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Point & Counterpoint: Should the Home Mortgage Interest Deduction Be Reduced?

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POINT COUNTERPOINT:

SHOULD THE HOME MORTGAGE INTEREST TAX BENEFIT BE REDUCED?

INTRODUCTION: Included among the President's Advisory Panel on Federal Tax Reform's recommendations were three proposals related to the current home mortgage interest deduction. Instead of a deduction, the panel recommended a flat 15% credit. Instead of the current \$1,100,000 mortgage caps, the panel recommended a mortgage cap based on the median regional price of housing. Finally, the panel recommended limiting the deduction to interest paid on only one home and eliminating the deduction for interest on home equity indebtedness. See Report of the President's Advisory Panel on Federal Tax Reform 70-75 (2005) (hereinafter cited as *Panel Report*).

The Panel Report praises the Tax Reform Act of 1986, albeit with a caveat: "While the 1986 Act was a historic event, it did not produce a lasting transformation of the tax system. The 1986 Act left in place or added various complicated tax benefits, including such items as exclusions for employer-provided fringe benefits, state and local tax deductions, tax-deferred annuities, new mortgage interest deduction rules, and complicated rules for determining alternative minimum tax liability. Many point to the 1986 Act as the high point of contemporary tax reform—and they may well be right—but its limitations suggest that truly sweeping comprehensive reform faces formidable political obstacles." *Panel Report* at 14.

Both participants in the debate refer to the 1986 Act in discussing the Panel's proposals relating to the tax treatment of home mortgage interest. Professor Deborah Geier of Cleveland State University, Cleveland-Marshall College of Law, argues for limits, questions the linkage between current tax benefits and homeownership, and explains why the Panel's recommendations do not sufficiently encourage homeownership by low income taxpayers. Professor Stuart Lazar of Thomas M. Cooley Law School criticizes the Panel for undervaluing the effect on housing costs in many locales, using the 15% credit rate as a disguised means of raising taxes, and not explaining how it determined that the current mortgage deduction results in too little business investment.

—Gail L. Richmond, Fort Lauderdale, FL

POINT: DESPITE ITS FLAWS, THE PANEL'S PROPOSAL IS A GOOD FIRST STEP

by Deborah A. Geier, Cleveland, OH

ON CAPITAL GAINS AND MARGINAL TAX RATES

The key to the Tax Reform Act of 1986, which was a thing of brilliance, was that it raised the capital gains tax rate to equal that imposed on ordinary income. Prior to the 1986 Act, the top ordinary income tax rate (applicable to labor income and investment returns other than capital gains, such as interest, rent, and dividends) was 50%, while the top capital gains rate was 20%. The 1986 Act repealed the special tax preference for capital gains, taxing all income at the same rate. This allowed a radical reduction in the top tax rate to 28% (33% for certain taxpayers) and, because the many spe-

cial rules pertaining to capital gains became entirely irrelevant or much less important to tax planning, resulted in radical tax simplification.

Most capital gains realized by median-earning households are tax-free, such as home sale gain, or tax-deferred, such as capital gains realized in tax-preferred retirement accounts. Thus, increasing the capital gains tax rate to equal that applied to ordinary income affected mainly high-income households that realized taxable capital gains. But those households also benefited mightily from the slashing of the top marginal tax rates. It was a stroke of genius. And the economy steadily expanded.

But, alas, such thinking is anathema to conservatives today, whose fondest wish is to tax only labor income, freeing all capital income (which is concentrated in the wealthiest of households) from tax. The President's Advisory Panel on Tax Reform ("Panel") never considered

taxing all income, whether from labor or capital, at the same rate at the individual level, as under the 1986 Act. Indeed, the Panel recommends further shifting the tax burden from capital to labor income. Its "Growth and Investment Tax Plan" recommends extending the 15% tax rate currently applicable to capital gains and dividends to interest, as well. Its "Simplified Income Tax Plan" recommends that 75% of capital gains be tax-free, reducing the effective rate on those gains to between 3.75% and 8.25%. The top tax rate on ordinary income such as wages, in contrast, would be either 30% or 33%, and the current 10% tax rate would be abolished. The lowest ordinary income tax rate would be 15%. *Panel Report* at 61.

This refusal to entertain returning to the 1986 bargain of taxing all income at the same rate means that overall ordinary income rates need to be higher than would otherwise be the case. This result is unfortunate, as the

inability to further reduce middle-class tax rates as a trade-off for repealing or reducing several middle-class tax deductions means that the Panel's recommendations are doomed. That's a shame, as there is much good in the plans, as well.

