THE MORTGAGE INTEREST DEDUCTION
FREQUENTLY ASKED QUESTIONS

Prepared by the National Low Income Housing Coalition
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Owning one's home is a quintessential American value. Most Americans consider home ownership to be the ideal form of housing tenure and will own their homes sometime in their lives or will aspire to do so. Slightly less than two-thirds of American households live in owner-occupied homes, with a modest decline in the home ownership rate as a result of the Great Recession. U.S. public policy, especially since the early 20th century, has supported this ideal. The most popular housing related public policy is the mortgage interest deduction. Indeed, the association between home ownership and tax breaks is so strong that most people believe buying a home comes with a tax advantage, even if they do not know what it is or how it works, or whether they will benefit from the tax relief.

What follows is a brief primer on the mortgage interest deduction.

1. WHAT IS THE MORTGAGE INTEREST DEDUCTION (MID)?

The MID is a federal tax expenditure that allows certain mortgage holders to deduct the cost of the interest paid on their mortgages from their taxable income for federal income tax purposes.

2. WHAT IS A FEDERAL TAX EXPENDITURE?

A federal tax expenditure is a provision in the U.S tax code that allows individual or corporate taxpayers to reduce the amount of federal income tax owed if they meet certain criteria. Tax expenditures are more familiarly known as tax breaks or tax loopholes. There were 169 tax expenditures listed in the FY17 federal budget prepared by the Office of Management and Budget (OMB).

Most economists and tax policy analysts agree that tax expenditures are a means of spending through the tax code and that their objectives could be met just as easily through direct spending. Tax expenditures result in taxes not being collected and thus are a cost to the federal Treasury.

3. WHAT IS THE TOTAL COST OF THE MID TO THE TREASURY?

According to OMB, the MID will cost $62.44 billion in FY16 and $948.49 billion between FY16 and FY25. The Joint Committee on Taxation of the Congress (JCT) estimates a cost of $77 billion in FY16 and $419.8 billion from FY15 to FY19.

4. WHAT ARE THE DATA SOURCES ON FEDERAL TAX EXPENDITURES?

The two primary sources of data on federal tax expenditures are OMB and the JCT.

OMB Estimates from FY17 Federal Budget are at: https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/ap_14_expenditures.pdf

JCT Estimates for FY15-19 are at: https://www.jct.gov/publications.html?func=startdown&id=4857

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OMB and JCT estimates regarding tax expenditures vary somewhat. The JCT document explains why there are differences. When reading studies or reports on any tax expenditures, it is important to know which source from which year is cited. NLIHC uses the OMB numbers unless otherwise stated.

5. ARE THERE OTHER FEDERAL HOUSING SUBSIDIES IN THE TAX CODE?

Yes, there are three other federal subsidies that support homeownership and one that supports rental housing. OMB considers the deduction of real estate property taxes, the exclusion of capital gains, and the exclusion of imputed rent to be individual tax expenditures that benefit home owners and OMB calculates their annual cost. JCT only counts and calculates the cost of the first two. The values for FY16 are:

FY16 Tax Expenditures	OMB	JCT
Deduction for Real Property Tax	$33.08 billion	$34.7 billion
Exclusion for Capital Gains	$40.58 billion	$29 billion
Exclusion for Imputed Rent	$101.1 billion	n/a

The tax expenditure that supports low income rental housing is quite limited in comparison. OMB estimates the value of the Low Income Housing Tax Credit in FY16 to be $7.88 billion; the JCT estimate is $8.1 billion.

6. HOW DOES THE MID WORK?

When filing annual federal income tax returns, taxpayer(s) can deduct from their taxable income the interest paid in that tax year on a home mortgage of up to $1 million. The deduction is based on the size of the mortgage, not on the value of the house. The interest can be on mortgages on first and second homes. In addition, the interest on up to $100,000 in a home equity loan can be deducted so the total cap of $1,100,000 on the value of mortgages for each home.

The value of the deduction, or the degree to which it reduces one's taxable income, depends on one's tax bracket. Thus, taxpayers in the 33% tax bracket will be able to reduce their taxes by 33% of the amount of interest paid. Someone in the 15% tax bracket will reduce their taxes by just 15% of the interest paid. In order to benefit from the MID, a taxpayer must file an itemized tax return.

7. WHO BENEFITS FROM MID? WHO DOESN'T?

Because the MID is a deduction, the only way to use it is to itemize one's annual tax return. Thus, the first test of who benefits from the MID is to consider what percentage of taxpayers file itemized tax returns and, in particular, what percentage of taxpayers claim the MID. According to JCT, in 2014, 168,943,000 tax returns were filed, only 27% of which were itemized. Just 20% of all tax returns claimed the MID.

Taxpayers with incomes of $100,000 or more who claimed the MID received 82% of the total benefit, while the top 18% of taxpayers who claimed the MID (those with incomes of $200,000 or more) received 42% of the benefit. The higher one's income, the more likely one is to itemize. Furthermore, one's tax bracket goes up with one's income; the higher one's tax bracket, the greater the percentage of interest paid is deducted from one's taxes. The MID benefits those who itemize their taxes and claim the deduction, and its benefit increases with higher income brackets.

