

**ETHICAL AND PUBLIC POLICY ISSUES IN TAX
LEGISLATION: THE CASE OF THE FIRST-TIME
HOMEBUYER TAX CREDIT**

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Abstract

This paper discusses the provisions of the first-time homebuyer tax credit by comparing them with the provisions of other tax credits. Desirable attributes for tax systems are also stated and defined. While the first-time homebuyer tax credit may be stimulating the housing market as designed, it violates the desirable attributes of good tax policy. Ethical and public policy implications are given.

INTRODUCTION

Federal income tax laws are often legislated with social or public policy objectives in mind. The first-time homebuyer tax credit was established by the Housing and Economic Recovery Act of 2008¹, signed by President Bush on July 30, 2008. The credit was amended by the American Recovery and Reinvestment Act of 2009, signed by President Obama on February 17, 2009.² The credit was amended again by the Worker, Homeownership, and

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¹ Public Law 110-289.

² Public Law 111-005.

Business Assistance Act of 2009, signed into law by President Obama on November 6, 2009.³

Because the amendments to the credit made in 2009 are effective for different time periods and do not affect the credit for homebuyers in 2008, both the original provisions and each set of amendments are relevant to this paper. The provisions for 2008 are applicable to first-time homebuyers who purchased a home after April 8, 2008 but by the end of that year. The amendments made in February 2009 apply to first-time homebuyers who purchased a home in 2009 before November 6. The amendments made in November 2009 apply to first-time homebuyers who buy homes from November 6, 2009 through April 30, 2010.

While some taxpayers who have taken advantage of this credit may have purchased a home even without the credit as an incentive, many taxpayers have purchased homes specifically because of the advantages offered by the government under this tax credit. However, many ethical and public policy issues arise when the income tax system is used to motivate certain behaviors. The next section will discuss the provisions of the first-time homebuyer tax credit by comparing them with provisions of other tax credits. The following section will discuss desirable attributes for tax systems. Some ethical and public policy issues related to the first-time homebuyer credit will then be discussed in relation to how well the provisions of the first-time homebuyer tax credit meet the desirable attributes for tax systems.

TAX CREDIT PROVISIONS

Exclusions, deductions, and exemptions reduce gross income in calculating taxable income. Thus, they provide a tax benefit by reducing the amount of income that would otherwise be taxable. Tax credits actually reduce a taxpayer's tax liability after the appropriate tax rates have been applied to taxable income. This section discusses some of the characteristics that can be associated with different personal tax credits and gives examples to illustrate.

³ Public Law 111-92.

The provisions of the first-time homebuyer credit are also explained. Most of the provisions of this credit are similar to those of the other credits mentioned, although the provisions are applied differently.

Nonrefundable and Refundable Credits

Nonrefundable credits can only reduce the tax liability down to zero. They are subtracted on Form 1040 in arriving at the amount of taxes owed, but if the total of the nonrefundable credits is greater than the sum of the regular and alternative minimum taxes, the tax liability is zero rather than some negative amount. Some examples of nonrefundable credits include the credit for child and dependent care expenses,⁴ the adoption tax credit,⁵ and the child tax credit.⁶

Some of the nonrefundable credits can be especially problematic for low-income taxpayers because the taxpayers may not have much or any income tax liability to offset with credits.⁷ These low-income taxpayers may not get the tax benefit they had expected. Perhaps with this problem in mind, some of the nonrefundable credits have special provisions. The adoption tax credit is nonrefundable but can be carried forward for up to five

⁴ Internal Revenue Code (IRC), Section 21.

⁵ IRC, Section 23. In 2010, legislation was passed which made the adoption tax credit refundable for 2010 and 2011 (moving the adoption tax credit to IRC, Section 36C), but the original provisions of the nonrefundable adoption tax credit are discussed in this paper, as they were in effect up through 2009.

⁶ IRC, Section 24.

⁷ Black, Katherine D. and Sheldon R. Smith, "Dependent Care Tax Benefits: A Sham and a Scam," *Tax Notes*, Volume 113, Number 2, October 9, 2006, pp. 175-180; Smith, Sheldon R., "The Adoption Tax Credit: Problematic Implications for Low-Income Taxpayers," *Journal of Accounting, Ethics & Public Policy*, Volume 7, Number 3, 2007, pp. 329-349; Smith, Sheldon R. and Katherine D. Black, "Dependent Care Tax Benefits: Ethical Issues in Taxation," *Journal of Accounting, Ethics & Public Policy*, Volume 9, Number 1, 2008, pp. 21-38; Smith, Sheldon R., Katherine D. Black, and Lynn R. Smith, "Ethics in Federal Income Tax Legislation: Expectations vs. Reality for Low-Income Taxpayers," *Journal of Accounting, Ethics & Public Policy*, Volume 9, Number 3, 2008, pp. 371-393.

years, allowing a longer time period for taxpayers to use this credit.⁸ The child tax credit is nonrefundable, but under certain circumstances, part or all of it can become refundable. Even so, the limitations on the nonrefundable credits may work against some low-income taxpayers.