THE MORTGAGE INTEREST DEDUCTION

As just one example, the current deduction for home mortgage interest is estimated to result in individual tax rates that are about 7.5% higher than they otherwise would be without the deduction. But the Panel recommends tightening the tax subsidy without reducing middle-class tax rates. Rather, the revenue raised would pay, in part, for the reduction of taxes on capital income. Reforming the tax subsidy for home mortgage interest is a worthy goal, but without an offsetting reduction in tax rates aimed at the middle class, it will be a hard sell to the American people.

A pure income tax would allow no deductions with respect to homeownership, as the income from the home is not taxed. The purpose of deductions under a pure income tax is to reduce the gross receipts earned from a business or investment to a net profit so that only that profit element is taxed. We do not tax the imputed rental income enjoyed by a homeowner who lives in his residence (rather than renting it out to a tenant), and we generally do not tax gain on the sale of a primary residence. So what is the purpose of the home mortgage interest deduction?

The deduction is an example of a tax expenditure, a provision that has nothing to do with properly measuring "income" in an income tax but rather is a way to implicitly spend money through the Internal Revenue Code and subsidize an activity for social policy reasons. The home mortgage interest deduction is ostensibly aimed at increasing the homeownership rate by subsidizing the borrowing costs to buy a home.

In other words, if the government wants to increase the homeownership rate, it has two options: enact a pure income tax and spend some of the revenue obtained on a targeted program to increase the homeownership rate, or enact an impure income tax that collects less revenue by allowing a tax-reducing subsidy for homeownership. Because of the anathema for direct spending programs in this country, much social policy spending is done through the Code.

If the government chose to spend money directly (by, say, sending a check to people) to increase the homeownership rate, the program would almost certainly be tailored to those lower on the income scale and those attempting to purchase their first home. Using the Code to deliver the subsidy, however, has several perverse effects. First, the deduction fails to help those who don't earn enough to owe tax or to itemize their deductions. Second, a \$1 deduction to someone whose income would otherwise be taxed at 30% saves 30 cents in tax, whereas a \$1 deduction to someone whose income would otherwise be taxed at 10% saves 10 cents. In other words, it's an upside-down subsidy. The Institute on Taxation and Economic Policy estimates that nearly 80% of the benefits from the home mortgage interest and property tax deductions go to the top 20% of taxpayers in terms of income, while only 5% goes to those in the bottom 60% of the income scale, the very taxpayers who may be struggling to own a home. See James R. Hagerty, *Housing Sector Seeks No Tax Remodeling*, WALL ST. J., Jan. 31, 2005, at A2.

Studies show that the deduction does not likely increase the homeownership rate. The benefit of the subsidy has varied dramatically over the last several decades with changes in tax and interest rates, and yet the homeownership rate has remained virtually unchanged (between 65% and 70%). Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deductions*, in 17

TAX POLICY AND THE ECONOMY 37 (James M. Poterba ed., 2003).

Moreover, homeownership rates in comparable economies, such as those of Canada and Australia, are virtually identical to the U.S. rate, even though no home mortgage interest deductions are allowed. The deduction produces substantial and inefficient windfall losses for the government by rewarding people for engaging in behavior (buying a home) that they likely would have engaged in without the subsidy.

Moreover, economists have long complained about other bad economic effects arising from the home mortgage interest deduction. Studies show that it serves mainly to cause buyers to purchase larger houses than they otherwise would, displacing business investment and other types of investment that have a greater impact on economic growth. See Glaeser & Shapiro, *supra*. Once a house is built and furnished, it just sits there, adding very little to overall economic growth. Economists would much rather see us buy a slightly smaller house and spend our investment dollars on infrastructure, research and development, or entrepreneurial activity that expands the economy in the long run.

The real estate lobby argues that repealing the home mortgage interest deduction would cause a collapse in home prices, because tax subsidies are now built into the price of houses. But Great Britain repealed its home mortgage interest deduction over a 12-year period, ending in 2000, and there was no crash in house prices, which kept rising.

