

The Home Mortgage Interest Deduction: Should Reform Mean Fear?

By Kira Wolak

Introduction

The home mortgage interest deduction (hereafter MID) detailed in 26 U.S. Code § 163 allows homeowners to deduct up to \$1,000,000 of interest paid on mortgages for a principal or secondary residence.¹ This popular deduction is the third largest tax break in America and costs the government between \$77 and \$100 billion per year.² While this tax deduction is lauded as a contributing factor to the rise of homeownership among the lower and middle classes, many economic scholars disagree on whether the tax break actually benefits low-to moderate-income families, or if the tax dollars are simply returning to the hands of the upper-class due to their higher value mortgages.

Their speculation has been transformed into action by the United States Congress, who, in the 2017 Tax Reform, modified two key components of the MID: the cap has been lowered to \$750,000 per household (a 50% increase from the originally proposed \$500,000 cap) and secondary residences and vacation homes no longer qualify for the deduction.³ However, the increase of the standard deduction from \$12,700 to \$24,000 for all taxpayers included in the 2017 Tax Reform also affects the MID; because the MID can only be claimed if a household's tax returns are itemized, the total itemized deductions must exceed the standard deduction to incentivize households to claim the

¹ 26 U.S. Code § 163 - Interest, LII / Legal Information Institute (2017), <https://www.law.cornell.edu/uscode/text/26/163> (last visited Feb 10, 2018).

² Alex Mayyasi, *The Case Against Everyone's Favorite Tax Break: The Mortgage Interest Deduction Priceonomics* (2017), <https://priceonomics.com/the-case-against-everyones-favorite-tax-break-the/> (last visited Feb 10, 2018).

³ Sarah O'Brien, *These changes under the GOP tax plan affect homeowners*, CNBC (2017), <https://www.cnn.com/2017/12/20/here-are-the-finalize.html> (last visited Jan 14, 2018).

MID.⁴ By first investigating which households were benefitting most from the original conditions of the MID, we can better understand how future homeowners will be impacted and whether Congress succeeded in targeting low-to moderate-income families as the primary beneficiaries of these tax breaks.

Applications of the Original Statute

According to the original statute, the MID allows homeowners to deduct up to \$1,000,000 of interest paid to mortgages on a principal or secondary residence, and up to \$100,000 of interest paid on a home equity line of credit.⁵ If individuals claiming the MID on their residence are married but filing separate returns, then the amount of their deduction cannot exceed \$500,000 and \$50,000, respectively.⁶ However, it was determined by *Voss v. Commissioner of Internal Revenue* that even if residents are not married, as with Bruce Voss and Charles Sophy, they are still subject to claiming only \$500,000 each, as delineated above.⁷ This is a crucial mechanism of the MID to ensure that the IRS does not implicitly encourage individuals to remain unmarried to benefit from this tax deduction, and eliminates bias toward couples based on their income, sexual orientation, and/or other personal or situations factors that may influence their decision not to marry.

However, the IRS does adhere to a strict definition of “homeowner” when determining who is eligible to claim the deduction. In *Puentes v. Commissioner of Internal Revenue*, Lourdes Puentes attempted to claim the MID on her tax return after paying several months of her brother’s mortgage payments when he became unemployed.⁸ Ms. Puentes had moved in with her brother, Benjamining Puentes, after her father, also living with her brother, had

⁴ Id.

⁵ 26 U.S. Code § 163 - Interest, LII / Legal Information Institute (2017), <https://www.law.cornell.edu/uscode/text/26/163>, (last visited Feb 10, 2018).

⁶ Id.

⁷ *Voss v. Commissioner Internal Revenue*, Nos. 12–73257, 12–73261. (2015), <http://caselaw.findlaw.com/us-9th-circuit/1710007.html>, (last visited Feb. 8, 2018).

⁸ *Lourdes Puentes v. Commissioner of Internal Revenue*, T.C. Memo. 2014-224, 2 (2014).

fallen ill.⁹ Though she was not listed on the Mortgage Interest Statement (Form 1098) of the lender, Ms. Puentes chose to pay her brother's mortgage payments and claimed the payment on her tax forms.¹⁰ However, because Ms. Puentes was not an equitable owner of her brother's house, she was not personally liable for the mortgage payment, thereby suspending her eligibility for the deduction.¹¹ This ruling places an unfair burden on families suffering from unemployment and other situational factors rendering them unable to meet their mortgage payments, and the strict application of MID could inhibit lower and middle class families who face similar circumstances from benefitting from the deduction.