Refundable credits can reduce the tax liability below zero and result in a payment to the taxpayer for amounts never withheld or paid. Refundable credits are included on Form 1040 as payments. Thus, if the total payments, including refundable credits, are more than the tax liability, the difference is paid to the taxpayer. Examples of refundable credits are the earned income tax credit⁹ and the additional child tax credit.¹⁰

The earned income credit is not only refundable but can also be received in advance during the year. Employees can have their employers reduce their withholding for each pay period by a portion of the earned income credit that will be claimed for the year.¹¹ Employees who otherwise have no withholding may even have an advance portion of the earned income credit added back to their paychecks. This provision allows the taxpayers to get the benefit of the credit on an ongoing basis rather than having to wait until after filing the annual tax return in the next calendar year.

The additional child tax credit is the portion of the child tax credit that becomes refundable in certain situations. This credit can be partially or completely refundable to the extent that a taxpayer's earned income exceeds 15 percent of a threshold amount.¹² The threshold amount increases over time through indexing. For 2009, the amount under normal indexing would have been \$12,550.¹³ However, as part of the economic stimulus

⁸ For 2010 and 2011, the adoption tax credit is refundable, so no carryforward period is needed adoption tax credits claimed in these years.

⁹ IRC, Section 32.

¹⁰ IRC, Section 24.

¹¹ IRC, Section 3507.

¹² IRC, Section 24.

¹³ Internal Revenue Service, Internal Revenue Bulletin: 2008-45, Rev. Proc. 2008-66., November 10, 2008.

bill passed in 2009,¹⁴ the threshold amount is only \$3,000 for 2009 and 2010, thus allowing more low-income taxpayers to benefit from the child tax credit.

The first-time homebuyer credit,¹⁵ under all of its versions, is also a refundable credit. A first-time homebuyer is defined as someone who has not had a present ownership interest in a principal residence for the three years prior to the purchase for which the credit is to be claimed. First-time homebuyers, even those with no existing tax liability, can take advantage of this tax benefit. Because this credit is refundable, all those who qualify for the credit, including low-income taxpayers, will receive a tax benefit equal to the full credit for which they qualify.

Dollar Limitations

Some credits have a specific dollar limitation stated in the tax code, with or without indexing of that amount. For example, the child tax credit is limited to \$1,000 per qualifying child. Although this limit has increased to \$1,000 per child from lower amounts when the child tax credit was first legislated, the amount is not automatically indexed.

The adoption tax credit also has a dollar limit. When originally legislated, the adoption tax credit was limited to \$5,000 per adoption.¹⁶ However, subsequent legislation increased the limit to \$10,000 per adoption and added an indexing provision.¹⁷ Because of increases due to the indexing and legislative adjustments, the dollar limit for the adoption tax credit is \$13,170 for 2010.¹⁸

The dollar limit on the first-time homebuyer credit for homes purchased on or after April 9, 2008 and before January 1, 2009 is \$7,500. However, the amendments to this credit increased

¹⁴ Public Law 111-005.

¹⁵ IRC, Section 36.

¹⁶ Public Law 104-188.

¹⁷ Public Law 107-16.

¹⁸ Internal Revenue Service, Internal Revenue Bulletin: 2010-42, Rev. Proc. 2010-35, October 18, 2010.

the amount to \$8,000 for home purchased after January 1, 2009. The November 6, 2009 amendments also added a credit for repeat buyers, those who had owned a principal residence for at least five consecutive years in the last eight years and replaced it with another home. The dollar limit for these repeat buyers is limited to \$6,500. The limits apply to both single and married taxpayers. However, if married taxpayers file separately, each is limited to one-half of the total. In addition, if two or more unmarried individuals jointly purchase a principal residence, the total credit available to all parties cannot exceed \$7,500 for 2008 or \$8,000 for 2009 and 2010 (or \$6,500 for repeat buyers starting November 6, 2009).¹⁹

The large dollar limit on this credit does not cause any problem for taxpayers with little or no tax liability since it is refundable. Thus, legislators had no need to consider a carryforward provision as was legislated for the adoption tax credit which was nonrefundable up through 2009.

Credit Percentage and Base

Many of the credits are calculated as a certain percentage of a base amount. The base might be something such as a certain expense incurred by the taxpayer. For example, the dependent care credit can be as much as 35 percent (or as little as 20 percent) of the base amount. The base for this credit is the amount of dependent care expenses incurred so that the taxpayer can be gainfully employed. The maximum dependent care cost that can be considered for the credit is \$3,000 if the taxpayer has one qualifying dependent or \$6,000 if the taxpayer has two or more qualifying dependents.²⁰ Thus, even though this tax code section does not include a direct dollar limit, the maximum credit possible would be \$2,100 for someone who had two or more qualifying dependents, incurred at least \$6,000 of qualifying dependent care expenses, and qualified for the 35 percent credit.

¹⁹ IRC, Section 36.

²⁰ IRC, Section 21.

The earned income credit percentage depends on whether the taxpayer has no qualifying child (7.65 percent), one qualifying child (34 percent), or two or more qualifying children (40 percent). The 2009 economic stimulus bill²¹ created a new, temporary category for those with three or more qualifying children. For 2009 and 2010 taxpayers with three or more qualifying children can get an earned income credit of 45 percent. The base is the amount of earned income the taxpayer has. However, once a taxpayer has reached a certain earned income amount, the credit stays constant over a range of earned income rather than continuing to increase; at an even higher earned income level, the credit is then decreased as earned income continues to increase.²²

The adoption tax credit is a 100 percent credit. The base is the amount of qualifying adoption expenses incurred. However, for adoptions of children with special needs, no base exists. Instead, the credit is available even if no adoption expenses were incurred.²³

The child tax credit is not calculated as a percentage of some base amount. It is simply the dollar amount mentioned above--\$1,000 per qualifying child.²⁴ So while some credits are calculated on a base of an amount of expenses, some credits such as the child tax credit or the adoption tax credit for adoptions of children with special needs require no specific expenses.

