Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Consider the Mortgage Interest Deduction*

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November, 2011

The government and knowledgeable commentators are concerned about the federal deficit, and intense efforts to address it have resulted in the creation of a Joint Special Committee on Deficit Reduction, innumerable studies and reports, proposals for reductions in entitlement spending, and at least tentative proposals for tax reform. Hidden in this large agenda is the understanding that all current programs that limit taxation, or provide deductions or credits from tax liabilities are subject to review.

One very popular tax deduction is that granted to homeowners for interest on the debt secured by their residence. This mortgage interest deduction has been in the statutes for decades, and when the Tax Reform Act of 1986 eliminated deduction of interest on all personal loans, it has been the primary provision in the tax code that provides deductibility on a household expenditure.

Not all interest on all mortgage loans is deductible. It is limited to those who itemize deductions and deductions must be greater than the standard deduction; the debt must be secured by a personal residence or second home; and it is deductible on only the first $1 million of debt used for acquiring or improving the residence or the first $100,000 of home equity debt used for any purpose.

While not strictly speaking a part of the mortgage interest deduction, some other tax incentive in the Code can be found in the provision that permits an exclusion of up to $250,000 (double that for married partners) on capital gains from the sale of a residence.

Opinions differ on what the effect would be if the deduction were eliminated. The Joint Tax Committee estimates that the tax expenditures on the deduction amount to over $100 billion annually. Other commentators

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estimate the savings as slightly higher than that. But it is a large number of around $1 trillion over a ten year period.

While that does not necessarily equal the savings that might accrue, it is certainly large enough to be a target. The most recent proposal of some Republicans on the Super Committee included the elimination of deductions of interest for second homes, so there is the possibility that the mortgage interest deduction could be whittled away before a major personal tax reform effort gets underway.

It is doubtful that there will be any new arguments advanced. Those supporting the deduction have long argued that it assists the housing market by encouraging consumers to buy houses and therefore promotes homeownership with all of its beneficial cultural and societal benefits. The home equity deduction permits homeowners to utilize the otherwise stagnant equity in their homes for necessary and desirable purchases. Finally, in the current environment, there is a fear that eliminating or substantially changing the deduction would exacerbate the housing downturn and, as a result, the inability of the country to fight its way out of the recession.

Those who support the deduction's elimination argue that the deduction is neither the fairest nor the most cost-effective method of promoting homeownership. Wealthy homeowners benefit out of proportion because (a) they itemize deductions in a far greater proportion than non-wealthy citizens, and (b) they purchase homes that cost amounts that permit them to utilize the entire deduction. Renters cannot deduct their rental payments. Another point that is usually raised is that the benefits of this deduction are spread disproportionally to three metropolitan regions — L.A., San Francisco and New York City.

Clearly hard and credible research is required to deal with the dramatically different conclusions drawn by those making these arguments.

Complete elimination of the deduction is not the only alternative available to those seeking to corral the deficit. Although the U.K. totally eliminated its mortgage interest deduction through phasing it out over a 12 year period (some first time homebuyers still can get a deduction for a small number of years), others have suggested reducing the size of the loan on which interest may be deducted, reducing or eliminating the interest on any second home loan, reducing or eliminating the use of deductions on home equity loans, etc. Others, focusing more on fairness, have suggested permitting renters to deduct a portion of the rent they pay, or turning the deduction into a tax credit. With respect to that alternative, opinions differ as to whether the credit should result in actual payments to taxpayers whose taxes might be less than the credit.

If we were in a normal stage of the cycle and if we did not have the deficit staring at us, the arguments could be played out over those points. But faced with the government deficit of an alarming amount, and the fact that it continues to grow, the fact that it might produce $1 trillion over ten years may be more important than all of the other arguments.

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