

**STATEMENT OF  
MORTGAGE BANKERS ASSOCIATION  
CONSUMER MORTGAGE COALITION**

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**THE COMMITTEE ON WAYS AND MEANS  
SUBCOMMITTEE ON OVERSIGHT**

**MARCH 20, 2007  
HEARING ON  
INTERNAL REVENUE SERVICE OPERATIONS  
AND THE TAX GAP**

**INTRODUCTION**

The Mortgage Bankers Association<sup>1</sup> and the Consumer Mortgage Coalition<sup>2</sup> appreciate the opportunity to submit this statement to the Subcommittee on Oversight in connection with its review of Internal Revenue Service operations and the tax gap. These comments focus on two of the options for addressing the tax gap contained in the Joint Committee on Taxation (“JCT”) staff’s August 1, 2006, letter to Senator Charles Grassley that would affect mortgage servicers:

- (1) reporting requirements for real estate taxes, and
- (2) reporting requirements for mortgage interest.

The mortgage industry shares with Members of Congress the strong view that, wherever practical, measures should be adopted that would reduce the tax gap. However, such measures must be administrable and must not increase, disproportionately to the resulting increase in tax compliance revenues, the tax administrative burden on businesses and individuals. As discussed

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<sup>1</sup> The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation’s residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA’s Web site: [www.mortgagebankers.org](http://www.mortgagebankers.org).

<sup>2</sup> The Consumer Mortgage Coalition is a trade association of national mortgage lenders, servicers, and service providers.

below, the industry has significant concerns regarding the two proposals that would affect mortgage servicers and believes that they should not be adopted.

### Background on Mortgage Lending/Servicing Industry

Some background on the modern mortgage industry is necessary in order to understand fully the problems inherent in the JCT proposals. The mortgage loan process today, as a result of significant evolutionary improvements that have lowered mortgage costs for millions of homeowners, differs significantly from the process that existed in the past.

In years past, a prospective homeowner would apply to his or her local bank for a loan and the bank, having made the loan, would hold the loan and service it for the entire loan term. Now, however, participants engaged in mortgage lending may not be involved in the origination of the mortgage loans they hold; they often purchase loans that have been originated by mortgage companies, third-party brokers, and/or other parties. Standardization of many types of mortgage loans and the creation of mortgage securitization vehicles have created efficient markets in which billions of dollars in mortgage loans and mortgage related securities change hands every day.

Also, the owner of a mortgage loan is not necessarily the party servicing the loan (e.g., collecting mortgage payments, sending overdue notices, assessing late charges, establishing escrow accounts for the payment of insurance, taxes, or other charges). A significant loan servicing industry has developed to take advantage of efficiencies of scale. Loan servicing rights are frequently transferred separately from ownership of the mortgages being serviced. In some cases, loan servicing functions with respect to a mortgage are divided between different parties (e.g., a separate tax servicing provider may handle property tax and other payments).

### Reporting Requirements for Real Estate Taxes

The JCT staff suggests two alternative options for addressing concerns that taxpayers may be overstating deductions for real property taxes by including amounts for non-deductible taxes and user fees. The first alternative option would require state and local taxing jurisdictions to report to the Internal Revenue Service (IRS) and taxpayers the amount of taxes paid (excluding non-deductible amounts). The second alternative option would require mortgage servicers to report to the IRS and taxpayers the amount of real estate taxes paid by taxpayers through escrow accounts. Our comments relate to the second option.

We believe that the proposal to require mortgage servicers to report deductible real estate taxes could not be implemented because mortgage servicers do not receive from state and local governments the information that would be necessary to accomplish the proposed reporting. Moreover, the proposal would impose significant costs and administrative burdens on mortgage servicers while providing little meaningful enhanced compliance by taxpayers.

- a. Mortgage servicers cannot independently make the determinations contemplated by the proposed reporting scheme.

Mortgage servicers pay taxes and other state and local impositions through escrow accounts in order to protect the lenders' interests in the mortgaged property. Because unpaid amounts become a lien on the property, mortgage servicers must pay all amounts billed by state and local jurisdictions, regardless of whether the amounts clearly fall in the category of deductible real property taxes.