The first-time homebuyer credit is a 10 percent credit based on the amount spent for a principal residence in the United States.²⁵ In this case, the base is a specific capital expenditure item rather than a specific expense item. Since the credit is a 10 percent credit, if a married couple filing jointly were first-time homebuyers on April 20, 2009, purchasing a small home in a rural area for \$60,000, they would only qualify for a \$6,000 first-time

²¹ Public Law 111-005.

²² IRC, Section 32.

²³ IRC, Section 23.

²⁴ IRC, Section 24.

²⁵ IRC, Section 36.

homebuyer credit, not the \$8,000 maximum credit mentioned earlier.²⁶

Credit Phaseout

Many of the credits have some type of phaseout of the benefit. For example, the credit percentage for the dependent care credit is 35 percent for those with adjusted gross income (AGI) up to \$15,000, but the percentage is decreased by one percent for each \$2,000 (or fraction thereof) of AGI above \$15,000 until it is decreased to 20 percent for those with AGI above \$43,000.²⁷ In this case, there is a reduction of the credit percentage for taxpayers with larger AGI, but there is no complete phaseout of the credit as AGI continues to increase.

The earned income credit is phased out for specific ranges of earned income. The phaseout percentage is 7.65 percent for those with no qualifying child, 15.98 percent for those with one qualifying child, and 21.06 percent for those with two or more qualifying children.²⁸ The beginning of the phaseout range, which is indexed, depends on whether there are any qualifying children or not and whether the taxpayers are married filing jointly or not. As a specific example for 2010, for married taxpayers filing jointly with two qualifying children, the phaseout begins at an earned income level of \$21,460. With a 21.06 percent reduction, the maximum credit of \$5,036 is completely phased out by the time earned income reaches \$45,373.²⁹

The phaseout for the child tax credit is a small-step decrease rather than a percentage decrease and is a phaseout based

²⁶ See Smith, Sheldon R., "The First-Time Home Buyer Credit: Technical Correction Needed," *Tax Notes*, Volume 122, Number 3, January 19, 2009, pp. 405-409 for an explanation of and suggested correction for the ambiguity in the wording of the tax code relative to the dollar limit on the credit for married taxpayers who file separately.

²⁷ IRC, Section 21.

²⁸ IRC, Section 32.

²⁹ Internal Revenue Service, Internal Revenue Bulletin: 2009-45, Rev. Proc. 2009-50, November 9, 2009.

on modified AGI. The allowable child tax credit is phased out for taxpayers with modified AGI exceeding \$110,000 (joint return), \$75,000 (individual not married), or \$55,000 (married individual filing separately). These are known as the threshold amounts and they have not been indexed. This credit is not reduced proportionately as the base amount increases. Instead, the amount of the credit allowable is reduced by \$50 for each \$1,000 (or fraction thereof) of modified AGI exceeding the threshold amounts listed.³⁰ Therefore, if a \$1 increase in modified AGI just puts a taxpayer over the threshold amount, it can mean a loss of \$50 of credit. In the case of the child tax credit, the phaseout range depends not only on the type of return filed but also on how many qualifying children the taxpayers have. Taxpayers who qualify for one \$1,000 child tax credit will have a phaseout range of \$19,001;³¹ taxpayers who qualify for two \$1,000 child tax credits will have a phaseout range of \$39,001; taxpayers who qualify for more child tax credits will have an even larger phaseout range.

The adoption tax credit is proportionately phased out for modified AGI in a \$40,000 range.³² The lower end of the range is indexed. For 2010, the lower end of the range is \$182,520, so the credit is completely phased out for those with modified AGI above \$222,520.³³

The new, first-time homebuyer credit is proportionately phased out over a modified AGI range of \$20,000. The original credit and the first amendment started the phaseout range at \$75,000 (\$150,000 for those married filing jointly), but the November 2009 amendment increased the beginning of the phaseout range to \$125,000 (\$225,000 for those married filing

³⁰ IRC, Section 24.

³¹ Some may think of this phaseout range as \$20,000, but one extra dollar of income in excess of \$19,000 above the threshold amount will completely eliminate the last \$50 of the credit.

³² IRC, Section 23.