THE PANEL'S PROPOSAL

Rather than completely repeal the deduction, however, the Panel recommends replacing it with a 15% tax credit. A taxpayer paying \$100 in mortgage interest would credit \$15 of that interest against his tax due, the economic equivalent of deducting that \$100 by someone in the 15% tax bracket. In other words, a taxpayer in the 30% tax bracket would enjoy the same \$15 in tax savings as someone in

the 15% tax bracket, thus eliminating the upside-down nature of the subsidy under current law. In addition, the interest paid on debt above \$227,000 to \$412,000 (depending on geographic location) would not be creditable, thus better targeting the buyer who is on the homeownership margin and eliminating the inefficient economic incentive to buy ever-larger homes in lieu of more productive investments for the economy. The current deduction would be phased out over a period of years.

If the purpose of the subsidy is to increase the homeownership rate, however, an even more efficient proposal would be aimed solely at first-time homebuyers. Nevertheless, the Panel's proposal is a good first step. Unfortunately, without a concomitant reduction in middle-class tax rates (which could be paid for by taxing all income at the same rate at the individual level), it is likely dead on arrival. That's a shame.

COUNTERPOINT: CURRENT LAW IS A BETTER OPTION

by Stuart Lazar, Rochester, MI

THE EVOLUTION OF CURRENT DEDUCTION LIMITS

Analyzing any tax reform proposal requires a comparison of the proposal to the ideal—what we think, in a perfect world, should be the correct answer—as well as a comparison to current law to determine whether the reform provides for a better result. The proposal by the Panel to replace the home mortgage interest deduction with a “Home Credit” fails to provide either the correct answer or a better result than the status quo while, at the same time, ignoring the potential impact of such changes on areas of the housing market.

Prior to 1986, individuals could generally deduct all interest they incurred regardless of how they used the borrowed funds. In 1986, Congress placed significant limitations on the deduction of “personal

interest”—defined generally as any interest incurred by an individual other than trade or business interest, investment interest, passive activity interest, qualified residence interest, certain interest on unpaid taxes, and interest on educational loans. Certain limitations apply to the deductibility of interest even in the aforementioned categories.

With respect to qualified residence interest, the Staff of the Joint Committee on Taxation noted in its explanation of the changes made to section 163 (dealing with the deductibility of interest) by the 1986 Act that “[w]hile Congress recognized that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, the Congress nevertheless determined that encouraging homeownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest.” Staff of Joint Comm. on Tax'n, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 263-64 (1987). Qualified residence interest, as defined by the 1986 Act, includes both “acquisition indebtedness” (indebtedness secured by a qualified residence that was used to acquire, construct or substantially improve such residence, limited to \$1,000,000) and “home equity indebtedness” (indebtedness secured by a qualified residence and limited to the lesser of \$100,000 or the excess of the fair market value of the residence over the amount of acquisition indebtedness with respect to such residence). A “qualified residence” includes the taxpayer's principal residence and one other residence. Thus, under current law, interest on a maximum of \$1,100,000 of debt securing the taxpayer's principal residence and vacation home is deductible.

THE PANEL MISINTERPRETS CURRENT TAX BENEFITS

The Panel proposes to reduce significantly the benefits currently provided in several ways. First, the amount of indebtedness eligible for

favorable tax treatment would be reduced from \$1,100,000 to an amount based on median area home purchase prices as determined from data provided by the Federal Housing Administration (resulting in limits for eligible indebtedness of between \$227,147 and \$411,704). Second, the current tax deduction would be converted into a tax credit. Finally, only acquisition indebtedness on a taxpayer's principal residence would be eligible for favorable tax treatment. Interest on home equity indebtedness and any vacation home debt would not be considered in determining the amount of the tax credit.

These Panel proposals would not further Congress' policy goal of encouraging homeownership and, in fact, the Panel seems to almost disregard the policy goal of homeownership in recommending this proposal. It claims that the Code currently favors investment in housing over other productive expenditures. To support this claim, the Panel cites a study by the Department of the Treasury's Office of Tax Analysis, which found that the economy-wide tax rate on owner-occupied housing is close to zero, compared to a tax rate of approximately 22% on other forms of business investment. From this, the Panel concludes that “[t]his may result in too little business investment. . . .” *Panel Report* at 71. It is unclear how it came to this conclusion or why it believes that a credit (rather than a deduction) will result in the right amount of business investment. In fact, if Congress has expressed a goal of promoting homeownership, one would expect that the tax rate on such investment would be lower than the tax rate on other types of investment. Raising the effective tax rate on homeownership, following the Panel's logic, would be a step toward discouraging homeownership.

