumers to avoid the tax that would apply if funds were invested in

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comparable house in a comparable neighborhood, or the rental value of a comparable car. The current Federal income tax system excludes from the measurement of an individual or household's income the imputed rental value of personal assets for a variety of reasons. For example, an individual does not receive the economic benefit in cash, but in kind, so the individual may not have means to pay the tax. In addition, the administrative burden of measuring and collecting such a tax could be outweighed by the simplicity of ignoring it. For these reasons and others, the custom since imposition of the income tax has been generally to exclude from the tax base imputed income from personal assets. See Part I, above, for a discussion of how households use debt to match the timing of the consumption of benefits to the timing of payments in the purchase of durable goods.

[30] Sec. 163(h)(1).

[31] Pub. L. No. 99-514.

[32] Internal Revenue Service, *Individual Income Tax Returns 1985*, Publication 1304 (Rev. 4-88).

[33] Internal Revenue Service, *Individual Income Tax Returns 1991*, Publication 1304 (Rev. 3-94).

[34] Pub. L. No. 99-514, sec. 511.

> assets producing taxable income and to avoid the cost of renting these items, a cost which would not be deductible in computing tax liability. Thus, the tax system under pre-1986 law provided an incentive to invest in consumer durables rather than assets which produce taxable income and, therefore, an incentive to consume rather than save. Although Congress believed that it would not be advisable to subject the imputed rental income of consumer durables owned by the taxpayer to income tax, Congress nevertheless concluded that it is appropriate and practical to address situations where personal expenditures are financed by borrowing. … By phasing out the deductibility of personal interest, Congress intended to eliminate a significant disincentive to saving.[35]

2. Deduction for home mortgage interest allowed

Present Law

Qualified residence interest is not treated as personal interest and is deductible, subject to limitations.[36] Qualified residence interest means interest on either acquisition indebtedness or home equity indebtedness.

Acquisition indebtedness

Acquisition indebtedness is indebtedness incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer.

Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. Thus, for example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to $150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to substantially improve the residence). Refinanced acquisition debt continues to be treated as acquisition debt to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the financing.

The indebtedness must be secured by the qualified residence and is limited to $1 million ($500,000 for married persons filing a separate return). A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

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[35] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 263; S. Rep. No. 99-313, Report of the Senate Committee on Finance to accompany H.R. 3838, 99th Cong., 2d Sess., May 29, 1986, p. 804; H. Rep. No. 99-426, Report of the House Committee on Ways and Means on H.R. 3838, 99th Cong., 1st Sess., December 7, 1985, p. 297.

[36] Sec. 163(h)(2)(D) and (h)(3).

Home equity indebtedness

Certain home equity indebtedness may give rise to deductible qualified residence interest. Home equity indebtedness, for this purpose, means debt secured by the taxpayer's principal or second residence to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

The amount of home equity indebtedness on which interest is treated as deductible qualified residence interest may not exceed $100,000 ($50,000 for married persons filing a separate return).

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used. For example, personal expenditures may include health costs and education expenses for the taxpayer's family members or any other personal expenses such as vacations, furniture, or automobiles. A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer in a lump sum payment (e.g., a traditional mortgage), a series of payments (e.g., a reverse mortgage), or the lender may extend the borrower a line of credit up to a fixed limit over the term of the loan (e.g., a home equity line of credit).

The aggregate limitation on the total amount of a taxpayer's acquisition indebtedness and home equity indebtedness with respect to a taxpayer's principal residence and a second residence that may give rise to deductible interest is $1,100,000 ($550,000, for married persons filing a separate return).

Points

Points (prepaid interest) with respect to a home mortgage are treated differently for Federal income tax purposes depending on the circumstances in which they are paid. In general, points are capitalized and amortized over the period of the indebtedness.[37] This rule generally applies to points on a refinancing of a qualified residence of the taxpayer. An exception to this general rule, however, permits a current deduction for points on debt incurred for the initial purchase or improvement of the taxpayer's principal residence. This exception does not apply to the taxpayer's second residence. The deduction is allowable only to the extent the points would be deductible as qualified residence interest (if they were not prepaid).

Legislative Background

The deduction for home mortgage interest, like other consumer interest, generally was not limited prior to the 1986 Act. When the deduction for personal interest was phased out generally under the 1986 Act, deductibility was nevertheless retained for interest on debt on the taxpayer's principal residence and a second home. The Omnibus Budget Reconciliation Act of

[37] Sec. 461(g).

1987 ("1987 Act")[38] modified this provision to permit a deduction for interest (not restricted to borrowing for educational or medical expenses) on home equity debt of up to $100,000, and on home acquisition debt of up to $1 million.

Congress described the reason for preserving a deduction for home mortgage interest as furthering the social policy goal of promoting home ownership:

> While Congress recognized that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, Congress nevertheless determined that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. Therefore, the personal interest limit does not affect the deductibility of interest on debt secured by the taxpayer's principal residence or second residence, to the extent of the basis of the principal residence (or second residence).[39]

3. Deduction for student loan interest

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit and an income phase out.[40] Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis certain educational institutions.[41] The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings

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[38] Pub. L. No. 100-203, sec. 10101.

[39] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 263; S. Rep. No. 99-313, Report of the Senate Committee on Finance to accompany H.R. 3838, 99th Cong., 2d Sess., May 29, 1986, p. 804; H. Rep. No. 99-426, Report of the House Committee on Ways and Means on H.R. 3838, 99th Cong., 1st Sess., December 7, 1985, p. 297.

[40] Sec. 221.

[41] Specifically, these are (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

The maximum allowable deduction per year is $2,500. For 2011, the deduction is phased out ratably for taxpayers with modified adjusted gross income between $60,000 and $75,000 ($120,000 and $150,000 for married taxpayers filing a joint return). The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of $5,000.

Effective for taxable years beginning after December 31, 2012, interest is deductible only during the first 60 months of required interest payments and the phaseout ranges revert to a base level of $40,000 to $55,000 ($60,000 to $75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002.

Legislative Background

Prior to enactment of the personal interest deduction limitation in 1986, student loan interest was deductible without limitation. During the period for which the personal interest deduction limitation was phased in, 1987 through 1990, student loan interest was partially deductible under the phase-in rules.[42] From 1991 through 1997, student loan interest generally was not deductible.

In 1997, a general deduction for student loan interest was added to the Code.[43] It was effective for interest paid in taxable years beginning after December 31, 1997. Congress indicated it made the 1997 changes because it understood that many students incur substantial debt in the course of obtaining undergraduate and graduate education, and believed that permitting a deduction for interest on certain student loans would help ease the financial burden on those students.[44]

In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") temporarily increased the adjusted gross income phaseout ranges for the deduction and eliminated rules limiting deductibility of interest to the first 60 months of required interest payments.[45] Congress believed it was appropriate to modify the deduction to make it available to

[42] The amount of personal interest disallowed during the phase-in period for the personal interest deduction limitation is the applicable percentage of the amount otherwise disallowed. The applicable percentage for 1987 is 35 percent; for 1988, 60 percent; for 1989, 80 percent; for 1990, 90 percent; and for 1991 and thereafter, 100 percent. Sec. 163(h)(5). For taxable years beginning in 1987, the 1986 Act personal interest limitation rules allowed a deduction for interest on debt secured by a qualified residence of the taxpayer and incurred to pay for qualified tuition and related expenses of the taxpayer, his or her spouse, or a dependent for attendance at specified types of educational institutions. 1986 Act, Pub. L. No. 99-514. The 1987 Act (Pub. L. No. 100-203) modified this provision to permit a deduction for interest (not restricted to borrowing for educational expenses) on home equity debt of up to $100,000 (as well as on home acquisition debt of up to $1 million).

[43] Taxpayer Relief Act of 1997, Pub L. No. 105-34, sec. 202.

[44] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, p. 21.

[45] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, sec. 412.

more taxpayers.[46] In 2010, these modifications were extended when the EGTRRA sunset was extended by two years, from December 31, 2010, to December 31, 2012.[47]

4. Deductible investment interest expense limited to net investment income for individuals

Present Law

General rule

In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment (investment interest) is limited to the taxpayer's net investment income for the taxable year.[48] Disallowed investment interest is carried forward to the next taxable year.

Allowable investment interest is an itemized deduction that reduces income taxable at ordinary income rates. The adjusted net capital gain[49] of an individual, which is subject to tax at a maximum rate of 15 percent for taxable years beginning before January 1, 2013, is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation.[50]

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[46] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 107th Congress* (JCS-1-03), January 24, 2003, p. 47.

[47] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 101.

[48] Sec. 163(d).

[49] Under section 1(h), the adjusted net capital gain of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain, plus qualified dividend income. The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year. "Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies may not exceed the net section 1231 gain for the year.

[50] Sec. 1(h)(2).

Net investment income

In general

Net investment income is investment income net of investment expenses.[51] Investment income generally consists of gross income from property held for investment,[52] and investment expense includes all deductions directly connected with the production of investment income (e.g., deductions for investment management fees) other than deductions for interest.[53] Investment income includes only so much of the taxpayer's net capital gain and qualified dividend income as the taxpayer elects to take into account as investment income.[54]

Interaction with two-percent floor on miscellaneous itemized deductions

The two-percent floor on miscellaneous itemized deductions allows taxpayers to deduct investment expenses connected with investment income only to the extent such deductions exceed two percent of the taxpayer's adjusted gross income ("AGI").[55] Miscellaneous itemized deductions[56] that are not investment expenses are disallowed first before any investment expenses are disallowed.[57]

For example, if an individual has $10,000 of gross investment income, $800 of investment expenses, and $700 of employee business expenses, the individual would have $1,500 of miscellaneous itemized deductions (i.e., $800 plus $700). Assume the taxpayer's AGI is $50,000. The taxpayer's two-percent floor is therefore $1,000, and the taxpayer is allowed only $500 of miscellaneous itemized deductions (i.e., $1,500 of deductions minus the $1,000 floor). Because expenses that are not investment expenses are disallowed first, all $700 of the employee business expense is disallowed, and only $300 of the $800 investment expenses is disallowed. The remaining $500 of the investment expenses is deductible. Thus, the taxpayer's

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[51] Sec. 163(d)(4)(A).

[52] Sec. 163(d)(4)(B).

[53] Sec. 163(d)(4)(C).

[54] Sec. 163(d)(4)(B)(iii). A taxpayer may claim a deduction for investment interest expense by filing IRS Form 4952, which enables the taxpayer to elect how much qualified dividends and net capital gain to include in investment income.

[55] Sec. 67(a).

[56] The miscellaneous itemized deductions are defined in section 67(b) to include itemized deductions of individuals other than certain specific itemized deductions. Thus, miscellaneous itemized deductions generally include, for example, investment management fees and certain employee business expenses, but specifically do not include, for example, interest, taxes, casualty and theft losses, charitable contributions, medical expenses, or other listed itemized deductions.

[57] H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-154, Sept. 18, 1986 (Conf. Rep.) ("In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.").

net investment income is $9,500 (i.e., $10,000 of gross investment income minus $500 of investment expenses).

Tracing interest on debt

In applying interest deduction limitations, either a tracing approach or a pro rata approach determines whether debt is associated with untaxed income. The tracing approach applies generally to interest deduction limitations applicable to taxpayers who are individuals.[58]

For purposes of the investment interest limitation, under the tracing approach, debt is allocated to expenditures in accordance with the use of the debt proceeds, and interest on the debt is allocated in the same manner.[59] Thus, generally, the disallowance of a deduction for investment interest depends on the individual's use of the proceeds of the debt. For example, if an individual pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase a car for personal use, interest expense on the debt is allocated to the personal expenditure to purchase the car and is treated as nondeductible personal interest rather than investment interest.

Legislative Background

Prior to the 1986 Act,[60] in the case of a noncorporate taxpayer, deductions for interest on indebtedness incurred or continued to purchase or carry property held for investment were generally limited to $10,000 per year, plus the taxpayer's net investment income.

Investment income under pre-1986 law was income from interest, dividends, rents, royalties, short-term capital gains arising from the disposition of investment assets, and any amount of gain treated as ordinary income pursuant to the depreciation recapture provisions, but only if the income was not derived from the conduct of a trade or business.

In determining net investment income under pre-1986 law, the investment expenses taken into account were trade or business expenses, real and personal property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income, and depletion, to the extent these expenses were directly connected with the production of investment income. For purposes of this determination, depreciation with respect to any property was taken into account on a straight-line basis over the useful life of the property, and depletion was taken into account on a cost basis.

The investment interest limitation was modified in the 1986 Act to eliminate the $10,000 offset against noninvestment income, and to coordinate the investment interest limitation with

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[58] By contrast, the pro rata approach applicable to certain financial institutions and certain other businesses disallows interest deductions based on the percentage of a taxpayer's assets comprised of tax-exempt obligations.

[59] Temp. Treas. Reg. sec. 1.163-8T(c).

[60] Pub. L. No. 99-514.

other limitations on deductions of individuals enacted in 1986, the personal interest limitation and the passive activity loss limitation rules.[61]

In modifying the investment interest deduction limitation in 1986, Congress expressed concern about income mismeasurement that resulted under the rules of prior law:

> Under prior law, leveraged investment property was subject to an interest limitation, for the purpose of preventing taxpayers from sheltering or reducing tax on other, noninvestment income by means of the unrelated interest deduction. Congress concluded that the interest limitation should be strengthened so as to reduce the mismeasurement of income which can result from deduction of investment interest expense in excess of current investment income, and from deduction of current investment expenses with respect to investment property on which appreciation has not been recognized.[62]

Congress noted at that time that under pre-1986 law, no part of long-term capital gains were included in net investment income for purposes of determining the investment interest deduction limitation. This was to prevent taxpayers from taking a deduction at higher rates than the rate at which the taxpayer's income was subject to tax. Congress concluded in 1986 that the continuation of this rule was inappropriate, because long-term capital gains were generally taxed at the same tax rate as ordinary income when the 1986 Act provisions were fully phased in. When those long-term capital gains and ordinary income tax rates were equalized in the 1986 Act, long-term capital gains were included in investment income for purposes of computing the investment interest limitation.

In 1990,[63] however, Congress raised ordinary income tax rates without increasing long-term capital gains rates, thereby reintroducing a rate differential. In 1993, a provision was added to the law excluding from long-term capital gains those amounts taken into account in determining investment income for purposes of the investment interest limitation, thus modifying the treatment under the 1986 Act when the rates were the same.[64]

In summary, the principal difference between the pre-1986 and the present-law investment interest limitation is that present law does not provide for the $10,000 offset of

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[61] Secs. 163(h)(1) and 469. The passive activity loss limitation was enacted to "curb the expansion of tax sheltering." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 210.

[62] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 263. See also Report of the Senate Committee on Finance to accompany H.R. 3838, S. Rep. 99-313, May 29, 1986, p. 803; compare Report of the House Committee on Ways and Means on H.R. 3838, H.R. Rep. 99-426, pp. 297-298.

[63] Omnibus Reconciliation Act of 1990, Pub. L. No. 101-508.

[64] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66. A similar exclusion for qualified dividend income (which is taxed at a 15-percent rate for taxable years beginning before January 1, 2013) was added in 2003, Pub. L. No. 108-27, sec. 302(b).

investment interest against other income. In addition, the present-law investment interest limitation is coordinated with other rules restricting the deductions of individual taxpayers that were enacted in 1986, specifically the personal interest limitation and the passive activity loss limitation, and investment expenses are determined after the application of the two-percent floor on miscellaneous itemized deductions.

5. Debt with respect to certain insurance products

Present Law

In general

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract[65] ("inside buildup").[66] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[67]

Present law imposes limitations on the deductibility of interest on debt with respect to life insurance contracts.[68] These limitations apply to all taxpayers, including individuals (households). An additional pro rata interest deduction limitation applies to taxpayers other than natural persons.[69] These limitations address the potential for arbitrage that could arise in the event that deductible interest expense relates to amounts excludable as inside buildup or as death benefits under a life insurance contract.

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[65] By contrast to the treatment of life insurance contracts, if a deferred annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract for purposes of determining income taxes, other than those imposed on insurance companies (sec. 72(u)).

[66] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, but only to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than a policy that would provide paid-up future benefits after the payment of seven level annual premiums (sec. 7702A).

[67] Sec. 101(a).

[68] Limitations on the deductibility of premiums also apply if the taxpayer is directly or indirectly a beneficiary under the policy or contract. Sec. 264(a)(1).

[69] If a business other than a sole proprietorship is directly or indirectly the beneficiary under a policy, such policy is treated as held by the business and not by a natural person. Sec. 264(f)(5). This rule is discussed further in *Tax Treatment of Business Debt*.

Interest paid or accrued with respect to the contract in the case of individual taxpayers

Single premium contracts

No deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract (the "single premium" deduction limitation).[70] A contract is treated as a single premium contract if substantially all the premiums on the contract are paid within a period of four years from the date on which the contract is purchased or if an amount for payment of a substantial number of future premiums is deposited with the insurer.[71]

Four-out-of-seven rule

In addition, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[72] The deduction denial does not apply if no part of four of the annual premiums due during the initial seven-year period is paid by means of such debt.[73] A tracing approach applies to determine whether premiums are paid by means of such debt.[74]

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[70] Sec. 264(a)(2).

[71] Sec. 264(c).

[72] Sec. 264(a)(3).

[73] Sec. 264(d). Further exceptions are provided: (1) if the total amounts to which the provision would apply in taxable year does not exceed $100; (2) if the amounts are paid or accrued because of an unforeseen financial hardship; or (3) if the indebtedness is incurred in connection with the taxpayers trade or business. However, the section 264(d) exceptions are inapplicable in situations in which the general interest deduction disallowance rule of section 264(a)(4) applies. The general rule of section 264(a)(4) was enacted in its current form in 1996, subsequent to the rules of section 264(a)(3) and (d) which were enacted in 1964.

[74] For example, if an individual borrows amounts under a life insurance contract that he or she owns, the debt is considered to be incurred with respect to the contract. Treasury regulations explain "direct or indirect borrowing" under the 1964 rule limiting interest pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise). These regulations provide this example: "[t]hus, for example, if a taxpayer borrows $100,000 from a bank and uses the funds to purchase securities, later borrows $100,000 from a second bank and uses the funds to repay the first bank, later sells the securities and uses the funds as a part of a plan …to pay premiums on a contract of cash value life insurance, the deduction for interest paid in continuing the loan from the second bank shall not be allowed (assuming that none of the exceptions contained in paragraph (d) of this section are applicable)." Treas. Reg. 1.264-4(c)(2).