³³ Internal Revenue Service, Internal Revenue Bulletin: 2009-45, Rev. Proc. 2009-50, November 9, 2009.

jointly). Those with modified AGI above the phaseout range will not be able to claim any first-time homebuyer credit.³⁴

Recapture Provision

Although many provisions of the first-time homebuyer credit are similar to the provisions of other credits, as originally legislated it has a unique provision. It has to be repaid by the taxpayer. The amendments made to this credit in 2009 remove this provision for the credit on qualifying home purchased starting on January 1, 2009. However, this recapture provision still applies to homes purchased from April 9, 2008 to December 31, 2008. In essence, those who are eligible to claim the credit for a home purchased in 2008 have to pay back the tax credit in the form of an additional tax of $6\frac{2}{3}$ percent of the credit amount each year over a 15-year period starting in the second tax year from when the credit was taken. This really makes the credit equivalent to an interest-free government loan rather than a true tax credit which permanently reduces a taxpayer's tax.³⁵

If the taxpayer sells the principal residence or ceases to use it as the principal residence prior to the end of the recapture period, any unrecaptured credit becomes due with the tax return for that year as an accelerated recapture. However, the amount to be recaptured at that time cannot exceed the gain on the sale of the house, assuming it was sold to an unrelated person.

If a taxpayer dies prior to the end of the recapture period, his/her unrecaptured credit does not have to be repaid. If the credit was claimed on a joint return, one-half of the original credit is treated as having been allowed to each spouse. Thus, if one spouse dies, any unrecaptured amount for the deceased spouse is not recaptured, but any unrecaptured amount for the surviving spouse must still be repaid.

Other provisions apply to the recapture if the residence is involuntarily converted such as through a fire or through the

³⁴ IRC, Section 36.

³⁵ Internal Revenue Service News Release, IR-2008-106, September 16, 2008.

government exercise of the right of eminent domain. In these cases, the taxpayer is still liable for the recapture but can avoid the accelerated recapture if he/she acquires a new principal residence within two years of the involuntary conversion. If so, the new residence is substituted for the converted residence in determining if accelerated recapture is applicable.

If the residence is transferred to a former spouse incident to a divorce or between spouses, the accelerated recapture provision is not triggered. Instead, the transferee must repay the unrecaptured credit for years after the transfer, including any accelerated recapture if the residence is sold or ceases to be the principal residence before the end of the recapture period.³⁶

Because this recapture provision is new, it may not be understood by taxpayers, especially since the amendments to the credit make repayment necessary for homes purchased in 2008 but not for homes purchased in 2009 or 2010. A taxpayer who claims the credit for a home purchased in 2009 or 2010 does not have to repay the credit unless the home is sold or ceases to be the principal residence within 36 months of the purchase. Some taxpayers who claimed the credit for a home purchased in 2008 may not understand that the credit has to be repaid through higher taxes in future years. Even taxpayers who understand the recapture provision may not appropriately plan for it.

Other Qualifications

Each of the credits has other qualifications, definitions, or limitations which are relevant to taxpayers in claiming them. For example, earned income or modified AGI have to be defined by each credit which uses these concepts. A qualifying child has to be defined for the child tax credit or for the earned income credit. An eligible child has to be defined for adoptions. A child with special needs also has to be defined since the adoption tax credit is different for adoptions of such children. A qualifying individual has to be defined for the dependent care credit. Employment-

³⁶ IRC, Section 36.

related expenses have to be defined for the dependent care credit, as do qualified adoption expenses for the adoption tax credit.

For the first-time homebuyer credit, several additional items are defined in Internal Revenue Code (IRC) Section 36 or in the laws passed to create or amend this credit: first-time homebuyer, principal residence, purchase, purchase price, and modified AGI. Modified AGI is defined as AGI increased by any amounts excluded by (1) the foreign earned income or housing cost exclusion,³⁷ (2) the exclusion for income from sources within Guam, American Samoa, or the Northern Mariana Islands,³⁸ and (3) the exclusion for income from sources within Puerto Rico.³⁹

Another characteristic of the first-time homebuyer credit was mentioned earlier—its temporary nature. As the credit was created and amended, the laws defined the time frames for applicable home purchases. When the credit was originally legislated, home purchases eligible for the credit had to take place on or after April 9, 2008 and before July 1, 2009. As amended, the 2008 rules apply to homes purchased on or after April 9, 2008 and by the end of 2008, and the February 2009 rules apply to homes purchased on or after January 1, 2009 up to November 6, 2009. The November 2009 rules apply to homes purchased from November 6, 2009 through April 30, 2010 (or through June 30, 2010 if a written, binding purchase contract is signed by April 30, 2010 to purchase by June 30, 2010).⁴⁰

Some individuals are specifically ineligible for the credit. Under the original legislation, no credit was allowed if (1) a credit relating to a first-time homebuyer in the District of Columbia is allowable to the taxpayer or the taxpayer's spouse for any year, (2) the residence is financed by tax exempt mortgage revenue bonds, (3) the taxpayer is a nonresident alien, (4) the taxpayer disposes of

³⁷ IRC, Section 911.

³⁸ IRC, Section 931.

³⁹ IRC, Section 933.

⁴⁰ Public Law 111-198 extended the required purchase date through September 30, 2010 for those who had written, binding contracts in place by April 30, 2010 to purchase by June 30, 2010.

the residence (or it ceases to be the principal residence of the taxpayer (and, if married, the taxpayer's spouse)) before the end of the year of purchase, or (5) if the home is purchased from a related person.⁴¹

When the credit was amended in February 2009, these limitations were changed slightly. A taxpayer still cannot take both the first-time homebuyer credit and the first-time homebuyer credit in the District of Columbia. However, instead of precluding someone eligible for the first-time homebuyer in the District of Columbia from taking the first-time homebuyer credit, the law now precludes someone who is eligible for the first-time homebuyer credit from taking the first-time homebuyer credit in the District of Columbia. Another amendment also allows a taxpayer to take the first-time homebuyer credit for 2009 or 2010 even if the home was financed by tax exempt mortgage revenue bonds.