Analysis of Original and Revised MID

While case law has already exposed one possible weakness of the MID, in order to truly understand its impact on the lower and middle classes, we must analyze which households are meeting the requisite of itemizing their tax returns in order to claim the MID. Researchers Dean Stansel and Anthony Randazzo of the Reason Foundation found that few low-income homeowners itemized their tax returns because the marginal benefit over the standardized deduction was too small of an incentive.¹² In 2009, only 20% of all taxpayers claimed MID; 70% of homeowners with an income of over \$200,000 claimed the tax deduction, while less than 25% with an income between \$40,000-\$50,000 and less than 15% with an income between \$30,000-\$40,000 claimed the deduction.¹³ These statistics validate that the MID is not benefitting low- to moderate- income families, but is instead simply returning wealth to the middle- and upper-class.

The reason for such disproportionate statistics is two-fold: not only do higher-

⁹ Id., 3

¹⁰ Id., 4

¹¹ Id.

¹² Dean Stansel & Anthony Randazzo, *Unmasking the Mortgage Interest Deduction: Who Benefits and by How Much?* (1st Ed. 2011), 5:

http://reason.org/files/mortgage_interest_deduction.pdf, (last visited Feb 10, 2018).

¹³ Id., 6

income individuals tend to purchase more expensive homes, therefore obtaining larger mortgage payments and qualifying for higher deductions, but graduated tax brackets increase wealthy homeowners' return on their MID as well. In his article, "Mortgage Interest Deduction: Not A Tax Break For The Middle Class," Ben Hallman cites economists from the University of Pennsylvania to illustrate how homeowners with an income between \$40,000-\$75,000 who claim the deduction only save, on average, \$523 on taxes, while those with incomes greater than \$250,000 save an average of \$5,459.¹⁴ Obviously, this enormously expensive tax break is a gross misallocation of government resources if its purpose is to empower low-to-moderate-income homeowners.

With these considerations in mind, the 2017 Tax Reform appears to be a step in the right direction. Low-to-moderate-income households are benefitting more from the nearly doubled standard tax deduction available to all taxpayers than if they had itemized their tax returns to claim the MID, which, as argued above, most did not do to begin with. Looking forward, the new cap of \$750,000 and limitation of the deduction to only a primary residence may have minor ramifications, but mainly for the upper class, especially those who live in areas with expensive real estate. While the cap is still high enough to avoid the risk of driving market prices down in an effort to preserve the option to itemize and receive the MID, homeowners straddling the cap may be reluctant to move or buy second residences. This is because mortgages drawn before 2018 are grandfathered in, allowing these homeowners to continue to deduct up to \$1,000,000 instead of only \$750,000 until the mortgage has been paid off.¹⁵ However, those who can afford \$750,000 residences will not be crippled financially by this reform, especially when there are multiple other tax breaks available to whitewash potential losses.

¹⁴ Ben Hallman, *Mortgage Interest Deduction: Not A Tax Break For The Middle Class*, The Huffington Post (2017), http://www.huffingtonpost.com/ben-hallman/mortgage-interest-deduction_b_2213304.html, (last visited Feb 10, 2018).

¹⁵ Alana Semeuls, *The GOP Targets America's Most Loved and Hated Tax Break (2017)*, <https://www.theatlantic.com/business/archive/2017/11/tax-bill-mortgage-interest-deduction/544847/>, (last visited Jan 14, 2018).

Homeownership & the MID: Myth or Motive?

Despite the savings both the United States government and American households will experience due to the reformed MID, there has been a severe backlash by several real estate lobbyists against the new MID regulations. William E. Brown, President of The National Association of Realtors, has said his organization “cannot support a bill that takes homeownership off the table for millions of middle-class families.”¹⁶ Homeownership seems to be a buzzword in American society often associated with the “American Dream,” and even Presidents Clinton and Bush have promoted America as a “homeownership society.”¹⁷ However, public financial analyst Mark Keightley has deduced that the causation between the MID and homeownership is not directly established. Keightley states that economists have identified the largest barrier to homeownership as the high, immediate transaction cost of a down payment; MID only increases after-tax household income, and not by an amount substantial enough to help individuals tackle a large down payment.¹⁸

The misconception that the MID empowers middle-class families to become homeowners can be detrimental, as it has the potential to warp citizens’ understanding of the 2017 Tax Reform’s actual effect on their income and economic mobility. The main proponents of this misleading rhetoric are consistently real estate professionals, and Alex Mayyasi of Priceonomics explains why this might be. According to his findings, the MID actually allows the price of homes to *increase*. Real estate agents, banks, and other related parties factor in the savings from the deduction when determining both market and mortgage prices. Mayyasi exposes how “lenders and realtors capture a chunk of the subsidy—perhaps 9-17% in the case of mortgage

¹⁶ *Id.*

¹⁷ Alex Mayyasi, *The Case Against Everyone’s Favorite Tax Break: The Mortgage Interest Deduction*, Priceonomics (2017), <https://priceonomics.com/the-case-against-everyones-favorite-tax-break-the/>, (last visited Feb 10, 2018).

