UNITED FOR HOMES
CAMPAIGN FOR THE NATIONAL HOUSING TRUST FUND

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THE MORTGAGE INTEREST DEDUCTION
FREQUENTLY ASKED QUESTIONS

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Owning one's home is a strong 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. Approximately 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.

What follows is a primer on the Mortgage Interest Deduction that is intended to make it more transparently understood.

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 individual federal income taxes.

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. Most economists and tax policy analysts agree that tax expenditures are spending through the tax code, whose 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. How many federal tax expenditures are there and how much do they cost?
There are 169 tax expenditures listed in the FY14 federal budget prepared by the Office of Management and Budget totaling $1,182,572,000,000 for 2014.
http://www.whitehouse.gov/omb/budget/Supplemental.
The Joint Committee on Taxation of the Congress also analyzes tax expenditures each year.
https://www.jct.gov/publications.html?func=startdown&id=4503.
The JCT document explains why there are differences between the two estimates.

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.

4. What is the total cost of the MID to the Treasury?
According to OMB, the MID will cost $101.5 billion in 2014 and $640.2 billion between 2014 and 2018. The JCT estimates a cost of $71.7billion in 2014 and $379 billion from 2013 to 2017.

5. Are there other federal housing subsidies in the tax code?

Yes, there are three others that support homeownership. OMB estimates the cost of the deduction of real estate property taxes, the exclusion of capital gains, and the exclusion of imputed rent[1] as individual tax expenditures that benefit home owners. JCT only counts the first two. The values for 2014 are:

2014 Tax Expenditures	*OMB*	*JCT*
Deduction for Real Property Tax	$25.16 billion	$28.6 billion
Exclusion for Capital Gains	$45.87 billion	$24.8 billion
Exclusion for Imputed Rent	$75.52 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 2014 to be $8.3 billion; the JCT estimate is $6.7 billion.

6. How does the MID work?

When filing annual federal income tax returns, the taxpayer(s) can deduct 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 for a cap of $1,100,000 on the value of mortgages eligible for tax breaks.

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 2011, 155,879,000 tax returns were filed, 30% of which were itemized. Just 22% of all tax returns claimed the MID.

The top 55% of taxpayers who claimed the MID (those with incomes of $100,000 or more) received 77% of the total 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.

Those who do not benefit from the MID are renters, homeowners who have paid off their mortgages, and homeowners whose incomes and/or mortgages are not high enough for them to itemize their tax returns.

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, include 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."

[1] Imputed rent is the value one gains from living in a home for which does not pay rent. While people who live in owner occupied homes make monthly mortgage payments to pay off loans, they essentially live in their homes rent free. If the mortgage holder chose to rent the house to someone else, he or she could still claim a tax deduction for the mortgage interest, but would have to declare the rent collected as income for which income taxes must be paid. The federal government foregoes the tax revenue from the rental value of a home when it is occupied by the mortgage holder or the owner once a mortgage is paid off. Not taxing imputed rent creates asymmetry between the tax treatment of owner-occupied and rental homes, and distorts housing markets in favor of home ownership.

9. Has it ever been changed?

The only major change 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. 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 are 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 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 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 one's income tax liability to zero, but cannot produce a tax refund that is greater that the pre-credit tax liability. (Ex: If total taxes owed before the tax credit are $500 and the tax credit is valued at $250, the tax refund is $250. If total taxes owed before the credit are $250 and the tax credit is valued at $500, no taxes are owed, but there is no 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. It is considered a federal tax expenditure, projected to cost $9 billion in revenue receipts in 2014 according to JCT. However, the total outlays in 2014 are projected to be $67 billion.

14. Why reduce the cap to $500,000?

Capping the amount of mortgage for which the interest can be deducted at a level that represents where most mortgages are 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 fact is that the vast majority of mortgages are $500,000 or less. Only 4% of all mortgages between 2007 and 2011 were over $500,000. To see the percentage by state, go to http://nlihc.org/sites/default/files/U4H_500k-mortgages-percent.pdf.

It is important to remember that the $500,000 cap does NOT apply to the 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, which are thought of as luxuries. Vacation homes made up 3.6% of all housing units in 2009 and second homes are typically modest. According to a survey by the National Association of Realtors, the median sales price for vacation homes in 2011 was $150,000 and the median household income of vacation home buyers was $99,500.

Since the mid-1970s, the Congressional Budget Office has produced a report every two years on options that Congress has for reducing federal expenditures. Each report suggests some change to the MID. Starting in the 1987 report through the 2001 report, CBO suggests a phasing out or limiting the MID for second homes. Based on the 2001 CBO figures, NLIHC calculates that the cost of the MID on second homes in 2013 is less than $1 billion or less than 1% of the total MID.

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, the number of homeowners who will get a tax break will grow from 39 million to 55 million, with 99% of the increase being households with incomes less than $100,000 a year.

Higher income households, primarily those with incomes of $200,000 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 the best window of opportunity for change in a long time.

One good argument for reform is the growth in the size of 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. While others would eliminate the MID altogether, most advocate for a modest change such as NLIHC is proposing.

Moreover, 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, and the Dominici-Rivlin deficit reduction project of the Bipartisan Policy Center. 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 on over five years, $197 billion in revenue would be raised in ten years.

21. What will be done with the savings from reform?

NLIHC proposes that all the savings from MID reform be directed to the National Housing Trust Fund to build, preserve, rehab, and operate rental housing that is affordable for extremely low income housing. There are several other ideas being floated about ways to use MID savings to help low income people.

The various commissions that have called for reform would direct the savings to deficit reduction. Others who support MID reform think it should go to deficit reduction.

One reason realtors and home builders object to any change in the MID is the fear that any savings will not be used for housing purposes and thus leave the housing economy.

The fundamental challenge is to convince all housing organizations and advocates that we need a unified message on what should be done with savings. 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 savings 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 seem to be a win for everyone.

Still have questions?

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