Whereas the previous versions of the credit did not require documentation of eligibility, the November 6, 2009 version requires that taxpayers attach a copy of their settlement statement to their tax return. This amendment also makes dependents ineligible for the credit and requires that the purchaser or the purchaser's spouse is at least 18 years old on the date of the purchase. As of November 6, 2009, no credit is allowed if the purchase price of the home exceeds \$800,000

The November 6, 2009 legislation also created some additional provisions for members of the military.⁴² Anyone in the military who was out of the United States on qualified official extended duty for at least 90 days during the period from January 1, 2009 to April 30, 2010 has a one-year extension of the deadline to purchase a home which will qualify for the credit. Additionally, the credit repayment provisions are waived for military personnel whose homes are sold or cease to be principal residences after

⁴¹ Public Law 110-289.

⁴² This section is written in terms of the military. However, it applies more broadly to members of the uniformed services, members of the Foreign Service of the United States, and employees of the intelligence community.

December 31, 2008 in connection with government orders for qualified official extended duty service.

If a first-time homebuyer purchases a principal residence in 2009 (or in 2010 before the deadline), the taxpayer can elect to take the credit on the 2008 (2009) tax return, either when originally filed or as amended. Since a credit claimed on an earlier return, even if it had to be amended, would be received before a credit claimed on a later return, most first-time homebuyers who qualify for the credit after 2008 will be better off claiming the credit on the prior year's return. However, if the taxpayer will be eligible for a larger credit based on modified AGI in the year of purchase rather than in the earlier year, it is possible that claiming the credit on the tax return for the year of purchase could be a better choice, even if the credit is not received as soon.

DESIRABLE ATTRIBUTES FOR TAX SYSTEMS

In his 1776 book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith was perhaps the first to outline the desirable attributes for a tax system. The four attributes he outlined were equality, certainty, convenience of payment, and economy in collection.⁴³

Over a period of 10 years from 1996 to 2005, five other lists of attributes have been developed. The Annual Report of the Council of Economic Advisors in 1996 suggested three main traits of a well-designed tax system: fairness, economic efficiency, and simplicity.⁴⁴ A report prepared for the Joint Economic Committee in 1998 claims that a good tax is fair, transparent, and not costly to administer or calculate. In addition, the system should make tax avoidance difficult and risky and should have a neutral economic impact on resource allocation decisions.⁴⁵ The Tax Division of the American Institute of Certified Public Accountants (AICPA)

⁴³ Smith, Adam, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Boulder, CO: NetLibrary, 1999.

⁴⁴ Council of Economic Advisors, Annual Report, 1996.

⁴⁵ Vedder, Richard K. and Lowell E. Gallaway, "Some Underlying Principles of Tax Policy," Prepared for the Joint Economic Committee, September 1998.

published ten guiding principles for good tax policy in 2001. These principles are equity and fairness, certainty, convenience of payment, economy in collection, simplicity, neutrality, economic growth and efficiency, transparency and visibility, minimum tax gap, and appropriate government revenues.⁴⁶ Hunter and Entin outlined four attributes of a sound tax system: neutrality, visibility, fairness, and simplicity.⁴⁷ The U.S. Government Accountability Office (GAO) also outlined criteria for a good tax system: equity, economic efficiency, simplicity, transparency, and administrability.⁴⁸

While these lists of attributes are all different, they do involve similar characteristics, often just disaggregated in different ways. These lists involve six primary characteristics of good tax systems: economy in collection, economic efficiency, equity and fairness, transparency, simplicity, and convenience of payment. A description of these attributes may be a good way to begin consideration of the ethical and public policy issues related to tax legislation, especially in light of the first-time homebuyer tax credit.

The following discussion will further define the six attributes on the condensed list. To illustrate the explanation of each attribute, two examples will be provided. These pairs of examples are of taxes that are better and worse at meeting each attribute, relative to each other.

Economy in collection means that the costs to collect a tax should be kept to a minimum for both the taxpayers and the administering government, and that tax avoidance should be risky and difficult. The Institute for Policy Innovation describes this attribute as technical efficiency, meaning that the tax should not be

⁴⁶ American Institute of Certified Public Accountants, "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals," Tax Policy Concept Statement No. 1, 2001.

⁴⁷ Hunter, Lawrence A. and Stephen J. Entin, "A Framework for Tax Reform," Institute for Policy Innovation, January 14, 2005.

⁴⁸ United States Government Accountability Office, "Understanding the Tax Reform Debate: Background, Criteria, & Questions," September 2005.

a significant burden on taxpayers to calculate or the government to administer. The GAO says that a desirable tax is administrable, allowing the government to collect it as cost effectively as possible. A more technically efficient tax system promotes economic growth because the resources saved in administrative and compliance costs can be redirected to more productive endeavors. A better example of economy in collection is funding highway construction and maintenance through a gas tax which is collected when gas is purchased. Although gas stations still have to collect and remit this tax, it is attached to an existing transaction for consumers. A worse example of economy in collection is funding highway construction and maintenance through tollbooth collections. Tollbooths need to be constructed every few miles and workers must be paid to collect fees. Each toll paid is a completely separate transaction, whether collected by individual workers, collected by a machine, or charged electronically at the tollbooth.