General rule

Finally, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual (with an exception relating to key persons in the business context).[75]

Life insurance, endowment, and annuity contracts may permit borrowing of the cash value of the contract by the holder of the contract. Under the interest deduction limitation, if an individual purchases a life insurance, endowment, or annuity contract, and, for example, borrows under the contract pursuant to its terms, the interest on the borrowing is not deductible.[76]

Legislative Background

A limitation has applied to the deductibility of interest with respect to single premium life insurance contracts since 1942.[77] The "four-out-of-seven" interest deduction limitation was added in 1964, and an additional interest deduction limitation with respect to life insurance, endowment, and annuity contracts was added in 1986.[78] More recently, additional interest deduction limitations with respect to such insurance contracts were added in 1996 and again in 1997.[79] In general, these interest deduction limitations have been based in part on concern over the opportunity for arbitrage, that is, the deductibility of interest expense with respect to untaxed investment income (inside buildup) of the insurance contract.

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[75] Sec. 264(a)(4). This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. In the case of a taxpayer that holds policies or contracts insuring other individuals (generally in the business context), a key person exception applies. Sec. 264(e).

[76] In general, a tracing rule applies to determine whether debt is incurred with respect to a life insurance, annuity, or endowment contract, as exemplified by Treas. Reg. 1.264-4(c)(2).

[77] Current sec. 264(a)(2) (former sec. 24(a)(6) of the 1939 Code), enacted in the Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798, sec. 129, 77th Cong., 2d Sess., October 21, 1942.

[78] Sec. 264(a)(3), enacted in the Revenue Act of 1964, Pub. L. No. 88-272, sec. 215, 88th Cong., 2d Sess., 1964; sec. 264(a)(4) and (e)(1) (subsequently modified), enacted in the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1003, 99th Cong., 2d Sess., October 22, 1986. As enacted in 1986, the sec. 264(a)(4) provision applied only to the extent that the aggregate amount of indebtedness with respect to policies covering an insured exceeded $50,000. This limitation was removed in 1996 (Pub. L. No. 104-191, sec. 501). In addition to interest deduction limitations, limitations are imposed on the deductibility of premiums with respect to life insurance, endowment and annuity contracts (sec. 264(a)(1)).

[79] These changes were directed primarily to business-owned life insurance. Current sec. 264(e), enacted in the Health Insurance Portability and Accountability Act of 1996, Pub. L. No 104-191, sec. 501, 104th Cong., 2d. Sess., July 31, 1996; and sec. 264(f), applicable to taxpayers other than natural persons, enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 105th Cong., 1st Sess., July 30, 1997.

For example, in enacting the 1964 interest deduction limitation, Congress stated,

> The annual increase in the cash value of the insurance policy to reflect interest earnings, which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays. Thus, for taxpayers in higher brackets, where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured.[80]

6. Disallowance of deduction for interest incurred to purchase tax-exempt obligations

Present Law

In general

The interest income an individual or household receives from an investment in debt is generally taxable as ordinary income, and gain or loss on sale of debt held as an investment is capital gain or loss.[81]

Interest on bonds issued by State and local governments, however, generally is excluded from the recipient's gross income for Federal income tax purposes.[82]

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[80] Revenue Act of 1963, Report of the Committee on Ways and Means, H.R. Rep. No. 749, 88th Cong., 1st Sess., page 61, September 13, 1963. In enacting the most recent of these interest deduction limitations in 1997, Congress expressed concern about the tax arbitrage of deducting interest expense that funds untaxed income:

> In addition, the Committee understands that taxpayers may be seeking new means of deducting interest on debt that in substance funds the tax-free inside build-up of life insurance or the tax-deferred inside buildup of annuity and endowment contracts. The Committee believes that present law was not intended to promote tax arbitrage by allowing financial or other businesses that have the ongoing ability to borrow funds from depositors, bondholders, investors or other lenders to concurrently invest a portion of their assets in cash value life insurance contracts, or endowment or annuity contracts. Therefore, the bill provides that for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of any life insurance policy or annuity or endowment contract issued after June 8, 1997.

Revenue Reconciliation Act of 1997 (as Reported by the Senate Committee on Finance), S. Rep. No. 105-33, 105th Cong., 1st Sess., p. 187, June 20, 1997 (footnotes omitted).

[81] The amount of capital losses that a taxpayer may deduct, including on sale of debt held as an investment, is generally limited to a taxpayer's capital gain. Under section 1211(b), an individual, trust, or estate may deduct all capital losses (i.e., both short- and long-term capital losses) against all capital gains (i.e., both short- and long-term capital gains). If aggregate capital losses exceed aggregate capital gains, such taxpayers may deduct up to $3,000 of the excess against ordinary income ($1,500 in the case of a married individual filing a separate return).

[82] The interest on qualified private activity bonds is included in a taxpayer's alternative minimum taxable income ("AMTI"). A private activity bond is a bond issued by a State or local government for which the State or local government serves as a conduit, providing financing to nongovernmental persons (e.g., private businesses or individuals). The alternative minimum tax ("AMT") is the amount by which a taxpayer's tentative minimum tax

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax.[83] This rule applies to tax-exempt obligations held by individual and corporate taxpayers.[84] The rule also applies to certain cases in which a taxpayer incurs or carries indebtedness and a related person acquires or holds tax-exempt obligations.[85]

Tracing approach

In the case of households, the method for allocating interest on debt to tax-exempt obligations is generally a tracing approach.[86] Under the tracing approach, the disallowance of a deduction for interest depends on whether the taxpayer's borrowing can be traced to its holding of tax-exempt obligations. Thus, for example, interest on debt is disallowed if the proceeds of the debt are used for and are directly traceable to the purchase of tax-exempt obligations, or if tax-exempt obligations are used as collateral for the debt. In the absence of direct evidence, the interest disallowance rule applies only if the totality of facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists. In general terms, the tracing rule applies only if the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

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exceeds the taxpayer's regular income tax. The tentative minimum tax is computed based upon a taxpayer's AMTI, which is the taxpayer's taxable income modified to take into account certain preferences and adjustments. One of the preference items is tax-exempt interest on certain tax-exempt bonds issued for private activities (sec. 57(a)(5)). As a result, interest on qualified private activity bonds is taxable for taxpayers who pay the AMT. Because a tax-exempt qualified private activity bond is equivalent to a taxable bond for bondholders who pay the AMT, the yield on qualified private activity bonds is typically higher than the yield on equivalent tax-exempt governmental bonds.

[83] Sec. 265. An interest deduction generally is not disallowed to an individual if during the taxable year the average adjusted basis of the individual's tax-exempt obligations is two percent or less of the average adjusted basis of the individual's portfolio investments and trade or business assets. See Rev. Proc. 72-18, 1972-1 C.B. 740, sec. 3.05.

[84] For this purpose, tax-exempt obligations do not include tax credit bonds; present law provides that for Federal income tax purposes, the credit associated with the bond is treated as interest that is includible in gross income (sec. 54A(f)). The rules applicable to corporate taxpayers are discussed in a companion document. See *Tax Treatment of Business Debt.*

[85] Although Treasury regulations have not been issued, section 7701(f) provides that the Secretary of the Treasury will prescribe regulations necessary or appropriate to prevent the avoidance of any income tax rules that deal with the use of related persons, pass-through entities, or other intermediaries in (1) the linking of borrowing to investment or (2) diminishing risks. See *H Enterprises Int'l, Inc. v. Commissioner*, T.C.M. 1998-97, *aff'd.* 183 F.3d 907 (8th Cir. 1999) (Code section 265(a)(2) applied where a subsidiary borrowed funds on behalf of a parent and the parent used the funds to buy, among other investments, tax-exempt securities).

[86] The tracing approach applies to individual taxpayers (and thus to households). See Rev. Proc. 72-18, 1972-1 C.B. 740. A pro rata method applies to dealers in tax-exempt obligations, corporations that are not dealers, and banks. The pro rata approach disallows interest deductions based on the percentage of a taxpayer's assets comprised of tax-exempt obligations (sec. 265(b)).

Legislative Background

The interest expense disallowance rules are designed to prevent taxpayers from engaging in tax arbitrage by using indebtedness that generates an interest deduction to purchase an asset that produces tax-exempt income.

The Federal income tax has excluded the interest on debt issued by States and their political subdivisions from the debt holder's gross income since the tax's inception in 1913.[87]

Section 265(a)(2) has remained largely unchanged since 1918.[88] The predecessor to section 265 was first enacted in the Revenue Act of 1917, which allowed a deduction for "all interest paid within the year on [a taxpayer's] indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation under this title."[89] The Revenue Act of 1918 contained a similar provision, allowing a deduction for all interest paid or accrued on indebtedness "except on indebtedness incurred or continued to purchase or carry obligations or securities…the interest upon which is wholly exempt from taxation under this title."[90]

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[87] The exception is now codified in sec. 103.

[88] Sec. 265(a)(2) states that no deduction shall be allowed for "[i]nterest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle."

[89] Revenue Act of 1917, sec. 1201(1), amending section 5(a) of the Revenue Act of 1916.

[90] Revenue Act of 1918, sec. 214(a)(2).

B. Discharge of Indebtedness Income

1. Tax treatment of income from discharge of indebtedness

Present Law

Gross income generally includes income that is realized by a debtor from the discharge of indebtedness.[91] The amount of discharge of indebtedness income generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Exceptions to this income inclusion rule are provided for debtors in Title 11 bankruptcy cases,[92] insolvent debtors, certain farm indebtedness, certain real property business indebtedness, and certain principal residence indebtedness that is discharged before January 1, 2013.[93] The rules for excluding cancellation of indebtedness income are different for each of these exceptions. For example, a debtor in bankruptcy need not be insolvent to have discharged debt excluded, and there is no limit to the amount of the exclusion. In contrast, the amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent.

In cases involving income from a discharge of indebtedness that is excluded from gross income, taxpayers generally are required to reduce tax attributes (such as net operating losses, tax credits, and the basis of property) by the amount of the discharge of indebtedness income that is excluded.[94]

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[91] Sec. 61(a)(12).

[92] Title 11 of the United States Bankruptcy Code contains chapters which describe the rules and procedure for the filing of a petition for relief. For example, Chapter 7, which is available to individuals, is a straight bankruptcy in which a trustee liquidates a debtor's assets and distributes the proceeds to the creditors. Chapter 11 is typically used for business debt because it allows the debtor to retain possession of assets continue normal business activities while reorganizing its finances so that it may pay its employees, reduce obligations to its creditors and produce a return for its stock holders.

[93] Sec. 108.

[94] Secs. 108(b) and 1017(a). The amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount of cash or the fair market value of other property used to satisfy the debt. The adjusted issue price is usually the issue price including any accrual of original issue discount, reduced by any principal payments made before the discharge and bond issuance premium accrued. See Treas. Reg. sec. 1.1275-1(b); Prop. Treas. Reg. sec. 1.163-13(d)(5).

Legislative Background

In 1931, the Supreme Court, in the case of *U.S. v. Kirby Lumber Co.*,[95] established that the gain or saving that a debtor realizes upon the reduction or cancellation of outstanding indebtedness for less than the amount due generally is income for Federal tax purposes.[96] In 1939, in response to the *Kirby* decision, Congress amended the Code to exclude the cancellation of indebtedness income of certain financially troubled taxpayers, provided that the taxpayer consents to a reduction in the basis of the taxpayer's other property.[97] The statutory rule generally requiring inclusion in income of discharge of indebtedness income became present-law section 61(a)(12) as part of the Internal Revenue Code of 1954.

The rule of inclusion was recodified with exceptions in 1986. Further exceptions have been added since 1986. For example, in 1993, Congress allowed noncorporate taxpayers restructuring a mortgage secured by real property used in a trade or business and worth less than the mortgage to reduce basis rather than recognize income from the discharge of debt,[98] and in 2007 added the exclusion for qualified principal residence indebtedness that is discharged before January 1, 2013.[99]

2. Exclusion of income from certain student loan forgiveness

Present Law

As described above, gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.[100] The professions to which the exception applies are medicine,

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[95] 284 U.S. 1 (1931).

[96] Prior to *Kirby*, an insolvent or bankrupt taxpayer had no income on a discharge of indebtedness and suffered no reduction in any tax attribute. See I.T. 1564, II-1 C.B. 59 (1923); Treas. Reg. 86, § 22(a)-14 (1935). See Rev. Rul. 69-43, 1969-1 C.B. 310 (declaring the 1923 ruling obsolete).

[97] The Revenue Act of 1939, Pub. L. No. 155, added sections 22(b)(9) and 113(b)(3) of the Internal Revenue Code of 1939, later codified as secs. 108 and 1017. Specific exceptions to the requirement of income inclusion were added (or in 1976, repealed) in legislation subsequent to 1939. In 1980, the Bankruptcy Tax Act, Pub. L. No. 96-589, significantly rewrote section 108. Additional specific exceptions to income inclusion were added in subsequent legislation in 1984, Pub. L. No. 98-369, as well as thereafter.

[98] Pub. L. No. 103-66, sec. 13150.

[99] Pub. L. No. 110-142, sec. 2(a). In 2008, the expiration date was changed from January 1, 2010 to January 1, 2013. Pub. L. No. 110-343, Division A, sec. 303(a).

[100] Sec. 108(f).

nursing, teaching,[101] and the law.[102] The broad class of employers condition is intended to prevent the provision of loan forgiveness from serving as indirect compensation from a specific employer or employers.[103]

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation.

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and such work must be performed for, or under the direction of, a tax-exempt charitable organization or a governmental entity.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program or certain State loan repayment or loan forgiveness programs.[104]

Legislative Background

In 1976, Congress first made available an exclusion from gross income for certain student loan forgiveness.[105] The exclusion applied only to loans made pursuant to a government-

[101] S. Rep. No. 98-169, p. 887 (1984); Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 1200.

[102] Rev. Rul. 2008-34, 2008-28 I.R.B. 76.

[103] An example of a loan requirement satisfying this condition is that a doctor work for any public hospital in any rural area of the United States. In contrast, a loan requirement that a doctor work for a specific hospital would not satisfy this condition. Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 1200.

[104] Sec. 108(f)(4).

[105] Tax Reform Act of 1976, Pub. L. No. 94-455, sec. 2117.

sponsored program requiring the loan recipient to work for a certain period of time in certain geographical areas or for certain classes of employers.[106] The primary purpose for this exclusion was to assist States and cities that had had trouble recruiting doctors, nurses, and teachers to work in certain rural and low-income urban areas.[107] In 1997, the exclusion was expanded to include forgiveness of loans made by certain tax-exempt organizations under conditions comparable to those of the government-sponsored programs to which the exclusion already applied.[108] The exclusion was further expanded in 2004 to include loan repayments received under the National Health Service Corps loan repayment program and certain State loan repayment programs.[109] In 2010, the exclusion was again expanded to include any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas.[110]

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[106] As initially enacted, the exclusion was available only for loans forgiven prior to 1979. The exclusion was extended by four years in 1978, however, so that it was available for loans forgiven prior to 1983. Revenue Act of 1978, Pub. L. No. 95-600, sec. 162. In 1984, a permanent exclusion for certain student loan forgiveness was enacted that was similar to the prior, temporary exclusions; this exclusion applied to forgiveness occurring on or after January 1, 1983. Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 1076.

[107] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 1200.

[108] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 225; see also IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, sec. 6004(f) (clarifying that the 1997 change applies to refinancing loans made pursuant to a program of a tax-exempt organization requiring the student to fulfill a public service requirement).

[109] American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 320.

[110] Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, sec. 10908.

IV. ECONOMIC INCENTIVES FOR HOUSEHOLDS UNDER PRESENT LAW

In general

The tax treatment of household debt has a number of potential consequences for both the efficiency of debt markets and the equity of treatment across borrowers and lenders in these markets. When borrowers and lenders face changes in the cost of acquiring and holding household debt as a result of new tax policies, they respond to these new costs by changing their demand for, or supply of, debt, distorting economic activity that would otherwise enhance the well-being of both lenders and borrowers (economists refer to this distortion as "efficiency loss"). On the other hand, if there are existing inefficiencies in the market (for example, due to spillover effects), taxes may reduce efficiency losses. Furthermore, if tax policies redistribute resources in a way that lawmakers believe to be more equitable, losses in efficiency due to the tax may be offset by a gain in equity. Also, the policies could trade off for a gain in simplicity of administration and compliance.

Deduction for home mortgage interest

The deduction for home mortgage interest reduces the after-tax cost of financing and maintaining a home. Because the Federal income tax allows taxpayers to deduct mortgage interest from their taxable income, but does not allow them to deduct rental payments, there is a financial incentive to buy rather than rent a home. Taxpayers are also allowed to exclude gains from the sale of their principal residences of up to $500,000 ($250,000 for married filing separately) from gross income. There is no such exclusion for other types of investments, further reinforcing the financial incentive to buy rather than rent a home.[111]

Homeowners also receive preferential treatment under U.S. tax law because the imputed rental income on owner-occupied housing (that is, the cost of rent which the taxpayer avoids by owning and occupying a home) is not taxed. Consider two taxpayers: one rents a home at a $1,000 monthly rate, and the other owns a home which carries a $1,000 monthly mortgage. All else equal, a renter pays taxes on a measure of income that includes the $1,000 used to pay rent and the homeowner pays taxes on a measure of income that does not include that same $1,000. If imputed rental income were included in income, it would be appropriate to allow a deduction for mortgage interest, property taxes, and depreciation as costs of earning that income. Because tax law allows taxpayers to deduct mortgage interest and property taxes to determine their taxable income but does not tax imputed rental income or allow them to deduct rental payment, it creates the incentive to buy rather than rent a home and to finance the acquisition with debt.

One study estimates that the mortgage interest deduction lowers the cost of capital for owner-occupied housing by seven percent.[112] Some researchers argue that this creates economic

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[111] There are also some tax incentives that may reduce the cost of renting relative to owning (for example, accelerated depreciation).

[112] James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings*, vol. 96 (May 2008).

distortions; the subsidized mortgage debt may lead households to demand houses that are larger and more expensive than would be demanded in the absence of the mortgage interest deduction. In markets where the marginal buyer itemizes, this increased demand for larger and more expensive homes leads to a rise in price for these homes above what the market dictates in the absence of the deduction. The mortgage interest deduction may also lower the cost of home mortgage loans relative to other types of debt. Households may increase their demand for owner-occupied housing instead of choosing from potentially higher pre-tax return investments in other sectors. Finally, if the mortgage interest deduction results in relatively lower cost of home mortgage debt, households may increase their holdings of home mortgage debt.

