2-1-2018

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Who Truly Benefits from the Mortgage Interest Deduction?

By Major Stephen Wildt, MBA, MST Student

With the Trump Administration’s proposal to simplify the Internal Revenue Code (IRC), there should be consideration to completely simplify the code because a partial simplification of the IRC only adds more confusion and complexity for the average taxpayer. One of the most important issues in the tax code is the mortgage interest deduction (MID) and it causes politicians and leaders great fear when considering the idea of removing the MID from tax policy. But should they feel fear? Well, there should be no fear because as we look at the actual statistics surrounding the deduction, we will be surprised by who benefits from it the most ... and it is not the average taxpayer.

Let Us See Who is Impacted

For the mortgage interest deduction to be utilized, a taxpayer needs to itemize deductions on their individual tax return. In 2014, only 29 percent of taxpayers itemized their deductions (43.9 million taxpayers itemized / 148.6 million taxpayers filed taxes), therefore only up to 29 percent of taxpayers can qualify for the mortgage interest deduction the way it is currently structured because to receive the MID, one has to itemize deductions. Of the 29 percent of taxpayers who itemize, those with an Adjusted Gross Income (AGI) over $75,000 per year consume over 73 percent of the mortgage interest deducted or $205 billion of the $280 billion of mortgage interest claimed on itemized tax returns. Another way to view it is that 21 percent (29% x 73% or 32.2M of the 148.6M taxpayers claimed the MID) of all taxpayers receive a benefit of $205 billion of mortgage interest deductions (see figure 1).

A tax credit, instead of a deduction, on mortgage interest will benefit most homeowners who have a tax liability, more so depending on if it is a refundable credit. However, this may still not be the best option to increase homeownership rates as shown in research. The proposal to replace the mortgage interest deduction with a 15 percent mortgage tax credit on a mortgage loan limit of $500,000 would distribute the mortgage tax subsidy more evenly across homeowners, which is approximately 74.1 million taxpayers. This proposal would increase the tax incentive for homeownership for lower and middle-class taxpayers, possibly leading to higher homeownership rates if it is designed correctly and specifically focuses on the taxpayers that actually need the assistance. Let us say that middle class taxpayers are those with $75,000 - $200,000 AGI and upper-class taxpayers are those with $200K AGI and above. My opinion is that the upper and upper-middle class taxpayers will buy homes regardless of the government subsidy. Figures 1 (see above) and 2 (see below) show that the majority of the MID goes to assisting the middle to upper class taxpayers. They are benefiting ten times more than the lower-income taxpayers, which

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4 Ibid.

runs counter to the equity and fairness principle of AICPA’s Guiding Principles of Good Tax Policy and it could be argued that the neutrality principle is also violated because of the effect on purchasing decisions.6

Figure 2. Average Tax Savings by AGI Group7
(Note: all numbers shown in Figure 2 are IN U.S. DOLLARS)

Under the proposed legislation of the MIC, with the phasing out of the mortgage interest deduction, some home-owning taxpayers may rise into the next upper tax bracket and possibly be exposed to AMT. Additionally, they will owe additional tax on the nondeductible portion of their mortgage loan because it would add it back to the AGI. But some of these phase-out adjustments will be offset by the standard deduction or other itemized deductions taken on the return that, collectively, are larger than the standard deduction.

7Internal Revenue Service, supra note 3.
If the politicians choose to partially simplify the tax code, they should consider the impact of changing from a mortgage interest deduction (MID) to a mortgage interest credit (MIC), which would impact income classes differently and benefit more homeowning taxpayers and possibly increase the homeownership rates. Those homeowners who do not itemize deductions would be able to benefit from a mortgage interest credit. Those who itemized deductions and took advantage of the mortgage interest deduction can now utilize itemized deductions or the standard deduction in addition to the MIC, which will be a minor negative impact from change in policy, but this change will make it fairer and more equitable to more taxpayers in a progressive tax system than the previous policy. As taxpayers move up in the tax brackets above 15 percent, the additional benefit of a MIC, versus a MID, will gradually decrease. Some taxpayers with AGI above $75,000 would receive less of a benefit under the proposed MIC than they currently receive under the MID. Those who do not itemize and own homes with mortgages will be impacted positively with a credit.

If there is a change in the policy to a 15 percent tax credit, only taxpayers who own and occupy a home would qualify for the credit. There would be approximately 74.1 million qualified homes, representing some portion of the 14 trillion dollar mortgage market at the end of 1st quarter of 2017. If Congress applies the label of “owner-occupied” homes as only for primary residences, this will disallow the credit for second homes. However, rental properties will still be able to deduct mortgage interest as a rental interest expense on Schedule E, which may lead to lower rents to keep renters from moving out and buying a home. Either way, this proposal is still in violation of the neutrality principle of good tax policy, which is a guiding principle for lawmakers, that taxpayers’ decisions to carry out a specific transaction should be minimally impactful. People who rent often do so because they are not able to obtain a mortgage loan, whether it be bad credit or affordability. However, many times renters are paying similar amounts in rent as a mortgage on the same home.

The value of the mortgage interest deduction is greater for higher income taxpayers, thereby benefitting those taxpayers more than the lower income taxpayers. Therefore, the MID may not

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negatively impact the higher-end housing market because the standard deduction (or other significant amounts of itemized deductions) combined with the MIC is still a significant tax liability deduction that will partially offset the new MIC proposal, which will also benefit the lower-end housing market.

The MIC proposal may negatively impact the RV and boat industries since the tax break on second mortgages and Home Equity Lines of Credit (HELOC) will no longer deductible. Lower income taxpayers are less likely to itemize due to a lack of deductions, so a credit works better for them. So, now, with the MIC policy proposal, taxpayers will be able to take the standard deduction and also claim the MIC.

State and local governments are also impacted if the MIC becomes law depending on whether or not their state tax system incorporates the MID in their tax liability calculation of individual taxpayers.

Those indirectly impacted could potentially include every taxpayer by possible adjustments in the economy as a result of the enactment of the MIC. For example, increased (or decreased) demand in the economy for homes because of the MIC could lead to higher or lower tax revenues on real estate transactions. Additionally, there could be increased or decreased investment account values from the economic activity derived from the implementation of the MIC. Since state and local government revenues may be impacted by this MIC proposal, it affects schools and other services paid for by state tax revenues – including those used to teacher salaries, minimize class sizes and the effective teaching of our children. Other impacts include all suppliers to the impacted industries, to include RV, boat, builders, contractors, subcontractors, home improvement stores and even retail stores.

I believe that the current mortgage interest deduction policy needs to be changed. I would recommend a non-refundable homebuyer credit of 15 percent of mortgage interest paid on mortgage loans below $500,000, with a maximum $3,000 credit. According to the Congressional

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Budget Office (CBO), this plan is most beneficial for taxpayers, and it should provide up to $16.5 billion reduction in the mortgage interest tax expenditure, which can be allocated towards reducing the deficit.\textsuperscript{10} Moreover, according to the \textit{Tax Foundation}, getting rid of the mortgage interest deduction altogether would increase government tax revenues by $101 billion based purely on the elimination of the deduction (not including any potential impacts on a dynamic basis). However, it is important to note that eliminating the deduction may have some negative impacts on the economy and housing market.\textsuperscript{11}

\textsuperscript{10} Ibid.