Research

Tax Simplification and the Mortgage Interest Deduction

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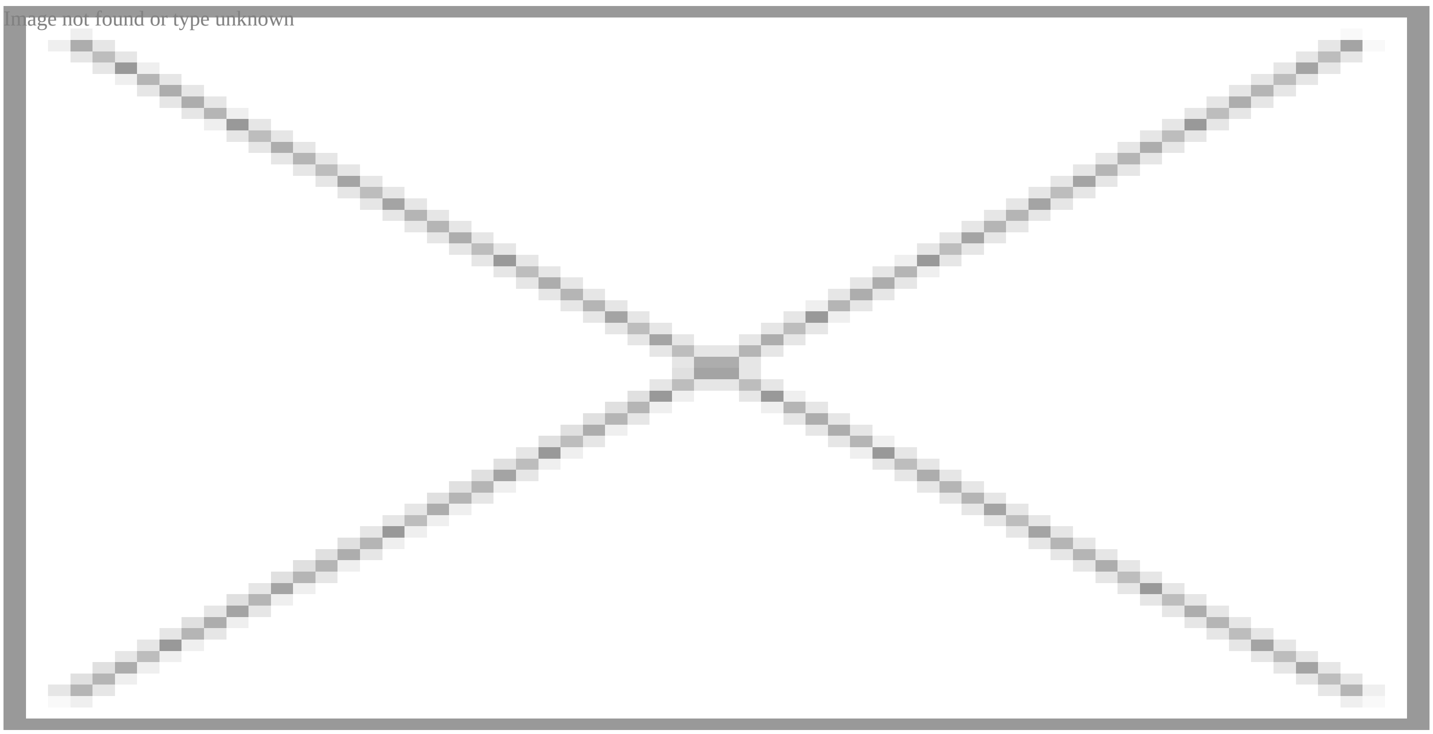
The mortgage interest deduction is a commonly used itemized deduction that has proven to be costly, and now contentious. A fundamental tax overhaul aimed at limiting or eliminating preferential tax expenditures in order to simplify the code and lower overall tax rates, as is being discussed in Congress, will likely modify the mortgage interest deduction. The Joint Committee on Taxation issued a Working Group Report on tax reform that included seven different options for the mortgage interest deduction including capping the deduction, expanding it, changing it to a credit, and leaving it untouched. [1]



The Congressional Budget Office estimates that the mortgage interest deduction will cost over $1 trillion from 2014 to 2023, about as expensive as the deduction for charitable contributions and the child tax credit combined. [2] The benefits of the deduction are largely skewed to those more likely to be homeowners versus renters but also more likely to itemize deductions (See Figure 1) – the highest income quintile.

In light of the possibility of a cap, it is useful to know the implications of alternative caps: who are affected buyers and where do they live for different cut-offs such as $200,000, $500,000, and $700,000. Using data from Zillow, a company that operates an online real estate database, AAF mapped home sales from January to March 2013 at three sales price levels — $250,000 and above, $550,000 and above, and $750,000 and above — (thereby permitting $50,000 in closing costs and fees that would not be subject to a cap) as a percentage of all sales in each zip code.

Overall, home sales above $250,000 from January to March 2013 in the U.S., on average, represented 31 percent of the total of 646,789 sales. Conversely, home sales above $550,000, roughly 47,900, comprised just 7 percent and those above $750,000, about 25,000, comprised only 4 percent.

As one would expect, not all states are equally affected. Just four states—Florida, California, Arizona and Texas—represent close to 40 percent of the 646,789 sales calculated by Zillow in the first quarter of 2013. The vast majority of sales over $250,000, over $550,000, and over $750,000 were also in just a handful of states, particularly California, New York, Florida, and New Jersey. For example, 15,400 of the 25,000 home sales over $750,000 were in made in California (40 percent), New York (12 percent), and Florida (11 percent). For context, 214,000 homes we're sold in total over the same time period in California, Florida and New York.

The larger lesson is that the bulk of potential home sales would likely be untouched even with the lowest cap of $200,000. Thus, capping the mortgage interest deduction at one of these levels may prove to be a winning compromise, one able to preserve some support for low and middle Americans purchasing homes while remain consistent with the aim of pro-growth tax simplification: a broader base with lower rates.

$750,000

$550,000

$250,000

[1] Joint Committee on Taxation, "Report to the House Committee on Ways and Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups," (May 2013); https://www.jct.gov/publications.html?func=startdown&id=4517
[2] Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Tax System," (May 2013); http://www.cbo.gov/publication/43768