Supporters of the home mortgage interest deduction believe that this policy has a positive effect on the U.S. economy, encouraging homeownership and accompanying positive spillover benefits. They assert that homeowners are more likely to care about their neighborhoods and towns than those who rent. In principle, if this care increases civic involvement and local decision-making that prioritizes long-run investments leading to long-term gains in property values, then the mortgage interest deduction creates social and economic value that may justify the cost of the policy. However, some research fails to find evidence for correlations between home ownership and social benefits such as increased civic involvement and local decision-making that prioritizes long-run investments.[113] Other research questions whether the home mortgage interest deduction serves its intended purpose of encouraging homeownership, noting that the deduction disproportionately benefits high-income taxpayers, many of whom would be homeowners in the absence of any deduction.[114] Because money is fungible, it is also possible that these taxpayers use mortgage loans to increase other consumption rather than home purchases.

In addition to effects on efficiency, the home mortgage interest deduction carries distributional consequences. The average tax savings from the mortgage interest deduction increases as annual household income increases.[115] Furthermore, the average tax savings from the mortgage interest deduction varies within income groups. Consistent with the "life cycle" theory of savings in which younger households borrow more than older households in order to smooth consumption over the life cycle, research suggests that for households with greater than $75,000 of annual income, average tax savings from the mortgage interest deduction are largest for younger homeowners (ages 25 to 35). For households with less than $75,000 of annual income, average savings are largest for middle-aged homeowners (ages 35 to 50).[116] Within income groups, the largest benefits generally accrue to taxpayers who have higher loan-to-value

[113] Gary Engelhardt, Michael Eriksen, William Gale, and Gregory Mills, "What Are the Social Benefits of Homeownership?" Experimental Evidence for Low-Income Households," *Journal of Urban Economics* (September 2009).

[114] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy* 17, Cambridge, Mass.: The MIT Press (2003).

[115] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010*-2014 (JCS-3-10), December 15, 2010, p. 60.

[116] Poterba and Sinai (May 2008).

ratios, and to those taxpayers purchasing more expensive homes. Table 7 below shows the distribution of tax expenditures for the mortgage interest deduction by income class in 2009. The largest tax expenditures accrue to those households with the highest incomes as they are more likely to own homes, are more likely to itemize deductions, face higher tax rates, and have larger mortgages.

Table 7.−Distribution by Income Class of the Tax Expenditure for the Home Mortgage Interest Deduction at 2009 Rates and 2009 Income Levels

Income Class	Tax Expenditure for Home Mortgage Interest Deduction		
	Returns (thousands)	Amount ($ millions)	Average Per Return in Dollars
Below $10,000	(1)	(2)	-----
$10,000 to $20,000	311	88	283
$20,000 to $30,000	1,000	521	521
$30,000 to $40,000	2,023	1,292	639
$40,000 to $50,000	2,923	2,329	797
$50,000 to $75,000	7,603	9,332	1,227
$75,000 to $100,000	6,754	10,066	1,490
$100,000 to $200,000	10,594	30,261	2,856
$200,000 and over	3,424	22,768	6,650
Total	**34,632**	**76,656**	**-----**

[1] Fewer than 500 returns.
[2] Positive tax expenditure of less than $500,000.
Note: details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

Table 8 shows homeownership rates by household income in 2009. Unsurprisingly, homeownership rates rise with household income, ranging from 40 percent ownership rates for households with $5,000 to $9,999 annual income to 92 percent ownership rates for households with greater than $120,000 annual income. Given the fact that homeownership rates are not closer to zero at very low levels of income, this data is again consistent with the notion that younger households borrow when their incomes are relatively low in order to smooth consumption over the life cycle. Because higher income households are more likely to itemize deductions, it is also consistent with the claim that the home mortgage interest deduction disproportionately benefits higher income households.

Table 8.−Homeownership Rates by Household Income

Household Income	Total Occupied Units	Owner Occupied Units	Homeownership Rate
Less than $5,000	5,849	2,539	43.4%
$5,000 to $9,999	4,683	1,884	40.2%
$10,000 to $14,999	5,963	2,788	46.8%
$15,000 to $19,999	6,062	3,123	51.5%
$20,000 to $24,999	5,961	3,110	52.2%
$25,000 to $29,999	7,637	4,507	59.0%
$30,000 to $34,999	5,966	3,600	60.3%
$35,000 to $39,999	5,593	3,482	62.3%
$40,000 to $40,999	10,290	6,852	66.6%
$50,000 to $59,999	8,654	6,328	73.1%
$60,000 to $79,999	13,780	10,535	76.5%
$80,000 to $99,999	10,073	8,409	83.5%
$100,000 to $119,000	6,840	6,007	87.8%
$120,000 or more	14,456	13,264	91.8%
Total	**111,806**	**76,428**	**68.4%**

Source: American Housing Survey: 2009, U.S. Census Bureau.

Deduction for interest on home equity loans

Deductions for interest on home equity loans contribute to lower after-tax costs to the borrower for home equity loans relative to other sources of loans. Because the use of proceeds is not restricted, this may create an incentive for households to borrow for any purpose, including for consumption or investment. For example, a home equity loan can be used to pay off other debt, purchase a car, or for medical or educational expenses. Some researchers believe restrictions on the tax-deductibility of non-mortgage interest payments have spurred home equity borrowing in the past. [117]

The increased ability to borrow attributable to home equity loans may allow households to smooth lifetime consumption more optimally. Also, households may be able to improve lifetime earnings if they reinvest the loans in ways that increase future earnings and wealth.

[117] Joyce Manchester and James Poterba, "Second Mortgages and Household Saving," *Regional Science and Urban Economics*, 19 (1989).

Supporters of the deduction on interest for home equity loans point to these possibilities as ways to improve equity in the tax treatment of households. On the other hand, some researchers find a significant negative correlation between a household's stock of second mortgage debt and its net worth, consistent with the view that households primarily use home equity loans to increase consumption.[118]

Deduction for student loan interest

Commentators have made three main arguments for government intervention in education markets. First, there may be positive spillover effects associated with education. For example, higher education levels are associated with increased average productivity and wages,[119] lower crime rates,[120] increased civic participation,[121] and improved health.[122]

Second, there may be failures in the market for student loans that result in less borrowing than is optimal. That is, some students may benefit from attending college but are unable to do so due to the inability to borrow. Market failures occur because, unlike the market for car loans or home loans, the market for student loans is not collateralized. If a borrower defaults on a car or home loan, the lender may sell the car or the home and use the proceeds to offset some of the losses. However, if a borrower defaults on a student loan, the lender cannot practically liquidate the value of the student's education, and must absorb the entire loss. The lender may be unable to price this risk properly due to lack of information about the student's future earnings or the cost of collecting on other assets. The loan is therefore riskier for the lender. As a result, lenders may issue fewer loans than is optimal. This introduces inefficiencies in the market. That is, both lenders and borrowers may be less well off as a result of the under-provision of loans.

Finally, government intervention may alleviate inequalities in access to higher education between low-income and high-income students to the extent that they exist. Studies show an extra year of education increases wages by between six and 13 percent.[123] As a result, equal

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[118] *Ibid*.

[119] Enrico Moretti, "Estimating the Social Return to Higher Education: Evidence From Longitudinal and Repeated Cross-Sectional Data," *Journal of Econometrics* 121(1-2), (2004).

[120] Lance Lochner and Enrico Moretti, "The Effect of Education on Criminal Activity: Evidence from Prison Inmates, Arrests and Self-Reports," *American Economic Review* 94(1), (2004).

[121] Kevin Milligan, Enrico Moretti and Phil Oreopoulos, "Does Education Improve Citizenship? Evidence from the U.S. and the U.K.," *Journal of Public Economics* 88(9-10), (2004).

[122] Adriana Lleras-Muney, "The Relationship Between Education and Adult Mortality in the United States," *Review of Economic Studies* 72(1), (2005).

[123] David Card, "Estimating the Return to Schooling: Progress on Some Persistent Econometric Problems," *Econometrica*, 69(5): 1127-1160 (2001). Thomas Kane and Cecilia Rouse, "Labor-Market Returns to Two- and Four-Year College," *The American Economic Review*, 85(3): 600-614 (1995). Stephen Cameron and Christopher Taber, "Estimation of Educational Borrowing Constraints Using Returns to Schooling," *Journal of Political Economy*, 1(1): 132-182.

access to higher education today may hold significant implications for the wage distribution as well as economic growth in the future.

Supporters of the student loan interest deduction note that the impact of credit market failures on lending is substantial in higher education. They suggest that the deduction for student loan interest mitigates this impact by reducing the cost of financing higher education. With lower cost of loans, more students apply for loans. If some of the cost of borrowing is subsidized by the government through an interest deduction, students are also willing to pay higher rates to borrow. Banks respond to this higher willingness to pay by increasing their volume of lending, alleviating some of the under-provision of loans in the market.

On the other hand, others point out that the positive spillover effects associated with education are large for elementary and secondary education, but small for post-secondary education where most of the returns are private. As a result, inefficiencies in the market may not be large in practice. Furthermore, even if the spillover effects were larger, this would not necessarily imply that the government should choose policies that subsidize debt-financed higher-education over other types of policies that also alleviate under-provision. Some researchers note that higher education finance policies are most effective when they target lower-income students as opposed to higher-income students, many of whom will attend college regardless of student loan costs. Other programs may be more effective at targeting those students who would not otherwise attend college.

Table 9 shows the distribution of tax expenditures for the student loan interest deduction by income class in 2009. This table shows the largest tax expenditures for student loan interest deductions accrued to households with greater than $50,000 of income annually.[124] For example, there were 1,129,000 households with $100,000 to $200,000 of income that claimed the deduction, a total of $203 million in expenditures for these households, for an average (per household) expenditure of $180. In contrast, households with less than $40,000 of income received an average expenditure of less than $100. Because of the subsidies for student loans, higher income families may be encouraged to borrow for education rather than pay cash. Because money is fungible, in doing so, they can increase consumption or other types of investment. This substitution can be made without increasing the level of education.

[124] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010*-20143 (JCS-3-10), December 15, 2010, p. 59.

Table 9.−Distribution By Income Class of The Tax Expenditure For The Student Loan Interest Deduction at 2009 Rates And 2009 Income Levels

Income Class	Tax Expenditure for Student Loan Interest Deduction		
	Returns (thousands)	Amount ($ millions)	Average Per Return in Dollars
Below $10,000	22	2	91
$10,000 to $20,000	275	17	62
$20,000 to $30,000	635	51	80
$30,000 to $40,000	843	83	98
$40,000 to $50,000	771	94	122
$50,000 to $75,000	1,616	215	133
$75,000 to $100,000	1,161	136	117
$100,000 to $200,000	1,129	203	180
$200,000 and over	-----	-----	-----
Total	**6,452**	**801**	**-----**

Source: Joint Committee on Taxation.

Deductible investment interest expense limited to net investment income for individuals

When a taxpayer incurs debt to purchase property that generates tax-exempt income, such as bonds issued by State and local governments, limitations on interest deductions generally apply. The reason for such rules is that allowing taxpayers to deduct interest on money used to acquire property generating tax-exempt income does not accurately measure a taxpayer's taxable income and creates an opportunity for tax arbitrage.

Because money is fungible, it can be difficult to ensure that taxpayers are not using the proceeds of debt that generate deductible interest to purchase obligations generating tax-exempt income. In general, two alternative methods apply for determining the portion of debt (and interest thereon) that is associated with a particular asset. Under the tracing method, which applies to individual taxpayers, the taxpayer's use of debt proceeds determines whether the debt is associated with the asset. Under the pro rata method, which applies to financial corporations and certain business taxpayers, interest deductions are disallowed based on the percentage of a taxpayer's assets comprised of tax-exempt obligations. Determining a taxpayer's use of debt proceeds, given the fungibility of money, is inherently more complex than a mechanical pro rata rule. Consequently, the tracing rules may be less effective at preventing tax arbitrage than the pro rata method. The tracing rule may allow taxpayers to plan the use of debt proceeds so as to ensure the interest is deductible. Alternatively, in some cases, the tracing rule may prevent the

deduction of otherwise deductible interest expense that is used to generate taxable investment income.[125]

Taxation of income from the discharge of indebtedness

Taxation of income from the discharge of indebtedness may affect the incentives of households to borrow. In principle, taxation of this income reduces the net benefit of filing for bankruptcy and reduces incentives to borrow.

Researchers are divided on the main causes of bankruptcy filings. Some studies claim that bankruptcy filings are primarily the result of adverse events (such as sickness, accidents, unemployment, divorce). Others claim that consumption patterns play a larger role.[126] If consumption patterns play an important role in households' decisions to file for bankruptcy, these filings may be strategic. That is, households may weigh costs and benefits in their decision to file. Furthermore, the availability of the option to file for bankruptcy can change households' consumption patterns if households are more likely to consume knowing they bear less than the full cost of consumption in the event of bankruptcy. Some research shows households do indeed behave strategically, filing for bankruptcy when the benefits of filing (for example, discharge of indebtedness) exceed the costs of filing (for example, forfeiture of assets).[127] Taxation of indebtedness income reduces incentives to borrow by reducing the net benefit of filing for bankruptcy. If adverse events are primarily responsible for bankruptcy filings, these incentives will have a smaller effect on actual borrowing. On the other hand, if consumption patterns are primarily responsible for bankruptcy filings, these incentives will have a larger effect on actual borrowing.

Some types of debt discharges are excluded from Federal income taxation. They include, for example: farm indebtedness, certain qualified real property business indebtedness, qualified principal residence indebtedness which is discharged before January 1, 2013, and certain student loan indebtedness. For these categories of debt, the exclusion from taxation reduces the cost of borrowing and therefore increases the incentives to borrow.[128]

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[125] For example, a taxpayer holding assets that produce taxable income may prefer to borrow to purchase a car even though the taxpayer may have sufficient investment assets to purchase the car with cash. The taxpayer may not want to liquidate those investments. Although the taxpayer borrows to purchase the car in order to continue to hold assets that generate taxable income, the interest expense on the borrowing nevertheless is disallowed because the debt proceeds are used to purchase the car.

[126] Ning Zhu, "Household Consumption and Personal Bankruptcy," *Journal of Legal Studies* 40 (2011).

[127] Scott Fay, Eric Hurst, and Michelle White, "The Household Bankruptcy Decision," *American Economics Review* 92 (2002).

[128] The circumstances under which forgiven student loan debt is excluded are quite limited. As a result, the expectation of excluding debt forgiveness likely has only a limited impact on the incentive for students to borrow.

Economic incentives and trends in household debt

Though a comprehensive analysis of underlying causes of trends in household debt is beyond the scope of this document, an analysis of economic incentives together with the data in Figure 3 in Section 2 suggests the trends discussed in Section 2 above are not driven solely by Federal tax rules governing debt and interest on debt.

Figure 3 in Section 2 shows an increase in household debt over the last sixty years. The majority of this increase is due to an increase in household mortgage debt and a relatively smaller portion of the increase is attributable to more modest increases in consumer credit.

Over this period, the value of the mortgage interest deduction declined. This decline was partly due to declines in income tax rates. Also, the Tax Reform Act of 1986 and subsequent legislation imposed limits on deductions of interest related to acquisition indebtedness and on interest related to other debt secured by a taxpayer's home equity. The declining value of the home mortgage interest deduction created incentives for households to reduce their quantity of mortgage debt. However, the concurrent increase in the quantity of mortgage debt appears to indicate that the overall trend in mortgage debt holdings by households is not entirely explained by tax rules over this period.

Similarly, interest deductions on consumer credit were generally disallowed as a Federal income tax deduction starting after 1986. However, Figure 3 in Section 2 shows consumer credit did not decline after 1986. This appears to indicate that the tax rules by themselves do not explain the trends in household debt over this period. While each tax rule by itself creates relatively straightforward economic incentives, the interaction of these rules with each other and with macroeconomic factors leads to more complicated results.

V. TAX TREATMENT OF HOUSEHOLD DEBT IN SELECTED COUNTRIES

A. Summary

There are both similarities and differences in the tax treatment of household debt across countries. A strict country to country comparison of these provisions is difficult because each country has distinct market institutions as well as a distinct set of policies (both tax and nontax) that may be similar in certain ways but dissimilar in others. A comprehensive analysis of foreign taxation of household debt is therefore beyond the scope of this publication. However, following is a brief overview of the similarities and differences in key tax provisions of household debt across seven countries: Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom. None of these seven countries allow deductions for consumer credit, such as credit card debt or auto loans. However, there is less uniformity in their treatment of other types of debt.

Deduction for interest on mortgage loans and home equity

Six of the seven countries do not allow a deduction of interest on residential mortgage loans that is comparable to the mortgage interest deduction under U.S. tax law.[129] However, three of these six countries provide somewhat related tax benefits.

Australia provides one-time grants of up to AU$7,000 (about US$7,485) to first-time home-buyers. France allows some limited tax credits on interest for residential mortgages. These tax credits equal 40 percent of the loan interest for the first year and 20 percent for each of the following four years on loans concluded between May 6, 2007 and January 1, 2011. The annual credits are capped at €3,750 (about US$5,423) for a single person and €7,500 (about US$10,845) for a couple. Finally, the United Kingdom provides a few exceptions to the disallowance of mortgage interest deductions. As a result, there are a few limited cases in the United Kingdom in which a tax benefit for mortgage interest is provided. Some examples of cases where mortgage interest deductions are allowed are: loans for the purchase of a caravan or houseboat that will be the only or main residence of the borrower; existing loans for life annuities (home income plans) where the annuitant is age 65 or over; and loans taken out before April 1988 for the purchase of a home for a dependent relative or a divorced spouse of the borrower.

In six of the seven countries, there is no explicit allowable deduction for interest on home equity loans.[130] This differs from the U.S. income tax law which allows deduction of interest on residential mortgage loans on amounts up to $1 million of debt as well as on interest on home equity loans on amounts up to $100,000 of debt.

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[129] Mexico allows for interest paid with respect to home mortgage loans to be deducted as long as the loan does not exceed 1.5 million investment units (approximately US$588,978).

[130] There is no information available on the deductibility of interest on home equity loans in Mexico.