Homeowners who do not benefit from the MID include those who have paid off their mortgages and those whose incomes and/or mortgages are not high enough for them to itemize their tax returns. The assumption is that if it is to a taxpayer's advantage to itemize, he or she will, and likewise, if the standardized deduction is the best choice, a taxpayer will take it. Additionally, renters do not benefit from the MID.

The National Association of Realtors asserts that non-itemizers with mortgages do benefit from the MID indirectly, because at least some of it is assumed to be included in the value of the standard deduction that all non-itemizers receive. However, under the United for Homes proposal, a taxpayer who pays mortgage interest and takes the standard deduction would receive an additional credit against his or her tax bill of 15% of the amount of interest paid.

8. WHAT ARE THE ORIGINS OF THE MID?

Contrary to popular opinion, the MID was not enacted to promote and incentivize homeownership. It was created in 1913, with the adoption of the 16th amendment to the U.S. Constitution that established the federal income tax. When the income tax was implemented, certain business expenses were allowed to be deducted, including interest on all loans. Very few Americans had home mortgages in those days and most personal and business finances were intermingled. Eventually, federally insured and 30-year mortgages multiplied after World War II, and the MID became more important to the emerging middle class. Even so, the earliest estimate of the cost of the MID in 1977 was just $4.7 billion. Dennis Ventry's history and critique of the MID calls it the "accidental deduction."

9. HAS IT EVER BEEN CHANGED?

The only major change to the MID occurred in the mid-1980s, when Congress undertook tax reform. For years, tax policy experts had been growing increasingly critical of the proliferation of tax expenditures and the MID in particular. While many tax expenditures were eliminated in the Tax Reform Act of 1986, the MID survived due to the intense lobbying pressure of the real estate and home building industries. In 1987, the $1 million cap was enacted, along with the $100,000 home equity loan provision. The political rhetoric of the time strongly conflated the MID with home ownership itself, setting the stage for the extreme popularity of the MID today.

10. IS THE MID AN INCENTIVE TO BECOME A HOMEOWNER?

Despite the deeply held beliefs that the purpose of the MID is to incentivize home ownership, there is actually little evidence that anyone makes the decision to move from being a renter to a mortgage holder in order to get a tax break. In fact, many low and moderate income first-time homebuyers do not benefit from the MID because they don't earn enough to justify itemizing their taxes. MID critics frequently point out that other countries that have similar or higher rates of home ownership do not have the MID. However, the MID does encourage people who already have mortgages to buy bigger, more expensive homes through which they take on more debt and thus get bigger tax breaks.

11. WHAT IS THE NLIHC PROPOSAL FOR REFORM?

NLIHC proposes to lower the cap on the amount of mortgage for which interest can be deducted from $1.1 million to $500,000. Mortgages for first and second homes and for home equity loans of up to $100,000 are eligible for the tax break as long as the total amount of mortgages does not exceed $500,000. NLIHC also proposes converting the tax deduction to a non-refundable tax credit of at least 15%.

12. HOW IS A TAX CREDIT DIFFERENT FROM A TAX DEDUCTION?

A tax deduction reduces one's taxable income on which one's total tax bill is based. A tax credit is a direct reduction of one's total tax bill. Taxpayers do not have to itemize their tax returns to benefit from a tax credit. Moreover, a tax credit as proposed here would be the same percentage for everyone, unlike a tax deduction whose value increases with income. Generally, tax credits are flatter and fairer.

13. WHAT IS THE DIFFERENCE BETWEEN A NON-REFUNDABLE AND A REFUNDABLE TAX CREDIT?

Most tax credits are non-refundable. They can reduce the amount of income tax owed to zero but cannot exceed the amount of tax owed before the credit is applied. (i.e.: If total taxes owed before a tax credit are $500 and the tax credit is valued at $300, the taxes owed after the tax credit are $200. If total taxes owed before a **refundable** tax credit are $300 and the tax credit is valued at $500, the tax refund after the tax credit is $200. If total taxes owed before a **nonrefundable** tax credit are $300 and the tax credit is valued at $500, no taxes are owed, but there is no tax refund.)

A refundable tax credit can actually produce a tax refund that is greater than the amount of taxes paid and owed. Refundable tax credits tend to be more costly than non-refundable tax credits. The Earned Income Tax Credit is an example of a refundable tax credit.

14. WHY REDUCE THE CAP TO $500,000?

Capping the amount of mortgage for which the interest can be deducted at $500,000, saves money and targets the benefit more toward middle and low income homeowners. Some people suggest that exceptions should be made for high cost areas, but the reality is that the vast majority of mortgages across the country are $500,000 or less. Only 5% of all mortgages between 2012 and 2014 were over $500,000. To see the percentage of mortgages over $500,000 by state, go to http://nlihc.org/unitedforhomes/mortgage-maps.