Economic efficiency is the effectiveness with which an economy uses its resources to maximize society's utility. A tax system that is economically efficient has the smallest possible impact on individuals' resource allocation decisions, minimizing any tax-induced negative impact on economic growth. One better example of economic efficiency could be a broad-based consumption tax which taxes all consumption equally, thus minimizing the impact of the tax on the consumption of certain items. A worse example is an excise tax levied on specific items and intended to affect the consumption of those items.

Taxpayers have varying opinions on what is fair, but equity and fairness are usually measured by horizontal or vertical equity. Horizontal equity means that similarly situated taxpayers receive similar tax treatment. A better example of horizontal equity is a broad-based income tax on all income. A worse example of horizontal equity is the federal income tax, with many different exemptions and deductions for different taxpayers who have the same income. Vertical equity means that taxes are based on taxpayers' abilities to pay. A better example of vertical equity is a progressive tax such as the federal income tax, which requires

higher-income taxpayers to pay higher tax rates. A worse example of vertical equity is a regressive tax such as the social security tax, which has an income limit that causes higher-income taxpayers to end up paying a lower average rate.

A tax with transparency is one that taxpayers are able to understand. The AICPA defines transparency as the basic notion that taxpayers should know (1) that a tax exists and (2) how and when the tax is imposed on them and others.⁴⁹ Transparent tax systems impose less uncertainty on taxpayers, who are then better able to plan their decisions about employment, investment, and consumption. Taxpayers should be able to estimate their tax liabilities with reasonable certainty based on the nature of their transactions during a taxable year. A better example of transparency is the social security tax, which is deducted by employers directly from taxpayers' earnings at specific rates. Taxpayers can see clearly on their pay stubs the amount of social security tax they are paying. A worse example of transparency is a use tax levied by many states in lieu of sales taxes on mail order and online purchases. This tax lacks transparency because many taxpayers do not know when and how to pay it, or even that it exists.

A tax with simplicity is not unnecessarily complicated. A simple tax minimizes taxpayer compliance burdens because taxpayers can understand the rules and comply with them correctly in a cost efficient manner. A better example of a tax with simplicity is a fee per vehicle to enter a national park. A worse example is an income tax with complicated forms, instructions, deductions, and credits.

A tax with convenience of payment is due at a time and in a manner that is most likely to be convenient for the taxpayer. Convenience of payment can be measured by the extent to which taxpayers are burdened with record maintenance and compliance considerations. A better example of a tax with convenience of

⁴⁹ American Institute of Certified Public Accountants, "Guiding Principles for Tax Law Transparency," Tax Policy Concept Statement No. 3, 2003.

payment is a sales tax paid at the time of purchase. The seller must collect the tax and remit it to the government, but no record keeping or other compliance costs are involved for the taxpayer. A worse example is a use tax for which taxpayers have to keep detailed records of what they purchased online or through the mail so they can calculate the use tax later when it is due.

Some of these attributes may have overlapping qualities. For example, the extent to which taxpayers are burdened with record maintenance and compliance consideration measures how well a tax fits the convenience of payment attribute but also affects the economy in collection attribute. As another example, a tax meeting the attribute of simplicity is easily understood by taxpayers so they can comply with it in a cost efficient manner, and this cost efficiency is also included in the consideration of how well the tax meets the economy in collection attribute. Additionally, because a tax that is simple is more easily understood by taxpayers and therefore has lower compliance costs, it is also more economically efficient because the resources saved on compliance can be put to more productive use.

Some of these attributes may conflict. For example, a tax that is considered equitable and fair probably requires some complicated provisions that lessen the simplicity and transparency of the tax. Furthermore, an equitable and fair tax may have provisions that impact individuals' economic decisions, thereby decreasing the economic efficiency of the tax. Because of the inherent conflicts between some of these attributes, no single tax can fully satisfy every attribute. However, the best tax system will meet as many of these criteria as possible as well as possible.

A tax should not be judged solely on how well it fulfills its intended economic or public policy objectives. In evaluating tax changes, policymakers should also consider whether or not the changes are moving our tax system toward or away from a system with desirable tax attributes. Therefore, although the first-time homebuyer credit may be stimulating the housing market as intended, this is not the only factor to consider when making a value judgment of the credit as good or bad tax policy. The extent

to which it meets the attributes of good tax policy must also be determined. Such a determination should be made by lawmakers when considering any legislative change in tax policy, because each incremental change either improves or worsens the overall tax system.