Deduction for interest on student loans

The tax treatment of student loans varies across these seven countries. Canada allows a deduction for all interest on student loans. Australia, France, Germany, Japan, Mexico, and the United Kingdom do not allow deduction of interest on student loans. However, of the six countries that do not allow student loan interest deductions, two countries provide a different tax benefit, and three countries provide nontax benefits for households that incur student loan debt. France provides a tax credit on loans obtained to finance non-tuition, education related costs. This credit is equal to 25 percent of the loan's interest for the first five years of the loan.[131] Mexico provides an income exclusion for yields on property held in trust when those yields are allocated to finance the education of straight-line descendants through the bachelor's degree level.[132] Germany offers cash grants and loans with little or no interest to low-income families. Australia offers interest-free government loans to domestic students and the United Kingdom subsidizes interest on certain government-provided loans. In addition, in a number of countries, wholly or partially subsidized tuition may be available for students eligible to attend a university. U.S. income tax law allows deduction of student loan interest, though this is phased out for taxpayers at higher income levels. However, it is difficult to compare incentives provided by other countries to the student loan interest deduction permitted under U.S. income tax law, because many other factors also differ across these other countries.

Deduction for debt incurred to finance investments

In five of the seven countries studied (as well as in the United States), interest and dividends earned on private investments are considered income in certain cases and the interest paid on money borrowed to earn this income is a deductible expense. There are two exceptions to this: France does not allow a deduction for debt incurred to finance investments but provides tax credits in particular cases; and Germany no longer allows deduction of this type of debt.[133]

Treatment of cancelled debt

In five of the seven countries (as well as in the United States), cancelled debt is generally treated as taxable income. However, the details of this treatment vary widely across countries. Variations among these countries' specific rules for cancelled debt create a spectrum of taxation across countries. For example, in Mexico, all cancelled debt is considered to be taxable income. On the other side of the spectrum, in the United Kingdom, cancelled debt is treated as income only in specific circumstances.[134]

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[131] For loans obtained between September 1, 2005 and December 31, 2008.

[132] Yields on property held in trust and allocated to finance the education of straight-line descendants are excluded from income.

[133] Effective January 1, 2009.

[134] Income arises only if the loan was employment-related, made to a shareholder of a closely held corporation, or involved a liability that had been previously been deducted.

Two countries are exceptions to this treatment of cancelled debt as taxable income: Germany does not treat any cancelled debt as taxable income; and Japan treats cancelled debt as a gift which is subject to a gift tax.

B. Law Library of Congress: Tax Treatment of Household Debt

Following is the Report for Congress, June 2011, Tax Treatment of Household Debt, prepared by the Law Library of Congress.

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The Law Library of Congress

REPORT FOR CONGRESS

June 2011

Global Legal Research Center
LL File No. 2011-005748

TAX TREATMENT OF HOUSEHOLD DEBT

This report describes the tax treatment of interest from personal loans in Australia, Canada, France, Germany, Japan, Mexico, and the United Kingdom. It focuses on the deductibility of interest for residential mortgages, student loans, and various consumer debts. It also deals with the deductibility of interest related to investment income and tax-exempt income, and with the tax consequences of the cancellation of a personal loan.

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TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Under Australian tax law, a general deduction provision allows interest costs to be deducted where they are incurred in gaining taxable income, provided that the expenditure is not of a capital, private, or domestic nature. The interest on loans used to finance income-earning investments, including rental properties and shares, will therefore be deductible. However, mortgage interest is not deductible where it relates to the purchase of a taxpayer's private residence. Programs are in place to provide assistance to first-time homebuyers. Deductions are not limited by the amount of income actually gained and can therefore offset other income. Deductions are not available if the interest costs relate to gaining exempt income.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The Income Tax Assessment Act 1997 (ITAA 1997) provides for "general" and "specific" deductions.[1] There are no specific deductions that apply solely to household interest expenses. Whether interest is deductible will therefore generally depend on the application of section 8-1 of the ITAA 1997 to the particular circumstances. This provision sets out two tests for allowing general deductions, referred to as the positive and negative limbs. The positive limbs state that taxpayers can deduct from their gross taxable income[2] any expense to the extent that

(a) it is incurred in gaining or producing taxable income, or

(b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing taxable income.[3]

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[1] *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) Div 8, *available at* http://www.comlaw.gov.au/Details/C2011C00374. *See also* AUSTRALIAN MASTER TAX GUIDE 846 (CCH Australia, 47th ed. 2010).

[2] Gross taxable income is called "assessable income" in Australia. An Australian resident's assessable income includes income derived from all sources, including employment, business, investment, and foreign source income. Once deductions are taken out the net taxable income is then called "taxable income" in Australian tax law. For clarity, however, references to taxable income in this report are to gross taxable income only. *See What is Income?*, AUSTRALIAN TAXATION OFFICE (ATO), http://www.ato.gov.au/content/48101.htm (last visited June 1, 2011). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 364, 856.

[3] ITAA 1997 s 8-1(1).

The first positive limb "has been interpreted as applying to non-business taxpayers, whereas the second limb is seen as providing a less restrictive deduction principle applicable to businesses."[4]

The negative limbs provide that a taxpayer cannot deduct an expense to the extent that

- it is of a capital nature,
- it is of a private or domestic nature,
- it is incurred in relation to gaining or producing various categories of exempt income, or
- there is a provision in the legislation that prevents it from being deductible.[5]

Whether interest is deductible is therefore determined by looking at the purpose of the loan and the use to which it is put, although these two things will often coincide.[6] The tests mean that interest on residential mortgage loans that is incurred by an individual in relation to his own private residence is not deductible.[7] However, a deduction may be claimed for interest incurred on a mortgage loan for a residential investment property from which the person derives rental income.[8] Interest expenditure relating to other personal debts that does not satisfy the requirements of section 8-1, whether because the borrowing is private or domestic in nature or does not have the required connection to the production of taxable income (e.g., employment or investment income),[9] such as home equity loans, auto loans,[10] credit card debt, and student loans,[11] will also not be deductible.

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[4] Dr. Justin Dabner, *Interest Deductibility - Australia and Canada Compared*, 2(3) J. AUS. TAX. 172 (1999), *available at* http://www.austlii.edu.au/au/journals/JlATax/1999/15.html. *See also* R.L. DEUTSCH ET AL., AUSTRALIAN TAX HANDBOOK 531(2009). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[5] ITAA 1997 s 8-1(2). *See also* DEUTSCH ET AL., *supra* note 4, at 531.

[6] DEUTSCH ET AL., *supra* note 4, at 564.

[7] *Id.* at 553 and 565.

[8] *See id.* at 53 and 560. *See also* Tom Toryanik, *Australia – Individual Taxation* ¶ 1.8.1.1., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (AUSTRALIA), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited May 27, 2011). The Australian Taxation Office (ATO) provides information about deducting mortgage interest in relation to investment properties at *Rental Properties – Claiming Interest Expenses*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00113233.htm (last modified Mar. 26, 2009); *and* ATO, RENTAL PROPERTIES 2010, *available at* http://www.ato.gov.au/content/downloads/IND00237831 N17290610.pdf.

[9] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 956.

[10] Motor vehicle expenses, including interest on a car loan, are deductible if incurred in the course of deriving taxable income or in carrying on a business. *See* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 909-18.

[11] "Self-education expenses," including loan interest, are generally deductable under section 8-1 if there is a sufficient connection with the taxpayer's income-producing activities. *See* DEUTSCH ET AL., *supra* note 4, at 571, 548. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 927.

A particular item of expenditure "may have to be apportioned into its deductible and non-deductible components."[12] This may occur where, for example, "expenditure is incurred in deriving both assessable and exempt income, or where expenses are incurred partly for income-producing purposes and partly for private purposes."[13]

The ITAA 1997 does provide for a specific deduction for expenses incurred by a taxpayer in borrowing money to the extent that the borrowed money is used for the purpose of producing taxable income.[14] This provision applies only to the cost of borrowing and not to the interest on the loan.[15] The legislation also provides that expenses incurred in discharging a mortgage given as security for a loan that was used for the purpose of gaining taxable income are deductible.[16] This includes any penalty interest for early repayment of the loan.[17]

B. Incentives for the Lender

There do not appear to be any incentives provided to lenders under Australian tax law.

C. Related Tax Benefits or Subsidies

Australian state governments administer and fund a First Home Buyer Grant program in each state.[18] This program was introduced to offset the effect of Goods and Services Tax (GST) on home ownership. It provides a one-time grant of up to AU$7,000 (about US$7,485) to first-time homebuyers that satisfy the eligibility criteria.[19]

Individual states may also provide additional assistance to homebuyers. For example, in New South Wales a duty exemption of up to AU$17,990 (about US$19,240) is available under

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[12] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[13] *Id.* *See supra* note 2 for an explanation of the meaning of "assessable income" in Australia.

[14] ITAA 97 s 25-25. *See also* DEUTSCH ET AL., *supra* note 4, at 588. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 963. *See also* Toryanik, *supra* note 8, ¶ 1.8.1.1. Examples of borrowing expenses are procuration fees, loan establishment fees, mortgage protection insurance, legal expenses, stamp duty, valuation and survey fees, commissions paid to brokers, and underwriters' fees.

[15] DEUTSCH ET AL., *supra* note 4, at 589.

[16] ITAA 1997 s 25-30. *See also* DEUTSCH ET AL., *supra* note 4, at 587. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 963-64 (referring to Taxation Ruling TR 93/7).

[17] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 964.

[18] *First Home Owner Grant General Information*, FHOGONLINE, http://www.firsthome.gov.au/ (last visited May 24, 2011).

[19] *First Home Owner Grant Scheme*, NEW SOUTH WALES (NSW) OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/general/eligibility/ (last updated Dec. 3, 2010). *See also* NSW Office of State Revenue, Factsheet: First Home Owner Boost Scheme (Dec. 2010), http://www.osr.nsw.gov.au/lib/doc/factsheets/fs_fhob2.pdf.

the First Home Plus Scheme[20] and a $3,000 supplement is available for people that build or purchase new homes.[21]

In addition to the state programs, the federal government operates a First Home Saver Accounts program to assist people to save for their first home.[22] This program involves a low tax rate (15 percent) on the interest earned on money in the account as well as government contributions equal to 17 percent of personal contributions each year (up to a maximum of $935 for the 2010/11 financial year).[23] Withdrawals from these accounts are not subject to further tax if used for the purchase of a first home that will be used as a person's own residence.

Most domestic undergraduate students in Australia are required to pay only a contribution to the cost of their education, while the Australian federal government contributes the majority of the cost.[24] The federal government also operates student loan programs for domestic students to use in paying their student contributions or fees.[25] There is no interest rate charged on the loans. Instead, a person's debt is indexed annually to reflect changes to the Consumer Price Index.[26] The loans are repaid over time through the tax system, with the rate of repayment based on an individual's taxable income.[27] This means that repayments are deferred until a person is earning above a particular income threshold, at which point there will be compulsory minimum repayment percentages depending on the person's income level.[28] Voluntary repayments can

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[20] *First Home Plus*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/general/fhplus/ (last updated July 9, 2010).

[21] *NSW Home Builders Bonus*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/nbb/ (last updated May 12, 2011). *See also First Home Benefits*, NSW OFFICE OF STATE REVENUE, http://www.osr.nsw.gov.au/benefits/first_home/ (last updated May 16, 2011).

[22] *First Home Saver Accounts*, THE AUSTRALIAN TREASURY, http://homesaver.treasury.gov.au/content/default.asp (last visited May 24, 2011). *See also First Home Saver Account – Home*, ATO, http://www.ato.gov.au/individuals/pathway.aspx?sid=42&pc=001/002/066 (last visited May 24, 2011).

[23] *Guide to First Home Saver Accounts – Benefits*, ATO, http://www.ato.gov.au/individuals/distributor.aspx?menuid=0&doc=/content/00250962.htm&page=1#P26_2695 (last modified Apr. 28, 2011).

[24] *Going to Uni – Undergraduate*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/Undergraduate/Default.htm (last visited May 31, 2011).

[25] *HELP Information for Payers*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/12115.htm&pc=001/002/008/013/001&mnu=0&mfp=&st=&cy (last modified Aug. 2, 2010). *See also Going to Uni – Paying For Your Studies (HELP loans)*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/Quickfind/PayingForYourStudiesHELPLoans/Default.htm (last visited May 24, 2011).

[26] *Going to Uni – Interest and Indexation*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS, http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/LoanRepayments/Interest-Indexation.htm (last visited May 24, 2011). *See also Higher Education Loan Program (HELP) Indexation Rates*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/74307.htm&pc=001/002/008/014/002&mnu=&mfp=&st=&cy=1 (last modified May 18, 2011).

[27] *See HELP and HECS Repayment Thresholds and Rates*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/8356.htm (last modified Apr. 19, 2011).

[28] *Going to Uni – Compulsory and Voluntary Repayments*, DEPARTMENT OF EDUCATION, EMPLOYMENT AND WORKPLACE RELATIONS,

also be made and result in a 10 percent bonus being added to each repayment by the government.[29] Both compulsory and voluntary repayments are not tax deductible.[30]

II. Deductibility of Debt Incurred to Finance Investments

Income from investments, including dividends,[31] interest, royalties, and rent, is included in a person's taxable income.[32] Therefore, under section 8-1 of the ITAA 1997, expenses incurred in the course of gaining or producing this income can be deducted, to the extent that the expenditure is not of a capital, private, or domestic nature.[33] This means that, as noted above, an individual may claim a deduction for the interest incurred on a mortgage loan that relates to a rental property. Section 8-1 also means that interest incurred on money borrowed to purchase other income-producing investments, such as stocks and bonds, is ordinarily deductible.[34]

As section 8-1 is general in nature, there have been a number of determinations, rulings, and cases related to the deductibility of interest incurred in borrowing funds for different investment products and arrangements.[35] This has also resulted in a list of tests that the courts will use to assist in determining whether a particular interest expenditure is deductible or not.[36]

Some of the rulings led to amendments to the legislation in relation to "capital protected" products and borrowings.[37] Specific provisions apply to

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http://www.goingtouni.gov.au/Main/FeesLoansAndScholarships/LoanRepayments/Compulsory-Voluntary.htm (last visited May 24, 2011).

[29] *Id.*

[30] *Id.*

[31] Dividends paid to shareholders are taxed under an imputation system. Individuals that receive franked dividends include the amount of the dividend and the franking credits in their taxable income, with the franking credits able to be claimed as a franking tax offset. *See Refunding Franking Credits – Individuals*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/8651.htm&pc=001/002/002/013/005&mnu=44711&mfp=001/002&st=&cy= (last modified June 29, 2010).

[32] *See* Toryanik, *supra* note 8, ¶ 1.5.

[33] DEUTSCH ET AL., *supra* note 4, at 565. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 948.

[34] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960; *see also* 948 and 955. *See also* DEUTSCH ET AL., *supra* note 4, at 561; ATO, D8 – Dividend Deductions, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00222869.htm (last modified June 28, 2010).

[35] DEUTSCH ET AL., *supra* note 4, at 565, 568. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960-62.

[36] *See* Grant Richardson & Ken Devos, *The Deductibility of Interest in Anglo-American Countries: A Comparison and Review of Policy*, 2 REV. L. J. 33 (1999), *available at* http://www.austlii.edu.au/au/journals/RevenueLawJl/1999/2.pdf. *See also* Karen Burford, *Going out on a Second Limb – An Analysis of the Deductibility of Interest by Recognising the Distinction Between the Positive Limbs of s 51(1)*, 5(1) REV. L. J 100 (1995), *available at* http://www.austlii.edu.au/au/journals/RevenueLawJl/1995/5.html; Dabner, *supra* note 4.

[37] *About Capital Protected Products and Borrowings*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/44515.htm&pc=001/002/013/009/004&mnu=44692&mfp=001/002&st=&cy (last modified July 25, 2008). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 960.

> investments in shares, units, stapled securities or beneficial interests in an entity holding such investments, where the investments (a) are listed on an approved stock exchange or in a widely held company or trust and (b) have a capital protection feature, that is a clause allowing the underlying investment to be sold for at least the invested amount.[38]

Interest costs incurred in borrowing funds used to purchase such investments may not be fully deductible: part of the interest costs are allocated to the capital cost of acquiring the option over the capital protected investment. This amount will be nondeductible "and will be taken into account in calculating a capital gain or loss on either the expiry of the option or disposal of the underlying investment in accordance with the capital gains tax rules."[39]

With regard to retirement savings and investments, the ITAA 1997 provides that the contributions of employers as well as personal contributions to pension funds are deductible, subject to limits.[40] Employers can also claim deductions for interest and borrowing costs connected with a contribution, but only if a deduction can be claimed for the contribution itself.[41] There is no similar specific provision for borrowing related to an individual's personal contributions.

A taxpayer can also deduct interest on money borrowed to pay a premium for a life insurance policy, but only if the risk component of the premium is the entire amount of the premium, and any amount that the insurer is liable to pay under the policy would be included in the taxpayer's taxable income.[42]

A. Annual Limits Relating to Investment Income

There does not appear to be an annual limit on deductions. To be deductible, "expenditure must be incurred, though not necessarily paid, in the year claimed."[43] The legislative provisions also mean that "the whole amount may be claimed in the year incurred even though the expenditure may help in the production of income in other years."[44] As long as expenditure is incurred in the course of gaining taxable income, "the Commissioner [of Taxation] cannot reduce the amount of the deduction simply because the expenditure is greater than the amount which would normally have been incurred by a prudent businessman."[45] However, where expenditure exceeds taxable income, or where it produces no income, this may mean that the reasons and motives of the taxpayer in incurring the expenditure will need to be

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[38] Tom Toryanik, *Australia – Corporate Taxation* ¶ 1.4.5., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (AUSTRALIA), http://ip-online.ibfd.org/kbase/ (by subscription) (last visited May 27, 2011). *See also* ITAA 1997 Div. 247.

[39] *Id.*

[40] ITAA 1997 ss 290-60, 290-150.

[41] *Id.* s 26-80.

[42] *Id.* s 26-85.

[43] Toryanik, *supra* note 38, ¶ 1.4.1. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 856.