Based on census data, there are over 87,000 state and local jurisdictions in the United States and there is no uniform means by which taxing jurisdictions break out amounts contained on property tax bills or provide property tax bill information to mortgage servicers. For example, in some cases, state and local governments bill only an aggregate amount even though that amount includes, in addition to potentially deductible real property taxes, other amounts that may not be deductible for homeowners.<sup>3</sup>

Unless state and local taxing jurisdictions were required to separately break out deductible and non-deductible amounts (and transmit that information to mortgage servicers in a format that their reporting systems can capture), servicers would have no practical way of making the determinations contemplated by the proposed reporting option.

b. Reporting by mortgage servicers would produce little compliance benefit.

Reporting on tax payments through escrows would provide little or no compliance benefit because more than half of all homeowners do not pay their property taxes through escrow accounts. According to the Census Bureau's 2005 American Housing Survey, 34 percent of all homeowners own their homes free and clear. Of the remaining homeowners (i.e., those with mortgage indebtedness), based on an informal survey of its members, MBA estimates that between 20 and 40 percent (depending on each lender's portfolio) do not pay their real property taxes through escrow accounts.

The primary goal of enhanced reporting with respect to real estate taxes would be to allow the IRS to use its computer matching program to verify the amounts claimed by taxpayers. However, because reporting of taxes paid through escrows would cover only approximately half of the universe of homeowners, matching would be of little use to the IRS.

For taxpayers with no mortgage debt on their homes and for taxpayers not paying taxes through escrows, the IRS would receive no report regarding property taxes with the result that claimed deductions would always exceed amounts reported to the IRS, in this case zero. Even in the case of homeowners covered by reporting, claimed amounts may legitimately exceed reported amounts; for example, the taxpayer may have a second residence (not covered by escrow reporting) on which the taxpayer is entitled to claim a real property tax deduction. Moreover, absent extraordinarily

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<sup>3</sup> For example, we understand that in Iowa, any type of unpaid bill or fee (e.g., speeding tickets, weed cutting) may appear on the property tax bill, while Indiana includes storm, garbage, and ditch charges on its property tax bills.

complicated special procedures to address situations in which real estate taxes are paid by the buyer or seller in connection with the closing of a purchase transaction, these tax payments would not be captured. Accordingly, any computer matching of this information would produce far too many “false positives” to be useful.

c. Reporting requirement would impose significant cost burdens on mortgage servicers and homeowners.

While reporting of real property taxes paid out of escrows would produce little additional compliance benefit, such a mandate would impose significant cost burdens on mortgage servicers. These cost burdens include substantial costs to redesign electronic reporting systems. The servicing systems in the market today do not contain the data fields necessary to distinguish between deductible and non-deductible escrowed items (even assuming the necessary information were furnished by state and local taxing authorities). Moreover, reporting this additional information to the IRS would require enhancements to, and various complex coordinations with, existing systems. Additional layers of programming and administrative complexity would be involved in accounting for and reporting tax refunds for taxes paid in prior years (e.g., in the case of duplicated tax payments), exemptions granted, and/or property tax bill corrections. One industry participant has indicated that the additional up-front costs for just that one company would be approximately \$9 million. That company also indicates ongoing costs with respect to this additional reporting would be over \$3 million per year. Because mortgage servicing is a low-margin business, these additional costs would likely be passed on to borrowers.

The JCT staff suggests the mortgage servicer reporting option may be preferable to reporting by state and local governments because an information reporting mandate on governments “would impose administrative burdens on governmental entities that may outweigh the compliance benefits.” However, reporting by mortgage servicers paying taxes out of escrows would require state and local governments to provide servicers the exact same information JCT staff concludes would be burdensome. Accordingly, the mortgage servicer reporting option is not, in any way, less burdensome to the state and local governments.

d. GAO study needed before considering proposal.

The JCT staff has noted that it has asked the U.S. Government Accountability Office (“GAO”) to: (1) analyze a sample of local governments to determine the extent to which localities nationwide are charging user fees for services and whether such localities are providing taxpayers with real estate tax bills that clearly distinguish between deductible taxes and nondeductible amounts; (2) coordinate with the IRS to determine the extent to which the deduction for real estate taxes is overstated and the extent to which any overstatement relates to taxpayers improperly claiming deductions for user fees; and (3) determine whether mortgage lenders are providing taxpayers with accurate information regarding real estate taxes paid.