It is important to remember that the $500,000 cap does NOT apply to either the purchase price or assessed value of a home. It is simply the size of the mortgage or the principal balance on the loan. Finally, a taxpayer with a mortgage larger than $500,000 can still get the benefit of the credit up to the $500,000 cap.

15. WHAT ABOUT SECOND HOMES?

Many people object to the idea that the interest can be deducted on mortgages for second homes. However, vacation homes comprised only 4.1% of all housing units in 2014.

16. WHO WILL BE AFFECTED BY THE NLIHC REFORM PROPOSAL?

The primary beneficiary of this proposal will be all the middle and low income homeowners who pay mortgage interest but who do not now take the mortgage interest deduction. Based on calculations done by the Tax Policy Center, under a 15% non-refundable credit, 14.7 million additional homeowners will get a tax break, more than two-thirds of whom have household income below $100,000. Higher income households, primarily those with incomes of $150,000 or more, will experience a tax increase.

17. WHY SHOULD THE MID BE MODERNIZED NOW?

The housing bust that started in 2007 has called into question much of how the U.S. housing finance system, including the role of the federal government, works. This period of recovery requires an examination of the role of the federal government and what reforms are needed. This environment offers an optimal window of opportunity for change.

One good argument for reform is the growth in federal expenditures on the MID and its outsized benefit to higher income homeowners. It is now the second largest federal tax expenditure. At a time of severely constrained federal resources, it is reasonable to question if there is not a better use of the funds represented by the MID.

18. HOW WOULD REFORM OF MID AFFECT THE HOUSING RECOVERY?

Some people worry that reform of federal housing tax policy should not be considered while the U.S. housing market is still recovering from the housing bust. Recognizing the continued challenges, NLIHC and our allies do not support a precipitous change. Rather, we propose a five-year transition for both the lowering of the cap and the phasing out of the deduction and phasing-in of the credit.

19. WHO SUPPORTS REFORM OF THE MID? WHO OPPOSES REFORM?

Lowering the cap and converting the deduction to a credit have been proposed by the 2005 Bush tax reform panel, the Bowles-Simpson deficit reduction commission, the Dominici-Rivlin deficit reduction project of the Bipartisan Policy Center and several members of the House of Representatives, including Keith Ellison (D-MN) and Barbara Lee (D-CA). Numerous tax policy experts and housing economists have called for reform, as well editorial pages of major newspapers.

The Bipartisan Housing Commission recommends significant expansion of rental housing assistance for extremely low income households and paying for it with revenue raised from MID reform.

The major defenders of maintaining the status quo are the real estate and home building industries, specifically the National Association of Realtors and the National Association of Home Builders. Both of these organizations have large memberships and considerable financial resources to deploy to defend their position and their ability to influence public policy cannot be underestimated.

20. HOW MUCH MONEY CAN BE SAVED WITH THE NLIHC REFORM PROPOSAL?

If the two changes are phased in over five years, $213 billion in revenue would be raised in ten years.

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21. WHAT WILL BE DONE WITH THE SAVINGS FROM REFORM?

NLIHC proposes that revenue raised from MID reform be directed to fund affordable housing programs, like the national Housing Trust Fund (HTF), to build, preserve, rehabilitate, and operate rental housing that is affordable for extremely low income households. Some groups believe the savings from MID reform should be directed towards other areas, including reducing the national debt and lowering tax rates. But, as various commissions that have called for reform recommend, NLIHC and its partners believe the funds should be retained as federal housing expenditures and redirected towards those with the greatest housing need – extremely low income households.

Retaining the savings for housing spending could assuage the fears of realtors and home builders, many of whom object to any change in the MID out of concern that the revenue raised will not be used for housing purposes and thus leave the housing economy.

The United for Homes Campaign urges housing organizations and advocates to embrace a unified message on what should be done with the new revenue. MID reform advocates who are also low income housing advocates assert that MID reform is the best, and perhaps last, opportunity the nation has to seriously address the severe shortage of affordable rental housing that low income people can afford.

If the choice is made to reform the MID and direct the revenue raised to the national Housing Trust Fund, we can end and prevent homelessness in the United States within 10 years without increasing the federal deficit. This would be a win for everyone in America.

22. HOW IS IT POSSIBLE TO FUND A SPENDING PROGRAM FROM TAX POLICY CHANGES?

Some people who work on tax policy are skeptical that it is possible to fund a spending program, such as a trust fund, by changes to the tax side of the federal budget. The proposal does not call for a direct link between MID reform and the HTF. Rather, the proposal suggests that a specific dollar amount raised by MID reform be designated as an allocation to the HTF. Remember, the HTF is a permanent program on the mandatory side of the federal budget.

There is precedent for this approach. In 2009, the House passed a “tax extenders” package that included a provision of $1 billion for the national HTF.

Still have questions?

Please send your question to outreach@nlihc.org and we will get back to you as soon as possible.