[44] *Id.*

[45] *Id.* (referring to *Ronpibon Tin NL v. FCT; Tongkah Compound NL v. FCT* (1949) 4 AITR 236).

examined in order to determine whether it will be deductible. This exercise may lead to expenditure being apportioned "between that attributable to the pursuit of assessable income and that attributable to other aims."[46]

Negative gearing of investments is therefore possible in Australia[47] as long as borrowed funds are used for a genuine income-producing purpose, such as to obtain rent from an investment property, interest will be deductible even if it exceeds the actual income gained.[48] Any excess interest may therefore be used to offset other taxable income of the taxpayer.[49] However, if another purpose of the borrowing is established (such as a private purpose),[50] or where there is "no objective expectation that income will exceed interest over the life of the arrangement," interest will be not be deductible either as a whole or in part.[51]

B. Deductions for Exempt or Tax-Favored Income

The general rule contained in the second limbs of section 8-1 of the ITAA 1997, as set out above, means that "no deduction is available for interest on borrowings relating to the production of exempt income."[52] However, a deduction is allowed for interest incurred in relation to deriving foreign dividend income that is classified as non-taxable income under provisions relating to foreign non-portfolio dividends and dividends from previously attributed Controlled Foreign Corporation or Foreign Investment Fund income.[53]

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

A list of provisions that allow a tax offset (or rebate) for different income and personal situations is set out in section 13-1 of the ITAA 1997. This includes offsets arising from franked dividends[54] and foreign income tax offsets.[55] There do not appear to be specific rules denying or

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[46] *Id.* (referring to Taxation Ruling TR 95/33). *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 857, 962. See *supra* note 2 for an explanation of the meaning of "assessable income" in Australia.

[47] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 955. *See also Rental Properties 2009-10 – Negative Gearing*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237831.htm&page=17&H17 (last modified June 29, 2010).

[48] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 947, 962.

[49] Toryanik, *supra* note 38, ¶ 1.4.5. *See generally* Jim O'Donnell, *Quarantining Interest Deductions for Negatively Geared Rental Property Investments*, EJ. TAX. RESEARCH (2005), *available at* http://www.austlii.edu.au/au/journals/eJTR/2005/4.html#Heading9.

[50] Toryanik, *supra* note 38, ¶ 1.4.5 (referring to *Ure v. FCT* (1981) 11 ATR 484).

[51] *Id.* (referring to *Spassked Pty Ltd v. FCT (No 5)* (2003) 52 ATR 337).

[52] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 954. *See also* DEUTSCH ET AL., *supra* note 4, at 566 (referring to Taxation Ruling TR 2005/11). *See also* ITAA 1997 s 6-15 (notes).

[53] Toryanik, *supra* note 38, ¶ 1.4.5.

[54] *See You and Your Shares 2009-10: How Dividends Are Taxed*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237927.htm&page=5&H5 (last modified June 29, 2010).

[55] *See Guide to Foreign Income Tax Offset Rules 2009-10*, ATO, http://www.ato.gov.au/content/00238031.htm (last modified June 29, 2010).

limiting these offsets where deductions are available in relation to borrowing to finance the investment.[56]

D. Other Limits on the Deductibility of Interest for Private Investments

In addition to general anti-avoidance provisions in the legislation,[57] there are various provisions that may limit the deductibility of interest.[58] However, in relation to debt deductions incurred in deriving investment income, it appears that the rules (for example, thin capitalization rules) primarily relate to income obtained through business activities.[59]

III. Special Treatment of Other Debt

It appears that there is no additional special treatment for either the borrower or lender in relation to other household debt.

IV. Treatment of Cancelled Debt

The Australian legislation contains debt forgiveness rules that relate to "commercial debt."[60] A debt is "commercial" if "part or all of the interest payable on the debt is, or would be, an allowable deduction."[61] The rules are targeted at remedying the effective duplication of tax deductions that might otherwise arise. Such duplication could occur because, for example, a creditor may be entitled to a deduction when a debt is forgiven, while the debtor is not taxed on any gain arising from the debt being cancelled and could continue to claim deductions relating to undeducted expenditures.[62]

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[56] *See, e.g.*, *You and Your Shares 2009-10: Allowable Deductions from Dividend Income*, ATO, http://www.ato.gov.au/individuals/content.aspx?menuid=0&doc=/content/00237927.htm&page=12&H12 (last modified June 29, 2010).

[57] *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) Pt IVA. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 878. These provisions mean that the Commissioner of Taxation may reduce the amount of a deduction otherwise allowable under s 8-1 where a tax avoidance scheme is involved. The High Court has found that the anti-avoidance provisions applied to disallow the tax benefits obtained under a split-loan arrangement, i.e., where a mortgage had been split into both a home loan for a private residence and an investment loan to refinance a rental property. Toryanik, *supra* note 38, ¶ 1.4.5 (referring to *Federal Commissioner of Taxation v Hart and Anor* [2004] HCA 26).

[58] *See* DEUTSCH ET AL., *supra* note 4, at 778-79. *See also* AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 959.

[59] *See, e.g.*, *D16 – Other Deductions*, ATO, http://www.ato.gov.au/individuals/content.aspx?doc=/content/00217609.htm (last modified June 29, 2010) (containing information on debt deductions relating to foreign income).

[60] ITAA 1997 Div 245. A debt is defined for these purposes as "an enforceable obligation imposed by law on a person to pay an amount to another person, and includes accrued interest." DEUTSCH ET AL., *supra* note 4, at 779.

[61] *CGT and Debt Forgiveness*, ATO, http://www.ato.gov.au/content/36559.htm (last modified May 18, 2011). *See also* DEUTSCH ET AL., *supra* note 4, at 779.

[62] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 980.

Under the debt forgiveness rules, the amount of debt that is forgiven is applied to reduce certain deductions of the debtor.[63] Specifically, a forgiven amount may reduce, in the following order: a taxpayer's prior income year revenue losses; net capital losses from earlier years; deductible expenditure; and cost base and reduced cost base of assets.[64]

The commercial debt forgiveness rules do not apply where the debtor is a shareholder of the company. The forgiveness of the debt in these situations results in an amount being deemed dividends and therefore included in the taxable income of the debtor.[65] The waiver of a debt will also result in an amount being considered taxable income where it constitutes a fringe benefit provided to an employee.[66] In most other cases, an act of debt cancellation will not result in the amount forgiven being treated as ordinary income of the debtor.[67]

The commercial debt forgiveness rules also do not apply if the debt is forgiven as a result of an action under bankruptcy law, in a deceased person's will, or for reasons of natural love and affection.[68]

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[63] DEUTSCH ET AL., *supra* note 4, at 779. *See also* ATO ID 2003/27, *Commercial Debt Forgiveness: Applying Total Net Forgiven Amount – Individual Debtor* (Feb. 14, 2003), *available at* http://law.ato.gov.au/atolaw/view.htm?docid=AID/AID200327/00001.

[64] *CGT and Debt Forgiveness*, ATO, *supra* note 61.

[65] AUSTRALIAN MASTER TAX GUIDE, *supra* note 1, at 126-27.

[66] *Id.* at 980.

[67] Such a result did occur in a case where a company's debt was forgiven and the resulting gain was deemed to be inextricably linked to the trading activities of the company, but this is not a common outcome. Roger Timms and Weiran Wang, *The Application of the Commercial Debt Forgiveness Provisions*, THE TAXPAYER (Jan. 18, 2010), *available at* http://www.taxpayersassociation.com.au/docman/small-business/debt-forgiveness-provisions/details.html (click on "Download" at bottom of page).

[68] *CGT and Debt Forgiveness*, ATO, *supra* note 61.

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CANADA

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Canada does not allow deductions to be taken for interest paid on mortgages or other personal expenditures, with an exception for certain student loans. Canada does not offer tax incentives to lenders to make personal use loans. Canada does have a Home Buyers' Plan that allows taxpayers to borrow money from their Registered Retirement Savings Plan and Registered Educational Savings Plan accounts, which is designed to encourage persons to purchase homes and pursue educational opportunities. Contributions to Registered Retirement Savings Plans and Registered Educational Savings Plans are limited, but the use of these plans can result in substantial tax savings.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Deductions for interest paid for personal use purposes are not allowed in Canada,[1] with an exception for student loans, as discussed below.

1. Residential Mortgage Loans

Canada has never allowed interest paid on residential mortgage loans to be deducted in calculating taxable income. Former Prime Minister Joseph Clark planned to create a limited deduction in 1980, but his government was defeated before it could be implemented.[2]

2. Home Equity Loans

The Income Tax Act[3] (I.T.A.) does not contain any provisions for the deduction of interest paid on home equity loans.

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[1] *Line 221—Carrying Charges and Interest Expenses*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/221/menu-eng.html (last modified Jan. 5, 2011).

[2] Stephen Gordon, *Why Canadians Should Be Glad Joe Clark Lost the 1980 Election*, WORTHWHILE CANADIAN INITIATIVE (Feb. 25, 2009), http://worthwhile.typepad.com/worthwhile_canadian_initi/2009/02/why-canadians-should-be-grateful-that-joe-clark-lost-the-1980-election.html.

[3] Income Tax Act, R.S.C. ch. 1 (5th Supp. 1989), http://laws-lois.justice.gc.ca/eng/acts/I-3.3/index.html.

3. Auto Loans

Interest on auto loans is not deductible in Canada.

4. Credit Card Debt

Interest paid to credit card companies for personal purchases are not deductible in Canada.

5. Student Loans

In Canada, undergraduate tuition fees for Canadian residents vary from province to province and, to a lesser extent, from university to university and program to program. The range is from an annual low of approximately US$3,000 in Quebec to slightly over US$6,000 in Ontario for most resident undergraduates in most programs.[4]

Interest paid on a student loan received under the major student loan programs established by the federal and provincial governments in Canada is deductible.[5] If a taxpayer does not have income to offset in the year he or she pays interest on a student loan, he or she may carry the unclaimed amount forward for five years.[6] Interest on foreign student loans is not deductible,[7] however, and parents cannot deduct the interest they pay on their children's student loans.[8]

B. Incentives for the Lender

The I.T.A. does not contain special tax provisions designed to encourage lenders to make loans available for home mortgages, home equity investments, or autos. Credit card companies are not taxed at a special lower rate.

Student loan programs are government funded. Interest earned on student loans by federal and provincial governments is not taxed by those governments.

C. Related Tax Benefits or Subsidies

The major incentive Canada has to encourage home ownership is its Home Buyers' Plan (HBP). Under this plan, individuals can withdraw up to Can$25,000 (approximately US$25,556) from their Registered Retirement Savings Plan (RRSP) to "buy or build a qualifying home for

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[4] *Canada's Higher Education and Career Guide*, CANADIAN-UNIVERSITIES.NET, http://www.canadian-universities.net/Campus/Tuition-Fees.html (last visited June 1, 2011).

[5] *Line 319 – Interest Paid on Your Student Loans*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns300-350/319-eng.html (last modified Jan. 5, 2011).

[6] I.T.A. § 118.62.

[7] *Id.*

[8] CANADA REVENUE AGENCY, *supra* note 5.

[themselves] or a related person with a disability."[9] "Qualifying expenditures" are expenditures on housing units located in Canada or shares in a Canadian cooperative housing corporation.[10] Withdrawals from an RRSP must be repaid over a period of fifteen years.[11] Payments are in equal installments beginning with the second year following the withdrawal.[12] Failure to make an annual repayment will result in the amount due having to be declared as income because contributions to RRSPs, like contributions to Individual Retirement Accounts in the United States, are generally tax deductible up to certain limits.

The rules respecting RRSPs have become quite complex in recent years. The amount that a taxpayer can deduct from otherwise taxable income on account of contributions to an RRSP is called the taxpayer's "contribution room."[13] The Canada Revenue Agency calculates each taxpayer's contribution room for him or her. For 2010, the maximum RRSP deduction limit was Can$22,000 (approximately US$22,000).[14] However, unused contributions may be taken for the years 1991-2010 to greatly increase a taxpayer's contribution room.

Canada also has Registered Education Savings Plans (RESPs).[15] Under these plans, contributors or "subscribers" cannot deduct their contributions to a plan in the same manner that a taxpayer can deduct contributions to an RRSP. Income from the plans is paid to beneficiaries who are enrolled in a postsecondary school. This income, which may be in the form of interest, is taxable income to the beneficiary, but not to the subscriber.[16] Since most students do not pay income tax at high rates, RESP payments are usually subject to little, if any, income tax. Consequently, an RESP allows a parent, grandparent, or other older person to avoid taxation on income earned on money set aside for a child's education.

In addition, Canada has Registered Disability Savings Plans, which are generally similar to RESPs, but are only available to persons who are eligible for Canada's Disability Tax Credit.[17] Income earned by these plans is taxable in the hands of a beneficiary not when it is earned, but when it is paid out.[18] Again, the incentive is a tax savings through deferral rather than a reduction in tax on account of contributions, as in the case of an RRSP.

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[9] *Home Buyers' Plan (HBP)*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/hbp-rap/menu-eng.html (last modified Dec. 10, 2010).

[10] I.T.A. § 146.01.

[11] *Id*.

[12] *Repayments Under the Home Buyers' Plan (HBP)*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/hbp-rap/rpymnts/menu-eng.html (last modified Dec. 10, 2010).

[13] *How Much Can I Contribute and Deduct?*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/cntrbtng/lmts-eng.html (last modified Dec. 22, 2010).

[14] *Id*.

[15] I.T.A. § 146.1.

[16] *How an RESP Works*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/resp-reee/hw-eng.html (last modified Oct. 15, 2010).

[17] *Registered Disability Savings Plan*, CANADA REVENUE AGENCY, http://cwww.cra-arc.gc.ca/tx/ndvdls/tpcs/rdsp-reei/menu-eng.html (last modified Oct. 29, Oct. 29, 2010).

[18] I.T.A. § 146.4.

II. Deductibility of Debt Incurred to Finance Investments

Interest and dividends earned on private passive investment income must be included in income and is taxed at marginal rates unless it is received from a taxable Canadian resident corporation. Interest and dividends received from a taxable Canadian resident corporation are given a tax imputation credit on account of the fact that they have been paid out of after-tax earnings. The formulas for calculating tax imputation are very complicated, but their net effect is to tax interest and income received from taxable Canadian resident corporations at a rate that is very close to what the individual would pay if the income was a capital gain.[19] In Canada, 50 percent of capital gains must be included in income, and the total of other income and half of capital gains are taxed at marginal rates.[20]

Interest paid on money borrowed to earn passive income is a deductible expense.[21] Interest paid for the purpose of earning income from rental properties is a business expense and is also deductible. Interest on purchases that provide no income but can only produce a capital gain is not deductible.[22]

A. Annual Limits Relating to Investment Income

There are no limits on the amount of interest that can be deducted for the purpose of borrowing money to make passive investments to earn income.

B. Deductions for Exempt or Tax-Favored Income

As mentioned above, the interest on money borrowed to make passive investments to earn tax-favored eligible income is deductible.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

D. Other Limits on the Deductibility of Interest for Private Investments

N/A

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[19] *Line 120 – Taxable Amount of Dividends (Eligible and Other Than Eligible) from Taxable Canadian Corporations*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/rprtng-ncm/lns101-170/120/menu-eng.html (last visited June 1, 2011).

[20] *Capital Gains 2010*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-e.html (last visited June 1, 2010).

[21] *Carrying Charges and Interest Expenses*, CANADA REVENUE AGENCY, http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/221/menu-eng.html (last visited June 2, 2011).

[22] *Id*.

III. Special Treatment of Other Debt

N/A

IV. Treatment of Cancelled Debt

Canada's I.T.A. provides that cancelled debts must be included in income in two situations. The first of these applies to forgiven employee loans.[23] The second applies to shareholders.[24] The rationale for the first rule is to "prevent employees from avoiding taxes by simply arranging to receive part of their wages or salary as fringe benefits rather than [as] cash remuneration."[25] The rationale for the shareholder inclusion also appears to be to prevent loan forgiveness to be used to avoid income tax.[26]

Aside from the two cases noted above, Canada does not have a general rule that forgiven loans must be included in the income of an individual taxpayer.

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[23] I.T.A. §§ 6(1)(a), 6(15).

[24] *Id*. § 15(1.2).

[25] Canadian Tax Reporter (CCH) ¶ 2303.

[26] *Id*. ¶ 4664c.

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FRANCE

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

French tax law has a marked preference for the use of tax credits instead of deductions. The French General Tax Code provides for limited tax credits on interest for residential mortgages and student loans. The 2011 Finance Law, however, abolished the tax credit granted in respect of interest incurred for loans obtained for the purchase or construction of the taxpayer's main residence. The abolition of this tax credit is not retroactive. It has been replaced by enhanced zero-interest loans for first-time homebuyers. The tax credit is granted instead to banks that provide this type of loan. Tax credits are granted for energy-saving equipment and equipment for disabled elderly persons purchased for the principal residence of the taxpayer. France also has two types of home savings plans that have substantial tax advantages, and a tax credit for school expenses. As a general rule, interest paid on debt incurred to finance investments is not deductable. Instead, tax credits are granted on a percentage of the amount of the capital invested in certain types of investments irrespective of whether the capital was borrowed.

The French General Tax Code enumerates eight categories of income that are taken into account to determine the taxable income of an individual: industrial and commercial; professional; agricultural; real estate; investment; wages, salaries, pensions, and annuities; remunerations paid to majority shareholders of certain business organizations; and capital gains.[1] Each category is subject to various rules for calculating adjusted gross income and the resulting sums are then added together. Adjusted income is reduced by a few specifically authorized deductions. French tax law has a marked preference for the use of tax credits instead of deductions.[2]

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The French General Tax Code does not authorize an individual taxpayer to take a deduction for interest paid on the types of debts listed below. Instead, it provides for limited tax

[1] CODE GENERAL DES IMPÔTS [C.G.I.] art. 1A, *available at* LEGIFRANCE, http://legifrance.gouv.fr/ (*Les codes en vigueur*).

[2] FRENCH TAX & BUSINESS LAW GUIDE (Sweet and Maxwell) ¶ 32310.

credits on interest for residential mortgage loans and student loans. In addition, since enactment of the 2009 Finance Law there is a general ceiling on the use of tax deductions, tax credits, and other tax benefits. For the taxation of 2011 income, the tax benefit limitation is the sum of the two following amounts: €18,000[3] plus 6 percent of the taxable income subject to the progressive rate schedule. This limitation applies per fiscal household.[4] Some tax benefits are excluded from that ceiling. They include those connected to the personal situation of the taxpayer or contributions made by the taxpayer out of disinterested generosity such as charitable gifts.[5]

1. Residential Mortgage Loans

Taxpayers are entitled to a tax credit for the initial five-year period of the loan on loans concluded between May 6, 2007, and January 1, 2011, for the acquisition or construction of their principal residence. The credit is equal to 40 percent of the loan interest for the first twelve months then 20 percent for each of the remaining years. This credit, however, is limited to €3,750 per year for a single person and €7,500 for a couple. It is increased by €500 per year for each dependent. These limits are doubled where one member of the family (the taxpayer, one of the spouses, or one of the dependents) is disabled.[6]

The tax credit rate is reduced from 40 and 20 percent to 30 and 15 percent respectively for a principal residence built or acquired between January 1, 2010, and January 1, 2011, that does not meet the low energy consumption building standards.[7]

The tax credit is raised to 40 percent of the interest paid over the initial seven years for a principal residence purchased or built on or after January 1, 2009, where the residence meets the low energy consumption building standards. [8]

The loans must have been obtained from a financial establishment located in France or in one of the member states of the Economic European Area (EU members, Iceland, and Norway) that have entered into a fiscal convention with France containing an administrative assistance clause to fight fiscal fraud.[9]

The 2011 Finance Law abolished the tax credit for interest incurred on loan offers issued on or after January 1, 2011, for the purchase or building of the taxpayer's main residence and, where the loan offer was issued before that date, for houses purchased after September 30, 2011. The abolition of the tax credit is not retroactive. The tax credit is replaced by enhanced

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[3] At the current exchange rate, €1 is equal to approximately US$1.44.