EVALUATION OF THE CREDIT ACCORDING TO THE ATTRIBUTES FOR GOOD TAX SYSTEMS

This section will examine whether the first time homebuyer credit meets the six previously defined desirable attributes of tax policy: economy in collection, economic efficiency, equity and fairness, transparency, simplicity, and convenience of payment. This section provides many examples of how the first-time homebuyer tax credit goes against public policy by violating the attributes discussed above. Some of the examples listed also have ethical implications, as the first-time homebuyer credit can result in many situations where taxpayers in substantially similar situations are treated very differently.⁵⁰

Economy in Collection

Recall that a tax with economy in collection seeks to minimize administrative and collection costs and makes tax avoidance risky and difficult. The first-time homebuyer credit as it was legislated in 2008 has a recapture provision requiring taxpayers to repay the credit over a 15-year period, an unusual provision for a tax benefit labeled as a credit. Because some taxpayers may not understand the recapture provision, the IRS is likely to incur significant legal and administrative collection costs over the following years in which the incremental recapture or full recapture provisions apply. Additional obscurity may exist in how the 2009 amendment of the credit applies to taxpayers who claimed the credit in 2008. Some taxpayers may assume that the

⁵⁰ Many examples of these situations are detailed in Smith, Sheldon R. and Amourae Riggs, "Anomalies of Tax Legislation: The First-Time Homebuyer Credit," working paper.

2009 amended provisions of the credit apply to them even though they claimed the credit under the 2008 provisions; thus they may assume that the credit that they claimed in 2008 no longer has to be repaid. If taxpayers make this assumption and do not comply with the 2008 recapture provisions, collection costs will further increase for the IRS.

Many of the significant costs imposed on the IRS in administering the credit arise from the lost revenue, legal costs of prosecution, and collection costs surrounding fraudulently claimed credits. Because the original credit provisions did not require taxpayers to provide documentation of their eligibility, many taxpayers who knew that they were not qualified claimed the 2008 credit fraudulently. An audit conducted by the Treasury Inspector General for Tax Administration (TIGTA) discovered 19,351 electronically filed tax returns on which taxpayers fraudulently claimed over 139 million dollars in credits for homes which had not yet been purchased.⁵¹ The audit also revealed that 70,005 taxpayers who did not qualify as first-time homebuyers fraudulently claimed over 479 million dollars in credits. The TIGTA also discovered that almost 4 million dollars in credits were claimed by taxpayers who were under 18 years old, including taxpayers as young as 4 years old. A tax with economy in collection makes tax avoidance difficult, but the original legislation of the first-time homebuyer credit made tax avoidance easy. Under the amendments legislated in November 2009, tax avoidance possibilities were reduced because taxpayers claiming the credit must now provide a copy of their settlement statement to prove that the sale was closed, and a taxpayer (or the taxpayer's spouse) must be at least 18 years old to claim the credit.

Economic Efficiency

⁵¹ Treasury Inspector General for Tax Administration, "The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit," Reference Number 2009-41-114, September 2009.

The very purpose of the first-time homebuyer credit is contrary to the concept of economic efficiency. An economically efficient tax has minimal impact on individuals' economic decisions, including the decision of what to consume. The first-time homebuyer credit seeks to stimulate the housing market by encouraging qualifying first-time homebuyers to purchase a home. Because the credit seeks to influence individuals' economic decisions of whether or not to buy a home, distortion in individuals' consumption decisions is not just a by-product of the first-time homebuyer credit – it is the whole purpose of the credit.

As discussed under the attribute of economy in collection, the first-time homebuyer credit may impose a significant legal and administrative cost burden on the IRS in the enforcement of eligibility requirements. The credit may also impose compliance costs on taxpayers, such as the cost of paying tax advisors for help understanding the eligibility and timing provisions of the credit or the costs of record keeping. The government's costs of administering the credit and taxpayers' costs of complying with the credit requirements consume resources that could be put to a more constructive, productive use elsewhere in the economy.

Equity and Fairness

The first-time homebuyer credit may cause significant horizontal inequities. Horizontal equity is the view that if two taxpayers are in roughly the same financial circumstances, it is unfair if one pays far more tax than the other. According to this principle then, if two taxpayers have identical financial situations except that one buys a home in 2009 and the other bought a home in 2007, then the \$8,000 difference in their 2009 taxes is considered unfair.

Other timing differences create similar horizontal inequities. For example, if one taxpayer bought a home on December 31, 2008 and another bought a home on January 1, 2009, the taxpayer who bought a home on December 31 will get a \$7,500 credit that must be repaid, but the taxpayer who bought a home January 1, just one day later, will get an \$8,000 credit that

does not have to be repaid. The taxpayer who purchased a home on December 31 could not avoid this drastic difference in tax liability through tax planning because the amended credit's effective date (January 1, 2009) came before its enactment date (February 17, 2009). In fact, it seems almost as though the taxpayer who purchased a home on December 31, 2008 is being punished for taking advantage of the credit as it was originally legislated, even though the taxpayer planned the timing of the purchase of the home according to the effective dates legislated under the original, temporary provisions. The unfair nature of timing differences such as these may be teaching taxpayers that it pays to not take advantage of original tax credit provisions, but instead to wait for extended, more generous provisions to be legislated under future amendments. Rewarding taxpayers who procrastinate taking action on credits like this one seems detrimental to the credits' purposes of creating desired economic stimulus.

Tax provisions which are intended to promote economic growth are likely to result in horizontal inequity.⁵² This statement certainly seems to hold true for the first-time homebuyer credit, because it was intended to promote stabilization or growth in the housing market and it does create horizontal inequities.

The first-time homebuyer credit may also violate the AICPA concept of intergroup equity and fairness, which is the notion that no group of taxpayers should be favored due to the detriment of another group without good cause.⁵³ Under this concept, it may be unfair that taxpayers who already own a home have to help fund the purchases of homes for taxpayers buying their residences in 2008, 2009 or 2010.

