The Mortgage Interest Deduction

Andrew Aurand, Senior Vice President for Research, NLIHC

The mortgage interest deduction (MID) is a federal tax expenditure that allows homeowners to deduct from their federal taxable income the interest paid on the first $750,000 of home mortgage debt originated after December 15, 2017 or on the first $1 million of home mortgage debt originated before December 16, 2017. Although the "Tax Cuts and Jobs Act of 2017" significantly reduced its cost, the MID remains a regressive tax benefit for higher-income homeowners at a cost of more than $145 billion between 2022 and 2025 in lost federal tax revenue (U.S. Department of Treasury, Office of Tax Policy, 2022). The revenue lost to the MID primarily benefits higher-income households and would be better spent on housing assistance for the lowest-income households with the greatest needs.

HOW IT WORKS

Taxpayers can subtract from their federal taxable income either (1) a fixed dollar amount known as the standard deduction or (2) itemized deductions allowed by the federal tax code. Taxpayers must itemize their tax deductions to benefit from the MID. Most taxpayers, however, do not itemize their deductions, because their standard deduction is higher. Affluent households are more likely to itemize their deductions and, therefore, benefit from MID. Fewer than 10% of the nation's 164 million federal tax returns in 2020 included itemized deductions. Further, tax returns with reported annual incomes of more than $100,000 accounted for only 19.4% of all tax returns, but they accounted for 59% of tax returns with itemized deductions (Internal Revenue Service, 2022).

MID's value to taxpayers depends on their marginal tax rate. Taxpayers in the 37% tax bracket, for example, can reduce their taxes by 37% of the interest paid for their mortgage, while taxpayers in the 22% tax bracket can reduce their taxes by 22% of the interest paid. Because higher-income homeowners are more likely to claim the MID and the value of the MID increases with income, taxpayers with incomes over $100,000 received 73% of MID's benefits in 2020 (Ibid).

HISTORY

Contrary to popular belief, MID was not created to encourage homeownership. When the federal income tax was implemented in 1913, personal interest on all loans was an allowable deduction from taxable income. At the time, it was difficult to differentiate personal consumption and home loans from business loans for farms, small businesses, and individual proprietors (Ventry, D., 2010). There is no evidence that Congress intended to use the interest deduction to encourage homeownership. One-third of homeowners had a mortgage in 1910, but few benefited from the interest deduction since 98% of households were initially exempt from the federal income tax given its generously high tax-free income threshold (Ibid). The post-World War II housing boom, fueled by FHA- and VA-insured mortgages, and the broadening of the federal income tax to cover more households made the interest deduction available to an increasing number of homeowners with mortgages. The cost of MID grew significantly through the 1980's to late 2000's, along with the growth in homeownership rates and home values. Before tax reform in 2017, the cost of MID was approximately $70 billion per year.

The "Tax Cuts and Jobs Act of 2017" made significant changes to the value of the MID to taxpayers. The act reduced the amount of a mortgage eligible for MID from $1,000,000 to $750,000 for loans taken after December 15, 2017 and eliminated the MID for home equity loans not for substantial home improvement. Previously, interest paid on up to $100,000 on any home equity loans could be deducted. The act also significantly increased the standard deduction for taxpayers, making itemized deductions less likely for middle-income taxpayers.

The “Tax Cuts and Jobs Act of 2017” reduced the cost of the MID from approximately $70 billion per year prior to tax reform to an estimated $30 billion in 2020 (U.S. Department of Treasury, Office of Tax Policy, 2017 & 2018), but skewed the MID’s benefits even more to affluent taxpayers.

OTHER THINGS TO KNOW ABOUT MID

A study of MID reform in Denmark indicated that the tax benefit does not promote homeownership, but induces homeowners to buy larger, more expensive homes and incur greater debt than they otherwise would (Gruber, J., Jensen, A., and Kleven, H., 2017).

MID also contributes to racial and gender inequities. A study by Trulia found that single women were 6.2% less likely than single men of the same age and income to own a home with a mortgage (Chacon, F., 2016). Black and Hispanic households were 56.9% and 50.9%, respectively, less likely than white households to own a mortgaged home. Without mortgages, single women and people of color do not receive MID benefits to the same extent as white households. An analysis by the Institute for Economic and Racial Equity (IERE) at Brandeis University and NLIHC found that white households received 71% of MID’s benefits even though they account for 66% of households in the United States. Black and Latino households received only 18% of MID’s benefits yet they account for more than 26% of U.S. households.

The MID is a costly federal tax expenditure that disproportionately benefits higher-income households who do not need assistance to afford their homes. The tax changes enacted in 2017 expire in 2026, when the standard deduction will decline to pre-2017 levels and the cap on mortgage debt eligible for MID will return to $1 million. As a result, the U.S. Treasury’s Office of Tax Policy estimates that the federal revenue lost to the MID will increase from nearly $39 billion in 2025 to $107 billion in 2026, if the tax package enacted in 2017 is not extended. At the same time, nearly eight million extremely low-income renters spend more than half of their incomes on housing (National Low Income Housing Coalition, 2022), forcing them to sacrifice other necessities. The federal revenue lost to the MID would be better spent on housing assistance for these lowest-income households who have the greatest need.