[4] C.G.I. art. 200-0 A.

[5] *Id.*

[6] *Intérêts des prêts contractés pour l'habitation principale*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_051.html#dgibro.ir2011.ud51.171.7 (last visited May 27, 2011); C.G.I. art. 200 quaterdecies.

[7] *Id.*

[8] *Id.*

[9] *Id.*

zero-interest loans (*prêt à taux zéro plus*) issued under strict conditions.[10] (See also Part I(C), "Related Tax Benefits or Subsidies.")

2. Home Equity Loans

No deduction is allowed for interest paid on home equity loans.

3. Auto Loans

No deduction is allowed for interest paid on an auto loan. (See also Part I(C), "Related Tax Benefits or Subsidies.")

4. Credit Card Debt

No deduction is allowed for interest paid on credit card debt.

5. Student Loans

Students in France do not pay any tuition at the university level. University students may nonetheless benefit from an education tax credit for loans they obtained to finance other costs related to their studies if they obtained the loan between September 1, 2005, and December 31, 2008, and they were twenty-five years old or under on January 1 of the year in which the loan was issued. The tax credit is equal to 25 percent of the loan's interest for the initial five-year period of the loan. This credit, however, is limited to €1,000 per year. The student must be registered at a university and domiciled in France during the years he or she requests the tax credit.[11] (See also Part I(C), "Related Tax Benefits or Subsidies.")

B. Incentives for the Lender

As seen above, the tax credit that was granted to individuals on their mortgage interest has been replaced by a tax credit granted to banks that provide mortgages for qualifying low-income borrowers purchasing their first home with a zero interest loan.

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[10] Loi n° 2010-1657 du 29 décembre 2010 de finances pour 2011 [2011 Finance Law] art. 90, *available at* LEGIFRANCE, http://legifrance.gouv.fr/affichTexte.do;jsessionid=6ACD821A554DA9CC6E58ED4B902537B9.tpdjo04v_1?cidTexte=JORFTEXT000023314376&categorieLien=id#JORFARTI000023315060.

[11] *Intérêts des prêts contractés par les étudiants*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_053.html#dgibro.ir2011.ud53.177.21 (last visited May 27, 2011); C.G.I. art. 200 terdecies.

C. Related Tax Benefits or Subsidies

1. Principal Residence

Energy Saving Equipment

Investments by individuals in their personal residence for qualifying major household equipment, such as energy-saving and energy-producing heating systems and thermal insulation, that are made over a consecutive five-year period between January 1, 2005, and December 31, 2012, give rise to a tax credit equal to 15, 25, or 50 percent depending on the nature of the equipment.[12] These rates are reduced by 10 percent for the taxation of 2011 income by the 2011 Finance Law. The tax credit is 15 percent for low-temperature heating devices, 25 percent for equipment used to connect to certain renewable energy or cogeneration sources, and 50 percent for equipment that produces energy from renewable energy sources or from certain heat pumps. The total credit amount, however, is limited to €8,000 for a single person and €16,000 for a couple. It is increased by €400 for each dependent.[13]

Equipment for Disabled or Elderly Persons

The acquisition of equipment for disabled and/or elderly persons for the taxpayer's principal residence purchased between January 1, 2005, and December 31, 2011, also gives rise to a tax credit. For expenses incurred during the year 2010, the tax credit is equal to 15, 25, or 30 percent depending on the equipment. The overall limits of the tax credit are €5,000 for a single person and €10,000 for a couple. The limit is increased by €400 for each dependent.[14]

Enhanced Zero-Interest Loans

Enhanced zero-interest loans (*prêt à taux zéro plus*) are reserved for first-time homebuyers. The term "first-time homebuyers" is understood as covering buyers who did not own their main residence within the two years preceding the loan request or who are disabled or were victims of a catastrophe. The loan may either finance the purchase of a new or old dwelling or the construction of the taxpayer's residence.[15]

These loans are subject to means testing. The annual income ceilings depend on the make-up of the household and the geographic zone where the property is located. The amount of the loan granted depends on several criteria including, for example, the age of the property, the

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[12] *Dépenses en faveur de la qualité environnementale de l'habitation principale*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/lienBrochure.html?ud_049.html#dgibro.ir2011.ud49.162.1 (last visited May 27, 2011); C.G.I. art. 200 quater & 18 bis de l'annexe IV.

[13] *Id*.

[14] *Dépenses d'équipement de l'habitation principale en faveur d'aide aux personnes*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2009/brochures_ir2009/ud_057.html (last visited May 27, 2011); C.G.I. art. 200 quater A.

[15] MINISTERE DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT, LE PRET A TAUX ZERO (Jan. 2011), http://www.developpement-durable.gouv.fr/IMG/pdf/Plaquette_PTZ_.pdf.

income of the purchaser, and the make-up of the household. The repayment period depends on the income of the purchaser and can be from six years to twenty-two years. These loans are complementary funding and are granted as a supplement to the main mortgage loan. They are financed by credit establishments that have signed a convention with the state. The state grants the establishment a tax credit equivalent to the amount of the interest it would have earned.[16]

Home Savings Plans

The home savings plans (*plans compte d'epargne logement*) were established in 1965 to encourage private individuals to build up their savings for homeownership. There are two types of plans: the property savings account and the property savings plan.

- The property savings account is a deposit account with a deposit ceiling of €15,300. After eighteen months of saving, the holder of the account may obtain a loan of up to €23,000 with a below-market rate. The state also provides for a bonus of €1,144.[17]

- The property savings plan allows the holder to save up to €61,200 during four years at which time he may be granted a loan at a below-market rate for a maximum amount of €92,000.[18] The state also pays a bonus of €1,525.

In both cases, the below-market rate depends upon the rate of interest accrued during the period of saving. There is no tax payable on the interest that accrues while one is saving. This interest is also capitalized at the end of each year. If the amounts saved are then used for the intended purpose, they can be withdrawn free of income tax.[19]

2. Auto Loans

Taxpayers who acquire environmentally friendly cars are rewarded with a tax bonus of up to €5,000 (the amount depends on the CO_2 emission level) by way of a price discount.[20]

3. School Expenses

A tax credit for school expenses is granted to taxpayers residing in France whose dependent children are continuing their secondary or higher education. The amount of the tax

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[16] *Id*.

[17] *Compte épargne logement*, MINISTERE DU DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT (Sept. 17, 2010), http://www.developpement-durable.gouv.fr/Phase-epargne.html.

[18] *Plan épargne logement*, MINISTERE DU LOGEMENT DE L'ECOLOGIE, DU DEVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT (Sept. 17, 2010), http://www.developpement-durable.gouv.fr/spip.php?page=article&id_article=17909.

[19] MINISTÈRE DU LOGEMENT DE L'ECOLOGIE, DU DÉVELOPPEMENT DURABLE, DES TRANSPORTS ET DU LOGEMENT, *supra* notes 16 & 17.

[20] Marc Henderson, *France–Individual Taxation* ¶ 1.8.3.2, *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: EUROPEAN TAX ANALYSIS, http://online.ibfd.org/kbase/ (by subscription) (last visited Apr. 15, 2011).

credit is €153 for a student attending a high school and €183 for a child attending an establishment of higher learning.[21]

II. Deductibility of Debt Incurred to Finance Investments

Investment income (*revenus de valeurs mobilières*) is subdivided into two categories: dividends and interest. As a general rule, 40 percent of dividends received by an individual from a company subject to corporate income tax or equivalent tax whose registered office is located in France or in an other EU member state, or in a country that entered into a double taxation treaty with France containing an administrative assistance clause, is exempt from tax. An additional €1,525 for a single taxpayer or €3,050 for a married couple is also exempt from tax. The remaining dividends are subject to income tax at the ordinary tax rate. Expenses are not deductable. The taxpayer, however, may elect a 19 percent withholding tax.[22]

Interest on current accounts, loans, government and corporate bonds, and similar debt instruments are taxable at the ordinary tax rate. The taxpayer may also elect a 19 percent withholding tax. No further tax is due on dividends or interest where a withholding tax is paid. Interest on certain types of saving schemes—for example, home savings plans—are exempt from tax.[23]

France does not appear to favor the deduction of interest as an incentive for investment by individuals. It prefers instead to grant tax credits. Only the following instances of deductibility of interest for individual taxpayers could be found; some are borderline between investments and other categories of income:

- Part of the interest paid on a small business loan taken by an individual to purchase capital in a non-quoted company that gives the individual a majority of voting rights with the goal of allowing him/her to exercise the function of director. The General Tax Code allows the deduction of 25 percent of the interest up to €20,000 for a single person and €40,000 for married couples.[24]

- Interest on debts contracted for the conservation, acquisition, construction, reparation, or improvement of real property.[25] This deduction relates to the real estate income category.

- Interest on loans granted to French citizens for their reinstallation in France when returning from a stay abroad.[26]

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[21] C.G.I. art. 199 quarter F.

[22] *Id.* ¶ 1.5.1.

[23] *Id.* ¶ 1.5.2.

[24] *Intérêt d'emprunt pour reprise d'une société*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida 2011/ brochures_ir2011/ud_071.html (last visited May 27, 2011); C.G.I. art. 199 terdecies-0B.

[25] C.G.I. art. 31 I(d).

[26] *Id.* art. 156 II 1°.

- Interest paid in connection with loans taken for business purposes, which is deductable when accrued.[27] This deduction is found in the General Tax Code under industrial and commercial income.

A. Annual Limits Relating to Investment Income

There is no specific annual limit relating to investment income. As mentioned in Part I, there is a general ceiling on the use of tax deductions, tax credits, and other tax benefits. For the taxation of 2011 income, the tax benefit limitation is the sum of the following two amounts: €18,000 plus 6 percent of the taxable income subject to the progressive rate schedule. This limitation applies per fiscal household.[28]

B. Deductions for Exempt or Tax-Favored Income

N/A

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

Tax credits are granted on a percentage of the amount of the capital invested in certain types of investments irrespective of whether the capital was borrowed. Examples are provided below.

Small Business Investment Funds

Individuals are encouraged to invest in small business investment funds (*fonds d'investissement de proximité*) through a tax credit. These funds invest in small- or medium-sized enterprises within the geographic area specified by the mutual fund. The tax credit is equal to 25 percent of the amount invested in such funds, up to a limit of €12,000 for a single person and €24,000 for a married couple.[29]

Investments in Innovation Mutual Funds

The General Tax Code provides for a 25 percent tax credit to taxpayers who invest in specialized innovation mutual funds between calendar years 1997 to 2012. As above, the

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[27] *Id*. art. 39 I 1º.

[28] *Id*. art. 200-0 A.

[29] *Souscription au capital des FIP*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_068.html (last visited May 27, 2011); C.G.I. art. 199 tercedies OA, VI.

ceilings are €12,000 for a single person and €24,000 for a married couple. The taxpayer must hold his investment for at least five years to avoid recapture.[30]

Purchasing Shares in Certain Qualifying Small- and Medium-Sized Companies

Purchasing shares in certain newly created or already existing small- or medium-sized companies before December 31, 2012, entitles the taxpayer to a tax credit equal to 25 percent of the amount of his investment within an annual limit of €20,000 for a single person and €40,000 for a married couple. The taxpayer must hold his investment for at least five years or the credit will be recaptured.[31]

Similar tax credits are given for investments in overseas territories,[32] investments in residential premises intended for letting,[33] the purchase of shares in qualifying cinema and television production companies (SOFICAs),[34] the purchase of shares in finance companies for traditional fishing (SOFIPECHEs),[35] and investment in forests.[36]

IV. Treatment of Cancelled Debt

French tax law only contains debt forgiveness rules that relate to the industrial and commercial income category of the taxpayer. Under these rules, the taxpayer must include the amount of the debt forgiven in its profits.[37]

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[30] *Souscription au capital des FCIP*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_067.html (last visited May 27, 2011); C.G.I. art. 199 terdecies 0 A-VI bis, VI quater, VI quinquies.

[31] *Souscription au capital des PME*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_065.html (last visited May 27, 2011); C.G.I. art. 199 terdecies-OA-I to V.

[32] Henderson, *supra* note 20, ¶ 1.8.3.5.

[33] *Id*. ¶ 1.8.3.6.

[34] *Id*. ¶ 1.8.3.17.

[35] *Id*. ¶ 1.8.3.18.

[36] *Investissements forestiers*, MINISTÈRE DU BUDGET, http://doc.impots.gouv.fr/aida2011/brochures_ir2011/ud_063.html (last visited May 27, 2011); C.G.I. art. 99 decies H.

[37] II LAMY FISCAL, IMPOTS SUR LE REVENU § 610 (Lamy 2011).

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GERMANY

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Currently, Germany does not treat any interest from a personal, non-business-related loan as tax-deductible. Germany does not grant income tax deductions for interest on residential mortgages, student loans, or consumer loans. Germany, however, provides other tax benefits and subsidies for homeownership and education.

For owner-occupied housing, portions of the acquisition or improvement costs can be deducted under an incentive program for retirement savings, and states and municipalities provide various subsidies for low-income housing.

For education expenses, some tax deductions are granted. For students from low-income families, generous cash grants and loans with little or no interest are available. Moreover, most universities charge little or no tuition.

Since January 1, 2009, passive investment income is taxed with a final withholding tax and no interest or other expenses can be deducted from this withheld tax.

Interest or other expenses cannot be deducted if they are attributable to the generation of tax-exempt income.

German law does not treat the forgiveness of a personal debt that is not related to the taxpayer's business as earned income.

Explanatory Remarks – Definition of Income

The German Income Tax Code defines the income of individual taxpayers by enumerating seven categories of income. Receipts obtained by individuals are taxed only if they fall within one of the following income categories:

1. Income from agriculture and forestry;
2. Income from trade or business;
3. Self-employment income;
4. Employment income;
5. Investment income;

6. Income from rents and royalties; and
7. Specified types of other income (including gains from annuities and from miscellaneous contractual relationships).[1]

Income is computed within each category according to different rules, and the deductibility of interest and other expenses varies within these categories.[2] An individual's taxable income is the sum of the income from the different categories, minus miscellaneous personal deductions.[3]

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Interest paid on loans incurred for personal purposes is not tax-deductible, and this principle applies to residential mortgage loans, home equity loans, auto loans, credit card loans, and student loans. Expenses related to these private purposes fall into the category of living expenses for which no relief is granted to taxpayers,[4] unless the law specifically makes an exception from this principle.[5]

Until 1996, generous tax benefits for new homeowners were available. These, however, have been reduced over the last twenty-five years. (See Part I(C), below, "Related Tax Benefits or Subsidies"). Although student loans are not tax advantaged, relief for educational expenses is granted through tax deductions and other benefits. (See Part I(C), below, "Related Tax Benefits or Subsidies").

B. Incentives for the Lender

There are no specific tax advantages for the lenders of consumer loans, residential mortgages, or student loans.

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[1] Einkommensteuergesetz [EStG], *repromulgated* Oct. 8, 2009, BUNDESGESETZBLATT [BGBL.] I at 3366, *last amended by* Gesetz, Apr. 5, 2011, BGBL. I at 554, § 2.

[2] EBERHARD RICK ET AL., LEHRBUCH EINKOMMENSTEUER 89 (2006).

[3] Andreas Perdelwitz, *Germany – Individual Taxation*, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY SURVEYS, http://online.ibfd.org (by subscription) (last updated Apr. 1, 2011).

[4] EStG § 4(1).

[5] Deductible personal expenses are child care expenses; contributions to various social security or pension programs; contributions to various retirement savings programs (EStG § 4f & 10); donations to charity (EStG § 10b); and relief from various hardship situations, including educational expenses of dependants (EStG §§ 33–33b).

C. Related Tax Benefits or Subsidies

1. Housing

In the last twenty-five years, Germany has reduced the level of tax benefits and subsidies granted for individual homeownership. Significant income tax deductions were granted for the purchase or the construction of a taxpayer's home that was acquired before 1996. These amounted to a deduction of 6 percent of the cost of acquisition during each of the first four years following acquisition, and another 5 percent in each of the next four years, up to a maximum annual amount of approximately US$7,000 during the first four years and an annual maximum of approximately US$5,500 during the next four years.[6] Additional deductions were granted to homeowners with children.[7]

Under this scheme of granting tax relief to new homeowners, the deductibility of mortgage interest played a short and minor role for homes acquired between 1991 and 1994.[8] The provisions were restrictive and proved unpopular as compared to the other tax benefits that were available.[9]

In 1996, the tax benefits for homeownership were replaced by cash grants for lower- and middle-class homeowners.[10] Since January 1, 2006, the cash grant for homeowners is no longer given for new investments, but earlier investments will continue to enjoy the benefit until its scheduled termination after a maximum of eight years.[11]

Currently, income tax deductions are granted to homeowners who acquire or improve housing in urban planning areas or that qualify for historic protection. Over a nine-year period, close to one-half of such costs can be deducted.[12] In addition, tax credits or deductions for investments in owner-occupied dwellings are also granted within the framework of a subsidy program that encourages individuals to save for their retirement.[13] Altogether, these subsidies aim to replace, to some extent, the cash grants for homeownership that were abolished in 2006.[14]

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[6] Einkommensteuergesetz, in the repromulgated version of Aug. 8, 1961, and as in effect through April 28, 1997, § 10e; EStG § 52(14), as currently in effect.

[7] EStG, as in effect through Dec. 27, 1996, § 34e.

[8] EStG § 10e(6a).

[9] LUDWIG SCHMIDT, EINKOMMENSTEUERGESETZ 861 (27th ed. 2008).

[10] Eigenheimzulagengesetz [EigZulG], *repromulgated* Mar. 26, 1997, BGBL. I at 734, *as amended*.

[11] EigZulG § 9.

[12] EStG §§ 10f & 10g.