Transparency

⁵² American Institute of Certified Public Accountants, "Guiding Principles for Tax Equity and Fairness," Tax Policy Concept Statement No. 4, 2007.

⁵³ *Ibid.*

The most basic notion of this attribute is that taxpayers should know that a tax exists. The first-time homebuyer credit fails to meet this principle because it was originally enacted on July 30, 2008, after its effective date of April 9, 2008. The original credit was therefore impossible to plan for. The first amendment to the credit was also impossible to plan for because its enactment on February 17, 2009 came after its effective date of January 1, 2009.

Simplicity

The AICPA “Guiding Principles for Tax Simplification” suggest that lawmakers avoid enacting multiple provisions to achieve essentially the same or similar objectives.⁵⁴ The first-time homebuyer credit does not meet this guideline because it has been legislated under three sets of provisions, and each version of the credit is designed to meet the same objective.

The AICPA also suggests a reduction in the frequency of tax law changes. The first-time homebuyer credit fails to meet this guideline because three versions of the credit have been legislated in a 17-month period.

The AICPA states that lawmakers should use consistent concepts and definitions. Taxpayers could be very confused by the recapture provision of the 2008 first-time homebuyer credit because most tax benefits labeled as credits do not have to be repaid. Thus calling the 2008 legislation a credit could be considered inconsistent with standard terminology. The term “first-time homebuyer” as defined by the credit provisions is inherently confusing because although one who was hearing the term for the first time would logically define a first-time homebuyer as someone who is buying a home for the first time, the credit defines a first-time homebuyer as someone who has not owned a home within the past three years. The clarity of the term is further obscured by the newest version of the credit, which keeps

⁵⁴ American Institute of Certified Public Accountants, “Guiding Principles for Tax Simplification,” Tax Policy Statement No. 2, 2002.

the previous definition of a first-time homebuyer but simultaneously extends the first-time homebuyer credit to include repeat buyers who are taxpayers who have owned and occupied a home as a primary residence for five consecutive years any time during the eight years before the replacement home is purchased. These repeat buyers do not qualify as first-time homebuyers, but they are treated as first-time homebuyers for the \$6,500 credit. These are not consistent concepts and definitions.

The AICPA also mentions that to simplify the tax system, changes made in tax law must be deliberate. It states that “frequent changes with little or no consideration of the need for real simplification can only be detrimental.”⁵⁵ Legislation like the first-time homebuyer credit appears more experimental than deliberate. Lawmakers seem more concerned with experimenting with the short-term economic effects of these types of credits than with how the credits are hindering progression towards a simpler tax system. The 2008 credit was introduced as temporary, was reissued under new provisions extending it until November 30, 2009, but was then reissued again under provisions extending it to 2010. Certainly these are the experimental types of actions which the AICPA calls “frequent changes with little or no consideration of the need for real simplification.”

Convenience of Payment

Because the credit aims to make it easier for first-time homebuyers to purchase a home, it is inconvenient that these taxpayers do not receive the credit at the time of the purchase. Many taxpayers have never purchased a home because they lack the accessible capital required for a down payment. Since the funds provided by the credit are not available until after the down payment has been made, the credit may have no affect on the ability for these taxpayers to purchase a home.

Recall that a tax with convenience of payment does not impose record-keeping burdens on taxpayers. The 2008 version of

⁵⁵ Ibid.

the first-time homebuyer credit imposes record-keeping burdens on taxpayers because they must track the incremental repayment of the credit over a 15-year period. The 2009 versions of the credit require taxpayers to track the 36-month period following the purchase of their homes so they do not trigger the recapture provision by selling their homes during that time.

ETHICAL AND PUBLIC POLICY IMPLICATIONS

Although the first-time homebuyer tax credit may be stimulating the economy through the housing market as it was specifically designed to do, it fails to meet any of the six criteria of good tax policy. The increasing compliance costs and economic inefficiencies of our current tax system suggest that tax reform should be a significant priority, but this credit is just one example of tax legislation that is hindering instead of promoting progress toward a better tax system. Good public policy demands better. In addition, taxes which meet the attributes described above, especially equity and fairness, are more likely to be seen by the public as more ethical taxes which may increase public support.

For meaningful change to take place, policymakers must recognize the importance of tax reform. Such recognition would require that instead of being concerned only with the short-term effectiveness of proposed tax legislation, lawmakers carefully consider how well the proposed legislation meets the criteria of good tax policy. Perhaps before enacting new tax legislation, policymakers should perform an evaluation of how well it meets the criteria of good tax policy, like the evaluation of the first-time homebuyer credit demonstrated in this paper. Such an evaluation will help lawmakers determine whether a potential piece of tax legislation will move our system toward or away from a tax system with desirable attributes.

CONCLUSION

No tax legislation can perfectly meet all of the attributes of good tax policy, especially since some of the attributes may conflict with each other. Tax policies such as the first-time

homebuyer credit designed to stimulate the economy are often temporary and are undertaken only with the thought of an immediate impact on the economy. Unfortunately, this means little or no thought is given as to how the proposed legislation will support the attributes of good tax policy. Lawmakers should consider the broad ethical and public and tax policy issues of proposed tax legislation in addition to just the narrow, targeted social policy objectives.