¹⁸ Mark P. Keightley, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, Congressional Research Services, <http://nationalaglawcenter.org/wp-content/uploads/assets/crs/R41596.pdf> (2014), 7, (last visited Feb. 8, 2018).

providers.”¹⁹ The ability to inflate profit margins using the MID demonstrates why various real estate associations have been lobbying against the reduction. With the 2017 Tax Reform, it is expected more households will claim the standard deduction rather than itemize their tax returns, removing the incentive the MID equipped real estate agents with to convince homebuyers to select mortgage packages with larger principals and higher rates.

While it is dubious whether the MID empowers homeownership as commonly perceived, the deduction can encourage homeowners to take out mortgages or home equity lines of credit larger than they can afford. Similar practices precipitated the 2008 housing bubble burst, and Mayyasi uses the sprawling foreclosures in Las Vegas suburbs to represent the possible consequences if the MID’s function continues to be misappropriated by real estate and lending groups.²⁰ The 2017 Tax Reform, however, may have possibly nixed that fate by increasing the standard deduction and unlinking the association between interest payments and tax savings. In fact, a further reduction of the MID may even incentivize households to pay down their mortgage debt faster since they would no longer be reaping ostensible benefits from the deduction. Stansel and Randazzo cite economists James Poterba and Todd Sinai who confirm this belief, estimating mortgage debt would decrease by 30%.²¹

While it may be strong to label the homeownership argument as a myth, the true function of the MID has been misconstrued by various benefitting parties who had lobbied against its reduction. If American citizens believe this rhetoric to be true, the consequences could be economically dangerous, including increased chances of foreclosure and the persistence of sliding scale pricing methods for mortgages based on calculated savings granted by the deduction. The MID will continue to cost the United States government millions in returned tax dollars annually, even after the 2017 Tax Reform,

¹⁹ Alex Mayyasi, *The Case Against Everyone’s Favorite Tax Break: The Mortgage Interest Deduction*, Priceonomics (2017), <https://priceonomics.com/the-case-against-everyones-favorite-tax-break-the/>, (last visited Feb 10, 2018).

²⁰ Id.

²¹ Dean Stansel & Anthony Randazzo, *Unmasking the Mortgage Interest Deduction: Who Benefits and by How Much?* (1st Ed. 2011), 5, http://reason.org/files/mortgage_interest_deduction.pdf, (last visited Feb 10, 2018).

dollars which have been shown to primarily benefit the upper-class. Awareness must be brought to American citizens regarding the true function of the revised MID to overcome any misinformation and allow voters to decide whether further reductions should be made.

Conclusion

The dollar value of the popular and controversial home mortgage interest deduction has been blown out of proportion, especially when various political and real estate representatives suggest it empowers low-income Americans to become homeowners. The studies discussed in this article clearly illustrate how households with an average income of \$50,000 are not benefitting from this deduction as much as their upper-class counterparts, and how the MID is being used to inflate the price of real estate by a substantial percentage. With the increase of the standard tax deduction, The Tax Policy Center has recently estimated that the original number of households claiming the MID would fall from 21% to 4% with the 2017 Tax Reform, granting the majority of households (specifically low- to moderate-income families) greater savings regardless of their mortgage situation.²² While the cap is negotiated to return to \$1,000,000 in 2026 (alongside a reduction of the standard tax deduction), if the reduced cap proves effective, the United States government may vote to reduce it even further and take others steps to wean American homeowners off their contrived dependence on the MID.²³

The MID is not a catalyst for American homeownership, but instead false encouragement for families undertaking mortgages and/or home equity lines of credit they may not be equipped to pay down. If the United States government truly wants to make homeownership a priority in their future tax policy, Congress should explore different non-itemized tax credits to make available to certain brackets of income-levels in conjunction with decreasing

²² Kathryn Vassel, *Who's affected by the mortgage changes in the House tax bill*, (2017), http://money.cnn.com/2017/11/03/real_estate/mortgage-interest-deduction-cap-tax-bill/index.html, (last visited Jan 14, 2018)

²³ Sarah O'Brien, *These changes under the GOP tax plan affect homeowners*, (2017), <https://www.cnn.com/2017/12/20/here-are-the-finalize.html>, (last visited Jan 14, 2018).

the MID, and reinvesting the savings from the cuts in deductions into low-income housing or other public sectors, such as education.