[13] Eigenheimrentengesetz, Aug. 1, 2008 BGBL. I at 1509. Currently, the deduction for retirement savings that can be used to deduct home acquisition costs is limited to a maximum amount of €2,100 (about US$3,040). *See* EStG § 10a.

[14] H. Nüssgens, *Selbst genutzte Wohnungsimmobilien werden in die Riester-Förderung einbezogen*, SOZIALE SICHERHEIT 259 (2008).

A few other federal subsidies are still being granted, among them, various opportunities to obtain subsidies for building savings contracts[15] that encourage potential homebuyers to save for several years before building or buying a home.[16] In addition, many states and local communities provide loans at subsidized interest rates for home purchases or improvements. These often employ preferences for young families; income limits and limits on the size of the subsidized housing also apply.[17]

2. Education

For several reasons the cost of higher education is less burdensome in Germany than in the United States. Most universities are owned and operated by the German states and they either charge no tuition or they limit tuition to about €500 (about US$650) per semester.[18] Moreover, a comprehensive federal program supports students from low-income backgrounds with cash grants and loans with little or no interest.[19] In addition, children qualify as dependents until age twenty-five if they are studying, and this grants to the parents an annual income tax-reducing allowance. Educational expenses for adults are also deductible up to certain limits.[20,]

II. Deductibility of Debt Incurred to Finance Investments

Private investment income is taxable income.[21] Until 2009, expenses incurred in the process of generating private passive investment income were deductible from the investment income,[22] and interest was one of the deductible expenses.[23] Since January 1, 2009, however, private investment income from securities has been taxed with a final nonadjustable withholding tax, and investment-generating expenses can no longer be deducted.[24]

Since 2009, the only tax benefit that accrues to the private investor is an income-reducing allowance of €801 (about US$1,050) of the annual investment income. This allowance is

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[15] Fünftes Vermögensbildungsgesetz, Mar. 4, 1994, BGBL. I at 406, *as amended*, § 8.

[16] Gesetz über Bausparkassen, *repromulgated* Feb. 15, 1991, BGBl I at 454, *as amended*, http://www.gesetze-im-internet.de/bausparkg/BJNR020970972.html.

[17] For Munich, *see* MÜNCHEN REFERAT FÜR STADTPLANUNG UND BAUORDNUNG, GEFÖRDERTER WOHUNUNGSBAU IN MÜNCHEN (Jan. 2011), http://www.muenchen.de/cms/prod2/mde/_de/rubriken/Rathaus/75_plan/06_stadtsanierung/pdf/mbt_e_vi.pdf.

[18] Verwaltungsgerichtshof für Baden-Württemberg, Feb. 16, 2009, No. 2 S 1855/7, available by subscription at the German legal database JURIS; *Hessen schafft Studiengebühren wieder ab*, FINANCIAL TIMES DEUTSCHLAND (June 3, 2008), available by subscription at the German legal database JURIS.

[19] Bundesausbildungsförderungsgesetz, *repromulgated* Dec. 7, 2010, BGBL. I at 1852.

[20] EStG §§ 10, 32.

[21] Section 20 of the Income Tax Code (EStG § 20) lists as taxable income what appears to be all conceivable forms of income from capital interest, dividends, related distributions, annuities, and other unspecified returns on capital.

[22] EStG § 9.

[23] RICK ET AL., *supra* note 2, at 732.

[24] EStG § 20(9), *as enacted by* Unternehmenssteuerreformgesetz 2008, Aug. 14, 2007, BGBl I at 1912.

doubled in the case of spouses filing jointly. The allowance combines the previous allowance of €750 (about US$925) that aimed at encouraging savings and another allowance of €51 (about US$75) that formerly was a non-itemized lump sum deduction for investment-generating expenses.[25]

A. Annual Limits Relating to Investment Income

N/A

B. Deductions for Exempt or Tax-Favored Income

Section 3c of the Income Tax Code provides that expenses are not deductible if they are incurred in relation to tax-exempt income.[26] This provision, however, appears to have little relevance for personal, non-business debt because none of it is deductible.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

N/A

IV. Treatment of Cancelled Debt

The cancellation of a private debt is not taxable income.[27] It does not fall within one of the statutorily defined income categories. In particular, cancellation of a debt could not result in income if it could be considered a gift.[28]

An individual taxpayer, however, who is self-employed or operates a business, farm, or forestry enterprise realizes a taxable profit when a debt is cancelled that relates to these income-generating activities.[29] Technically, such a discharge from indebtedness must be entered on the books as a gain, to be included in the computation of the annual business profit.[30] Yet even the discharge of a business-related debt is not a taxable receipt if the creditor forgave the debt for personal reasons, such as family relations.[31]

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[25] SCHMIDT, *supra* note 9, at 1729.

[26] EstG § 3c.

[27] Bundesfinanzhof, Mar. 12, 1970, No. IV R 39/69, BUNDESSTEUERBLATT II 518 (1970).

[28] SCHMIDT, *supra* note 9, at 1848.

[29] *Id*. at 204.

[30] EStG § 4.

[31] Bundesfinanzhof, Mar. 12, 1970, No. IV R 39/69, BUNDESSTEUERBLATT II 518 (1970).

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June 2011

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JAPAN

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

A tax credit for interest paid on housing loans is available for homeowners in Japan who bought a home with a mortgage and moved into it between 1991 and 2013. Homeowners may also claim a tax credit for certain remodeling expenses and for qualified new homes.

With regard to debt incurred to finance investments, interest expenses on the acquisition of shares may be deducted from dividend income. Japanese law does not appear to provide for special treatment for other household debt or for debt cancellation.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

The deductions that are allowed in calculating the taxable income of individuals are listed in Japan's Income Tax Law,[1] and expenses not listed therein are not deductible. Consequently, interest is not deductible if it is paid for the following types of loans:

1. Residential Mortgage Loans
2. Home Equity Loans
3. Auto Loans
4. Credit Card Debt
5. Student Loans

For interest paid on mortgage loans, however, a tax credit is granted (See Part I(C), below, "Related Tax Benefits or Subsidies.")

B. Incentives for the Lender

Japanese tax laws do not provide incentives for the lender.

[1] Shotokuzei hō [Income Tax Law], Law No. 33 of 1965, *last amended by* Law No. 71 of 2010, bk. 2, ch. 2, § 4 (arts. 72–88).

C. Related Tax Benefits or Subsidies

1. Residential Mortgage Loans

a. *Public Housing Financing System*

The Japanese government established its housing policy after the Second World War. As originally conceived, the policy had "three pillars":

(1) Homeownership promotion through low-interest loans provided by the Government Housing Loan Corporation (GHLC);

(2) Public rental housing for low-income people constructed by local governments with heavy subsidies from the central government; and

(3) Housing by the Housing Corporation for middle-income workers.[2]

The GHLC was abolished in 2007, and the Japan Housing Finance Agency (JHFA) was created and succeeded to GHLC's rights and obligations. The JHFA is an incorporated administrative agency owned by the government.[3] The JHFA does not provide loans directly to households except in special situations, such as houses rebuilt after a disaster.[4] Instead, it engages in the securitization business for housing loan products with a long-term, fixed interest rate, so that private financial institutions can more readily provide these loans.[5] Financial institutions that sell these housing loans are allowed to set their fee portions of the interest rates at their own discretion.

There are other public housing finance systems as well. Under the *Zaikei* (asset forming) Housing Savings System, workers who are employed by firms that participate in the System can make regular deposits to a participating financial institution for at least five years.[6] The deposit is made by the employer, who withdraws a set amount of money from the worker's salary and sends it to the financial institution.[7] Interest generated by the deposit is exempt from tax.[8] The deposit may be used only for the acquisition of a home. An eligible employee may borrow up to

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[2] Yosuke Hirayama, *Outline of Japanese Housing*, ASIA-PACIFIC NETWORK FOR HOUSING RESEARCH, THE JAPAN CHAPTER (Faculty of Human Development, Kobe University), http://www.edu.kobe-u.ac.jp/hudev-hiraken/apnhr/intro_apnhr.html (last visited May 27, 2011).

[3] JHFA has an English language website, at http://www.jhf.go.jp/english/index.html (last visited June 1, 2011).

[4] Dokuritsu gyōsei hōjin Jūtaku kin-yū shien kikō hō [JHFA Law], Law No. 82 of 2005, *last amended by* Law No. 79 of 2009, art. 13.

[5] *Id*.

[6] Kinrōsha zaisan keisei sokushin hō [Law to Promote Workers' Asset Forming], Law No. 92 of 1971, *last amended by* Law No. 26 of 2008, art. 6, para. 4.

[7] *Id*.

[8] Sozei tokubetsu sochi hō [Tax Special Measures Law], Law No. 26 of 1957, *last amended by* Law No. 12 of 2011, art. 4-2.

ten times the amount of the deposit (up to 40 million yen, or about US$490,000).[9] A public corporation, the Employment and Human Resources Development Organization of Japan (EHRD),[10] borrows money from participating financial institutions[11] and lends the money to the employers.[12] The employer then makes a loan contract with the employee. There are certain physical requirements for the home purchased.[13]

Local governments also provide housing loan support measures. In the past, many municipal governments had direct or indirect housing loan programs for eligible residents. It appears, however, that most of them abolished such programs due to financial difficulties.[14] There are still municipal governments that pay/reimburse a portion of housing loan interest for/to qualified residents, often for specific purposes. For example, in the 2011 fiscal year (ending March 31, 2012), the Tokyo Metropolitan government will pay 1 percent of the housing loan amount that was borrowed from designated financial institutions for ten years for qualified households that will demolish their homes in areas where homes made of wood are concentrated and rebuild fire-resistant homes.[15]

b. *Tax Credit*

i. Tax Credit for Housing Loan

A tax credit for interest paid on a housing loan is available for qualified homeowners who built or bought a qualified home and moved into it between 1991 and 2013.[16] The terms and maximum amounts of the tax credit vary depending on the year in which the homeowner moved in. The following requirements are based on the program applicable to homeowners who move into their homes during 2011. To qualify for the 2011 tax credit,

- the homeowner's taxable income must be 30 million yen (about US$370,000) or less;

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[9] Law to Promote Workers' Asset Forming, art. 9, para. 1; Kinrōsha zaisan keisei sokushin hō sekō rei [Enforcement Order of Law to Promote Workers' Asset Forming], Order No. 332 of 1971, *amended by* Order No. 58 of 2010, art. 33.

[10] The Organization does not have an English language website. Its website in Japanese is available *at* http://www.ehdo.go.jp (last visited June 1, 2011). Its *Zaikei* webpage is available *at* http://www.ehdo.go.jp/zaikei/zaikei.html (last visited May 27, 2011).

[11] Law to Promote Workers' Asset Forming art. 12.

[12] *Id*.

[13] *Id*.

[14] Jūtaku rōn jichitai yūshi tte? [What Is a Local Government Housing Loan?], Teishūnyū demo okane o tameru hōhō [Method to Save Money Even for Low-income People], http://money.fastingsky.com/2011/02/post_27.html (last modified Feb. 18, 2011).

[15] Heisei 23 nendo tōkyō to kojin jūtaku rishi hokyū josei no boshū [Opening of Housing Loan Interest Supplement by Tokyo Metropolitan Government], Tokyo Metropolitan Government, http://www.toshiseibi.metro.tokyo.jp/juutaku_seisaku/281buybuildB1.htm (last visited May 27, 2011).

[16] Tax Special Measures Law, Law No. 26 of 1957, *last amended by* Law No. 12 of 2011, art. 41, para. 1.

- the seller of the house may not be a spouse, family member, or other person who has a special relationship with the buyer/new owner;
- the homeowner must move into the house within six months from the date of purchase;
- the loan must be from a qualified loan provider;
- the term of the loan payment must be ten years or more; and
- the home must satisfy physical conditions that the Ministry of Finance Ordinance specifies.[17]

The amount of the tax credit is 1 percent of the amount of the loan as of December 31 of the applicable year, up to 400,000 yen (about US$4,900). The tax credit may be claimed for ten consecutive years as long as the owner continues living in the home and the taxable income of the owner is 30 million yen or less.[18]

There are variations to this tax credit system. When a person builds a house or buys a newly-built house that qualifies as a "long-lasting, high-quality home," more tax credit is available. This tax credit system varies by year. For example, if a person buys and moves into a qualified home during 2011, the amount of the tax credit is 1.2 percent of the amount of the home loan as of December 31 of the year, for a period of ten years. The maximum amount of the tax credit is 600,000 yen (about US$7,300) annually. This tax credit is available for people who buy a qualified home and move into it between June 4, 2009, and December 31, 2013. The amount of the tax credit will decrease for persons who move into a qualified home in 2012 and 2013 to 1 percent of the home loan.[19]

A tax credit is also available for certain housing loans for remodeling when the homeowner is fifty years old or older, needs daily living assistance, or is disabled, or lives with a family member who is sixty-five years old or older, needs daily living assistance, or is disabled and remodeling is undertaken to make these person's daily living easier (i.e., barrier-free).[20] Also, home insulation costs may be included in the remodeling fee if it is done at the same time as the barrier-free remodeling.[21] This tax credit is available for five years, and the amount of the tax credit is 2 percent of the loan of the first 2 million yen (about US$24,400) and 1 percent of the remainder, up to 8 million yen.

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[17] *Id*.

[18] *Id*. art. 41, para. 2, item 8.

[19] *Id*. art. 41, para. 5.

[20] *Id*. art. 41-3-2; Sozei tokubetsu sochi hō shikōrei [Tax Special Measures Law Enforcement Order], Order No. 43 of 1957, *last amended by* Order No., art. 26-4, para. 3.

[21] Tax Special Measures Law art. 41-3-2, para. 2; Tax Special Measures Law Enforcement Order art. 26-4, para. 7.

ii. Tax Credit for Housing Expense With or Without a Housing Loan

When a resident remodels his home to make it earthquake resistant or has an inspection of his home to measure how earthquake resistant it is under a local government's earthquake resistance project between April 1, 2009, and December 31, 2013, he or she may claim a credit against income tax of up to 200,000 yen (about US$2,440).[22]

When a person buys a newly-built home that qualifies as a "long-lasting, high quality home," 10 percent of the difference in cost (up to 10 million yen, or about US$122,000) between an ordinary home and a "long-lasting high quality home" may be deducted from income tax. When the person elects to claim a tax credit for the housing loan described in the previous section, the tax credit for newly-built homes cannot be applied, however.[23]

2. Home Equity Loans

N/A

3. Auto Loans

N/A

4. Credit Card Debt

N/A

5. Student Loans

N/A

II. Deductibility of Debt Incurred to Finance Investments

Interest expenses on the acquisition of shares may be deducted from dividend income.[24]

A. Annual Limits Relating to Investment Income

The amount of the interest expense deduction is limited to the amount of the investment income.[25] In other words, a taxpayer may not deduct a higher amount of interest than the annual income received from investments.

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[22] Tax Special Measures Law art. 41-19-2.

[23] *Id*. art. 41-19-4, para. 4.

[24] Income Tax Law, Law No. 33 of 1965, *last amended by* Law No. 71 of 2010, art. 24, para. 2.

[25] *Id*.

B. Deductions for Exempt or Tax-Favored Income

Japanese law does not have a provision that limits individual interest deductions on debt incurred to purchase or carry tax exempt income.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

It appears that there is no additional special treatment for either the borrower or lender in relation to other household debt.

IV. Treatment of Cancelled Debt

There is no provision in the Income Tax Law regarding treatment of debt cancellation. However, cancelled debt is treated as a gift under the Inheritance Tax Law, so a person may have to pay gift tax for a forgiven or cancelled loan.[26] Cancelled debt is not regarded as a gift if the debtor has lost assets and it is very difficult to pay off the debt.[27]

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[26] Sōzoku zei hō (Inheritance Tax Law), Law No. 73 of 1950, *last amended by* Law No. 6 of 2010, art. 8.

[27] *Id*.

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MEXICO

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

Residential mortgage loans are deductible under Mexico's tax regime, but other types of consumer debt apparently is not. Starting in fiscal year 2011, tuition paid to private schools (preschool through high school) may be deductible provided that applicable requirements are met. No information could be located concerning incentives for lenders. However, Mexico promotes its real estate market with incentives applicable to eligible Real Estate Investment Trusts. Expenses incurred by individuals to generate dividend income are not deductible. Cancelled debt is taxable.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

1. Residential Mortgage Loans

The amount of interest that is paid with respect to home mortgage loans contracted with financial system entities is deductible, as long as the amount of the mortgage loan does not exceed 1.5 million investment units[1] (equal to approximately US$588,978 as of June 3, 2011). Investment units "provide for a flexible currency unit to account for inflationary adjustments to Mexican currency."[2] Mexico's Central Bank (*Banco de México*) publishes the investment unit values periodically.[3] Financial institutions must inform the taxpayer, by February 15 of each year, of the amount of the interest paid in the tax year.[4]

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[1] Arturo Pérez Robles, *Mexico – Individual Taxation* ¶ 1.8.1.1., INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: COUNTRY ANALYSES (MEXICO), http://online.ibfd.org/kbase/ (by subscription) (last visited June 1, 2011). *See also* Ley del Impuesto sobre la Renta [hereinafter, Income Tax Law] art. 176-IV, *as amended*, Diario Oficial de la Federación [DO], Jan. 1, 2002, available on the website of Mexico's House of Representatives *at* http://www.diputados.gob.mx/LeyesBiblio/pdf/82.pdf.

[2] Jaime González-Bendiksen et al., Mexican Tax Guide (CCH) ¶ 6285.20, http://intelliconnect.cch.com (by subscription) (last visited June 1, 2011).

[3] *Id.*

[4] Pérez Robles, *supra* note 1, ¶ 1.8.1.1.

2. Home Equity Loans

No information could be located on the deductibility of home equity loans.

3. Auto Loans

The website of Mexico's Tax Administration Service indicates that investments in automobiles for personal use are not deductible.[5]

4. Credit Card Debt

No information could be located on the deductibility of credit card debt.

5. Student Loans

No information could be located on the deductibility of student loans. However, starting in fiscal year 2011, tuition paid to private schools (preschool through high school) may be deductible, provided that applicable requirements are met.[6] In addition, Mexico's Income Tax Law provides the following income exclusion applicable to education expenses:

> Yields on property held in trust are not considered income to the extent such yields are allocated … to finance the education of straight-line descendants through the bachelor's degree level, provided that the studies have official recognition.[7]

Public universities are mostly free in Mexico, although some charge low fees.