The Panel also cites, as a reason to change current law, the statistic that the tax incentives for housing are not shared equally among taxpayers. According to the Panel, the majority of the tax benefits currently go to the

minority of taxpayers that itemize deductions—with more than 55% of the tax benefits going to the 12% of taxpayers who had cash income of more than \$100,000 in 2004. *Panel Report* at 72. The Panel believes that converting the current deduction into a tax credit that may be taken regardless of whether a taxpayer itemizes or takes the standard deduction would increase the number of taxpayers able to take advantage of the tax benefit. It has determined that providing a 15% “across-the-board” tax credit rather than a deduction based on a taxpayer’s marginal tax rates would provide for a greater sharing of the tax benefits relating to homeownership.

While the Panel is correct that a greater portion of the tax incentives relating to homeownership are received by those in higher-income groups, it makes the common mistake of analyzing taxes in a vacuum. The Panel fails to take into account non-tax subsidies for those citizens who pay little to no taxes at all. Although such subsidies may not completely erase the gap between benefits provided to the “haves” and the “have-nots,” they may significantly narrow it.

Moreover, while more tax deductions currently go to taxpayers in the higher tax brackets, it is those taxpayers who currently pay a higher share of the income tax. The Panel notes that the top 20% of households earn about 60% of all income and pay about 70.6% of all federal taxes (compared to the bottom 20%, which earn 2% of all income but pay only 0.4% of all federal taxes). *Panel Report* at 30-31. Thus, it is not surprising that taxpayers in the higher tax brackets receive a greater share of the tax benefits.

THE PROPOSAL IS A HIDDEN RATE INCREASE

The Panel’s proposal to replace the current tax deduction with a 15% tax

credit is a back-door way of increasing marginal tax rates on higher-income taxpayers. Deductions generally offset income under our current tax system, with the result that income earned and spent on a deductible item results in no additional tax liability. For example, a taxpayer who earns \$200,000 and incurs \$10,000 of deductible expenses is taxed generally at the same rate as a taxpayer who earns \$190,000 with no deductible expenses. Under the Panel’s proposal, a taxpayer in a marginal tax bracket above 15% who earns \$200,000 and incurs \$10,000 of mortgage interest will be taxed at a higher rate than a taxpayer with \$190,000 of taxable income and no interest deduction. Any credible tax reform proposal would work to increase transparency in our system, not cloud the effective tax rate even more.

THE PANEL IGNORES ECONOMIC REALITY

Finally, the Panel completely ignores the effect that its proposal will have on the U.S. housing market. It cannot be contested that tax benefits of homeownership are taken into account in a taxpayer’s determination of the homes which she can afford and the price paid for a particular home. If that fact is undisputed, how can the Panel’s proposal not cause a reduction in the value of homes in this country? By using a region’s median housing price to determine the amount of indebtedness eligible for the Home Credit, the Panel is conceding that approximately half of the homes purchased in the region would be affected by the mortgage cap. Whether or not a taxpayer is financing an “expensive” home, the value of that home is affected by the value of more expensive homes in that region. A increase in the after-tax cost of financing, which the proposal would

create, is likely to reduce the value of those homes. A decline in prices for the nation’s most expensive housing stock can only negatively affect the prices of lower cost houses. If, for example, the value of a \$500,000 home drops even 5% (to \$475,000) as a result of the Panel’s proposal, the value of homes previously in the \$400,000-\$475,000 price range must similarly decline in value. This will lead to a corresponding decline in value of homes in all price ranges.

The Panel also fails to account for abnormally high housing prices in such locales as Boston, San Francisco, and New York. Taxpayers in these areas will be seriously affected by the proposed changes. Similar negative consequences will be felt by taxpayers in areas where a large number of homes are sold to vacationers (such as Cape Cod, Massachusetts, Newport, Rhode Island, and Traverse City, Michigan) because purchasers of second homes will not receive any tax benefits under the Panel’s proposal. The Panel’s meager phase-in of these rules over a five-year period for preexisting home mortgages will do little to prevent a decline in housing values. Fair market value is determined, in large part, by what a purchaser is willing to pay—an amount that will almost certainly decrease absent the current tax incentives for homeownership.

The current tax treatment of qualified residence interest is far from perfect. The Panel’s proposal does little, however, to advance Congress’ clearly-stated policy of encouraging homeownership while, at the same time, it will have an almost-certain negative effect on home prices. In today’s uncertain economy, and with interest rates continuing to rise, those whose home is their most valuable asset have much to fear should the Panel’s recommendations come to fruition. ■