We believe that the GAO should also study and report to Congress on: (1) whether the proposed reporting of taxes paid through escrows would be administrable; (2) the cost and administrative burdens such a reporting requirement would impose; and (3) whether such a reporting requirement would generate information that the IRS would be able to use effectively in enhancing compliance. The industry would be pleased to assist the GAO in its consideration of all of these matters and believes that, after a full examination by GAO, Congress will conclude that it should not adopt the proposed reporting of taxes paid through escrow accounts.

### Reporting Requirements for Mortgage Interest

The JCT staff suggests two options for providing the IRS additional information intended to facilitate better enforcement of current law interest deduction rules. Current law permits points paid for refinancing loans to be deducted only on a prorated basis over the term of the refinancing loan (rather than in the year paid) and limit interest deductions on home equity indebtedness to interest on only \$100,000 of such indebtedness. The first option would expand current mortgage servicer information reporting to include some indication (e.g., check-the-box) whether the loan which produced the interest payment by the taxpayer was a refinancing. The second option would require that the mortgage servicer also report, in the case of refinancing loans, the amount by which the refinanced loan exceeded the outstanding balance of the loan being refinanced.

a. Check-the-box reporting.

While a check-the-box indication of whether reported interest relates to a refinanced mortgage appears simple, there are, in fact, many practical difficulties inherent in this proposed reporting that weigh against adopting the proposal.

First, mortgage servicers do not now uniformly keep any indication in their records as to whether loans are acquisition loans or refinancings. While such information could be maintained in the future, servicers would not be able to produce reports regarding loans made prior to the time they start maintaining such information (i.e., this reporting would not be possible with respect to any loan made before the date of enactment of the proposed reporting).

Second, it is not always clear whether a loan would be a “refinancing” subject to this reporting. For example, it is unclear how the proposal would apply in the case of home equity lines of credit where the amount of the loan will vary from time-to-time. Also, the mortgage industry concept of refinancing may not always match the concept relevant for tax purposes. In some cases, mortgage servicers may place non-performing loans into a different status and modify the loan terms. While mortgage servicers may treat these loans as refinancings for certain purposes and the IRS may treat the modified loans as new loans under the rules of IRC Section 1001, it is doubtful that the loans, as modified, would or should be treated as refinancings for purposes of determining the deductibility of home mortgage interest.

Also, because mortgage lenders often purchase (rather than originate) loans, if this reporting scheme were adopted it would be necessary for the selling lender to notify the purchasing lender whether the loan being transferred is a refinancing.

Because the proposed check-the-box reporting could only relate to future loans, it would be many years before the reporting covered any significant percentage of homeowners, with the result that the proposal would (even assuming full utilization of the information by the IRS) have only limited impact on compliance revenues.

b. Reporting of Increased Loan Proceeds in Refinancings.

As is the case for the check-the-box reporting, the proposed annual reporting of whether loan proceeds exceed the amount of the loan that was refinanced could not apply to loans made before the mortgage servicers maintain such information. Even if the reporting could be implemented with respect to future loans, it would likely provide the IRS little useful information. Consider a simple example in which a taxpayer refinances a loan twice. If the original loan were for \$100,000 and the first refinancing were for \$110,000, the proposed reporting scheme would require annual reports to the IRS with respect to the \$10,000 excess. However, if the second refinancing occurred relatively soon after the first refinancing (as could be the case in a time of rapidly dropping mortgage interest rates such as existed in 2003 and 2004), the second refinanced loan principal might equal the principal amount of the first refinanced loan (i.e., \$110,000), with the result that no excess would be reported in future years.

Moreover, as with the proposal to require reporting of deductible property tax amounts, this proposal would involve significant cost and administrative burdens for servicers to implement. Existing computer systems that handle origination and servicing of loan transactions do not now include information with respect to prior loans that have been refinanced by an existing loan. The calculations required by the proposed reporting scheme would necessitate costly initial and ongoing system programming and maintenance costs.

c. GAO study needed before considering proposal.

The JCT staff indicates that it has asked the GAO to contact representatives of financial intermediaries (e.g., real estate closing agents) and financial institutions (e.g., mortgage banks) to discuss the feasibility of expanded third-party information reporting. The industry would be pleased to assist the GAO in its consideration of this question and believes that, after a full examination by GAO, Congress will conclude that it should not adopt the proposed additional reporting regarding interest payments.

We believe that the foregoing discussion makes clear that Congress should not adopt the JCT proposals on property tax and interest reporting. We would be pleased to answer any questions Members of the Subcommittee may have regarding our comments and concerns.