B. Incentives for the Lender

No information could be located concerning incentives for lenders. However, Mexico provides incentives to eligible Real Estate Investment Trusts, as follows:

> To promote the Mexican real estate market, a number of incentives are granted to investments in Mexican real estate investment trusts, mainly:

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[5] *Al deducir sus gastos* [*The Deduction of Expenses*], GOBIERNO FEDERAL, SAT (Servicio de Administración Tributaria), http://www.sat.gob.mx/sitio_internet/asistencia_contribuyente/principiantes/errores/36_756.html (last visited June 1, 2011).

[6] Decreto por el que se otorga un estímulo fiscal a las personas físicas en relación con los pagos por servicios educativos [Decree granting a tax incentive to individuals with regard to payments for educational services], DO, Feb. 15, 2011, available on the website of Mexico Department of Treasury, *at* http://www.shcp.gob.mx/lashcp/MarcoJuridico/documentosDOF/2011/febrero/decreto_15022011.pdf. *See also Mexico Politics: Private Education Now Tax Deductible*, ECONOMIST INTELLIGENCE UNIT (Mar. 11, 2011), http://www.eiu.com/index.asp?layout=VWArticleVW3&article_id=957877680&region_id=1510000351&country_id=1520000152&channel_id=210004021&category_id=&refm=vwCh&page_title=Channel+Latest&rf=0 (by subscription).

[7] González-Bendiksen et al., *supra* note 2, ¶ 2505.80. *See also* Income Tax Law art. 106.

- Deferral on the income tax applicable on the capital gain resulting from contribution of real estate to the trust.
- The trust is not required to make estimated income tax payments.
- Foreign pension and retirement funds enjoy an exemption for income generated by the assets contributed to the trust and income from the sale of the participation certificates issued by the trust.
- Exemptions also apply for nonresidents and individuals who sell publicly traded participation certificates issued by the trust.[8]

C. Related Tax Benefits or Subsidies

The following services are exempt from Value Added Tax:

> Commissions and other payments made by the borrower to the lender under a loan secured through mortgage for the acquisition, extension, construction, or repair of real property destined to residential purposes, except for those payments arising after the corresponding loan has been granted and for payments from the borrower to third parties.
>
> …
>
> Interest derived from mortgage credits or credits with a trust guaranty for the acquisition, extension, construction or repairing of real property intended for residential purposes.[9]

Mexico's federal government provides financial aid to eligible low-income individuals for the purchase or construction of a home.[10]

II. Deductibility of Debt Incurred to Finance Investments

Dividends

According to the International Bureau of Fiscal Documentation (IBFD), dividends are taxed as follows:

> Investment income is normally included in the individual recipient's taxable base. Dividends must be accrued as any other income for the individual. This person can credit against its annual income tax the income tax paid by the distributing company, provided that this income tax is considered accruable income and the individual has the certificate issued by the distributing company regarding the dividend.[11]

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[8] González-Bendiksen et al., *supra* note 2, ¶ 1330.10.

[9] *Id*. ¶ 5205. *See also* Ley del Impuesto al Valor Agregado [Value Added Tax Law] art. 15 (I), (X-d), *as amended*, DO, Dec. 29, 1978, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/77.pdf (last visited June 2, 2011).

[10] *Esta es tu Casa* [*This Is Your Home*], GOBIERNO FEDERAL, COMISIÓN NACIONAL DE VIVIENDA, http://www.conafovi.gob.mx/programas-estrategicos/tu-casa (last visited June 2, 2011).

[11] Ricardo León & Mariana Eguiarte, *Mexico – Individual Taxation* ¶ 1.5.1., IBFD: COUNTRY SURVEYS, http://online.ibfd.org/kbase / (by subscription) (last visited June 2, 2011).

The *Mexican Tax Guide* further states that

> No deductions are allowable against dividend income, which is includable with other ordinary income, on a gross basis. Dividends paid out by Mexican entities are subject to no withholding tax at all.[12]

Interest

With regard to the treatment of interest, the *Mexican Tax Guide* explains that

> Taxpayers are required to recognize as ordinary income the "real" interest received during the tax year and add it to all other ordinary income of the taxpayer generated in the tax year.[13]
>
> . . .
>
> When the inflation adjustment to determine the "real" interest … is greater than the interest received, the result is deemed a loss. The loss may be subtracted from the other ordinary income generated in the tax year, except for income from dependent personal services … and income from business and professional activities …. The part of the loss not subtracted in the tax year may be carried forward to the five following tax years until exhausted, adjusted for inflation … from the last month of the tax year in which incurred to the last month of the tax year in which applied, or from the last inflationary adjustment made to the last month of the tax year in which applied, as the case may be.[14]
>
> . . .
>
> Real interest is the amount by which the interest exceeds the inflationary adjustment.…[15]
>
> . . .
>
> All corporations and individuals paying interest to individuals is required to withhold and pay in the tax withheld. …
>
> The tax withheld is considered an estimated payment.[16]

Income from Real Property

The IBFD provides the following guidance with regard to the taxation of income from real property:

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[12] González-Bendiksen et al., *supra* note 2, ¶ 3165.

[13] *Id.* ¶ 3060.10.

[14] *Id.* ¶ 3060.30.

[15] *Id.* ¶ 3065.10.

[16] *Id.* ¶ 3070.10.

Rental income is taxed on its net amount, i.e. the gross rent received less related expenses (including the amount of the local property tax paid during the same tax year, maintenance expenses, construction and improvements, insurance premiums for insurance covering the immovable property, interest on loans to finance the acquisition of the property or construction of improvements). However, individuals may elect to deduct 35% of the rent as "constructive expenses" instead of deducting the substantiated expenses. All taxpayers can deduct the amount of the local property tax paid during the same tax year.[17]

A. Annual Limits Relating to Investment Income

N/A

B. Deductions for Exempt or Tax-Favored Income

N/A

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

N/A

III. Special Treatment of Other Debt

No information could be located on this topic.

IV. Treatment of Cancelled Debt

Pursuant to Mexico's Income Tax Law, "[t]he amounts forgiven by the creditor and the debts paid by a third party on the taxpayer's behalf"[18] are taxable income.[19]

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[17] León & Eguiarte, *supra* note 11, ¶ 1.5.2.

[18] González-Bendiksen et al., *supra* note 2, ¶ 3200.10.

[19] Income Tax Law art. 167(I).

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UNITED KINGDOM

TAX TREATMENT OF HOUSEHOLD DEBT

Executive Summary

There are very few tax deductions that are permitted for household debt in the United Kingdom. Residential mortgage interest relief was removed in 2000. There are limited circumstances in which interest from loans may be deducted for tax purposes.

I. Debt Incurred for Certain Personal Use Purposes

A. Deductions for Interest Paid

Tax deductions for interest paid in the United Kingdom (UK) have been severely restricted over the past twenty years. There are currently a very limited number of loans for which a deduction[1] may be taken on interest paid.[2]

1. Residential Mortgage Loans

The deduction for interest paid on residential mortgages (known in the UK as Mortgage Interest Relief) was withdrawn as of April 6, 2000.[3]

Individuals that own property that is rented out may deduct interest paid on the mortgage for that property as a business expense.[4]

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[1] Deductions, where applicable, are provided on the net income of the tax year in which the interest payment was made. Income and Corporation Taxes Act 1988, c. 1, § 353.

[2] BRITISH MASTER TAX GUIDE 2010-11, ¶ 1884.

[3] Telephone conversation with Inland Revenue, July 6, 2011, at 7:40am. *See also Mortgage Interest Relief*, HM REVENUE AND CUSTOMS, http://www.hmrc.gov.uk/stats/mir/intro.pdf (last visited May 11, 2011); Inland Revenue, *Withdrawal of Mortgage Interest Relief* (Mar. 1999), http://archive.treasury.gov.uk/budget/1999/nr/ir2.txt.

[4] Alan Holmans, Christine Whitehead & Kathleen Scanlon, Fiscal Policy Instruments to Promote Affordable Housing (Cambridge Centre for Housing and Planning Research, 2002), *available at* http://eprints.lse.ac.uk/29958/1/Fiscal_policy_instruments_to_promote_affordable_housing_%28LSERO%29.pdf. *See also* HM REVENUE AND CUSTOMS, *supra* note 3.

2. Home Equity Loans

There are no current tax deductions for interest paid on home equity loans. However, relief is provided for loans that were taken out before April 1988 for the improvement of a property that is the only, or main, residence of the borrower.[5]

3. Auto Loans

There are no tax deductions available for interest on loans taken out to purchase a personal vehicle.

4. Credit Card Debt

There are no deductions available for interest paid on credit card debt.[6]

B. Incentives for the Lender

There appear to be no tax incentives for lenders responsible for financing residential mortgage loans, home equity loans, auto loans, or credit card debt.

C. Related Tax Benefits or Subsidies

1. Student Loans

Student loans for UK students are provided through the Student Loans Company.[7] This is a Non-Departmental Public Body, which administers government funded loans on a not-for-profit basis to students across the UK.[8] The interest rate payable on these loans is subsidized by the UK government and set to the rate of inflation.[9] When these loans become due, they are payable through the tax system, and no tax deductions are permitted for either the interest or the payments.

2. Subsidies for the Purchase or Construction of a New Home

In terms of home ownership, the majority of tax incentives in the UK are geared towards ensuring that housing is affordable and accessible to all sectors of the population. For example, the transfer tax (known in the UK as Stamp Duty Land Tax), which applies to the purchase of a

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[5] HM REVENUE AND CUSTOMS, *supra* note 3.

[6] Her Majesty's Revenue and Customs, Helpsheet 340: Interest and Alternative Finance Payments Eligible for Relief on Qualifying Loans and Alternative Finance Arrangements 2 (2011), *available at* http://www.hmrc.gov.uk/helpsheets/hs340.pdf.

[7] Teaching and Higher Education Act 1998, c. 30, http://www.legislation.gov.uk/ukpga/1998/30/section/22; *Welcome*, STUDENT LOANS COMPANY, http://www.slc.co.uk/ (last visited May 18, 2011).

[8] *About Us*, STUDENT LOANS COMPANY, http://www.slc.co.uk/about%20us/index.html (last visited May 18, 2011).

[9] Teaching and Higher Education Act 1998, c. 30; *Welcome*, STUDENT LOANS COMPANY, *supra* note 8.

home, is waived if the home is below £125,000 (approximately US$160,000) for all home purchases, or £150,000 (approximately US$210,000) in specified disadvantaged areas.[10] First-time homebuyers are exempt from the transfer tax on properties up to £250,000 (approximately US$400,000) if purchased between March 25, 2010, and 25 March 2012.[11]

For the construction of new homes, as well as certain cases where buildings are converted or renovated, any Value Added Tax (VAT) (sales tax) that would be payable, which is currently rated at 20 percent, is zero rated. This applies to the labor and material costs used in constructing or renovating these buildings. VAT is chargeable at the standard rate of 20 percent if the home is to be used as a vacation home, or the buyer cannot live in it year round or use it as their private residence.[12]

Individuals that provide social housing may receive funding for the construction or purchase and rehabilitation of rental units from the Housing and Communities Agency,[13] a non-departmental government body, and Local Authorities (local government). These are funded by the central government and Local Authorities, respectively.

The government further offers a "Homebuy" program, through which a reduced fee loan provides for up to 30 percent of the value of a home for households that make under £60,000 (approximately US$96,000) per year and are either first-time homebuyers or are currently renting a council or housing association property and purchasing a house in a specified area.[14] This is known as an "equity loan" and becomes payable after five years. Fees are charged in the sixth year and are currently 1.75 percent of the loan's value, which increases each year by the Retail Price Index (RPI) plus 1 percent.[15]

II. Deductibility of Debt Incurred to Finance Investments

Income derived from dividends, interest, royalties, and immovable properties are all considered investment income, which is taxable under UK's income tax regime. According to the British Tax Guide, "income tax is charged on the full amount of the interest arising in the tax year. The person liable to tax is the person entitled to or receiving the interest."[16] Moreover, unless they are subject to a tax exemption, dividends and other distributions from a company are

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[10] Finance Act 2003, c. 14, § 57 & sch. 6. *See also Stamp Duty Land Tax Rates and Thresholds*, HM REVENUE AND CUSTOMS, http://www.hmrc.gov.uk/sdlt/intro/rates-thresholds.htm (last visited May 21, 2011).

[11] Finance Act 2010, c. 13, § 6.

[12] Her Majesty's Revenue and Customs, Notice 708: Building and Construction (Feb. 2008), http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000513#P341_32640.

[13] *Our Funding*, HOMES AND COMMUNITIES AGENCY, http://www.homesandcommunities.co.uk/ourwork/our-funding (last visited May 25, 2011).

[14] *Low-Cost Home Ownership Schemes – A Guide*, DIRECT.GOV, http://www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/HomeBuyingSchemes/DG_4001347 (last visited May 31, 2011).

[15] *Equity Loans – How They Work*, DIRECT.GOV, http://www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/HomeBuyingSchemes/DG_171504 (last visited May 31, 2011).

[16] RAY CHIDELL & TREVOR JOHNSON, BRITISH TAX GUIDE: INCOME TAX 2010 at 269 (2010).

"generally chargeable as savings and investment income,"[17] irrespective of whether the source is a UK or non-UK company.

Deductions on interest payments on loans procured, *inter alia*, for investment purposes are deductable, however, only "in respect of certain specified loans."[18] According to the International Bureau of Fiscal Documentation Country Analysis for the UK,

> Interest paid by an individual is allowable as a general deduction from income if it is:
>
> - Loan interest, whether annual interest or not, but excluding interest on a bank overdraft and credit card interest, and
> - For a specified purpose.[19]

Under Part 8, Chapter 1 of the Income Tax Act 2007 (ITA 2007),[20] the purposes of the loans for which interest expenses can be deducted are listed as follows:

- To buy plant or machinery for partnership use
- To buy interest in closed company
- To buy interest in employee-controlled company
- To invest in a partnership
- To invest in a co-operative
- To pay inheritance tax.[21]

Interest payments on a loan used to purchase a life annuity are also tax deductable where certain conditions are satisfied. These include, *inter alia*, where the borrower is age 65 or over, and where the loan was taken out before March 9, 1999.[22]

A. Annual Limits Relating to Investment Income (and Other Limits on the Deductibility of Interest for Private Investments)

There do not appear to be any annual limits on deductions for interest payments with respect to loans for investment purposes under UK's income tax regime. However, schedule 30

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[17] *Id*. at 282.

[18] Belema Obuoforibo, *United Kingdom–Corporate Taxation* ¶ 1.8.1.1., *in* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION [IBFD]: EUROPEAN TAX SURVEYS, http://ip-online.ibfd.org/kbase/ (last visited May 31, 2011).

[19] *Id*.

[20] Income Tax Act 2007, c. 3, *available at* http://www.legislation.gov.uk/ukpga/2007/3 (last visited May 31, 2011).

[21] HM Revenue & Customs, Savings and Investment Manual – SAIM10010 – Relief for Interest Paid: Introduction, http://www.hmrc.gov.uk/manuals/saimmanual/saim10010.htm (last visited May 7, 2011).

[22] CHIDELL & JOHNSON, *supra* note 17, at 65.

of the Finance Act 2009[23] introduced rules to the ITA 2007 that aimed to deny tax relief for loan arrangements "if the main purpose of the arrangements is to avoid tax."[24] Under section 384A of the ITA, tax relief with respect to interest payments is disallowed where loan arrangements are

> very likely to produce a "post-tax advantage," and the arrangements seem to have been made in order to reduce what would have been the borrower's income tax or capital gains tax liability (or such liability of a person in similar circumstances to the borrower), had the arrangements not been made.[25]

According to the European law firm, Field Fisher Waterhouse, the restriction is aimed at

> … schemes structured to utilise tax relief for interest paid to ensure that the borrower investor is virtually guaranteed to make an after-tax profit. This can arise where, for example, arrangements give rise to a payment to the borrower which, together with the amount of the tax relief from the borrower's interest payments, is equal to or more than the amount needed to meet the borrower's obligations under the loan.
>
> The new restriction denies tax relief for interest paid where the loan in question is made as part of arrangements "*which appear very likely to produce a post-tax advantage.*" A "*post-tax advantage*" will arise where an amount becomes payable to the borrower (or a connected person) or for the borrower's benefit which, taking into account the tax relief which would otherwise be available, equals or exceeds the borrower's obligations under the loan. The test is applied objectively and applies whether or not obtaining tax relief is a main purpose of the underlying transaction. Where the restriction applies, *no* interest deduction is allowed under section 383 ITA.[26]

Under section 384(2) of the ITA 2007, interest payments on a loan are also ineligible for deductions if they exceed a "reasonable commercial" amount. According to the British Tax Guide "a 'reasonable commercial' amount of interest on the loans for the relevant period is an amount which, together with any interest paid before that period (other than unrelieved interest) represents a reasonable commercial rate of interest from the date the loan was made to the end of that period."[27] The interest "representing the excess is not eligible for relief."[28]

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[23] Finance Act 2009, c. 10, sch. 30, *available at* http://www.legislation.gov.uk/ukpga/2009/10/schedule/30 (last visited May 31, 2011).

[24] CHIDELL & JOHNSON, *supra* note 17, at 57.

[25] Obuoforibo, *supra* note 19, ¶ 1.8.1.1.

[26] *Tax Update – Anti-Avoidance Targets 'Post-Tax' Advantages*, FIELD FISHER WATERHOUSE (May 2009), http://www.ffw.com/publications/all/alerts/anti-avoidance-targets.aspx (emphasis in the original).

[27] CHIDELL & JOHNSON, *supra* note 17, at 57.

[28] *Id.*

B. Deductions for Exempt or Tax-Favored Income

In the UK, "there is no general principle barring a deduction of expenses related to exempt income—it's all a matter of statutory interpretation for each category of income."[29] Nor does there appear to be any general rule that restricts deductions of interest expenses incurred to produce tax-advantaged income.

C. Non-Applicability of Tax Benefits in Lieu of Denying Exemption

There do not appear to be any rules under UK's income tax regime that would limit other tax benefits with respect to tax-exempt income.

III. Special Treatment of Other Debt

Other than the items specified above there appears to be no other special treatment for other debt in the UK.

IV. Treatment of Cancelled Debt

Under the UK's income tax regime, cancelled debt is treated as income only in specific circumstances. According to Ault & Arnold:

> The *United Kingdom* continues to have restrictive rules on cancellation of indebtedness income. In general, income arises only if the loan was employment-related, made to a shareholder of a closely held corporation, or involved a liability that had previously been deducted (e.g., in the business income context).[30]

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June 2011

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[29] HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 292 (2010).

[30] *Id.* at 227 (emphasis in original).