



NATIONAL
ASSOCIATION *of*
REALTORS®

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STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

SUBMITTED TO:

THE UNITED STATES SENATE
COMMITTEE ON FINANCE

TAX REFORM WORKING GROUP ON
INDIVIDUAL INCOME TAX

APRIL 2, 2015

EXECUTIVE SUMMARY

- NAR believes that individual tax rates should be as low as possible while still providing for a balanced fiscal policy, and that our tax system can and should be simplified and improved. However, certain long-standing tax provisions, such as the deductions for mortgage interest and state and local taxes paid, are deeply embedded in the price of homes. Eliminating or reducing these widely-used and simple tax provisions can have harsh and dangerous unintended consequences to the economy and to taxpayers. The first principle in tax reform should be “do no harm.”
- Homeownership has long been central to American values, and its economic and social benefits are immense and well documented. From its beginning, our tax system has facilitated homeownership by making it more affordable. We see no valid reason to reverse or undermine this basic decision and believe that the only *viable* tax system for America is one that would continue to nurture homeownership.
- Critics have charged that the mortgage interest deduction (MID) favors wealthier taxpayers at the expense of those with more modest incomes, and that it benefits only those relatively few taxpayers who are eligible to itemize their deductions. However, 58 percent claiming the MID earn less than \$100,000 and 89 percent earn less than \$200,000 per year. Looking at the population the deduction was designed to benefit, homeowners with mortgaged homes, MID is claimed by 71 percent. Moreover, over 70 percent of homeowners utilize MID over their lifetimes.
- While a taxpayer must itemize in order to claim the mortgage interest deduction, it is not true that those who do not itemize get no value from the MID. When Congress decided to simplify the tax law by providing for the standard deduction, legislative history (both original and subsequent) shows that the standard deduction was based on a composite basket of typical deductions that taxpayers claimed, including the MID, taxes paid, charitable contributions made, and so forth. Thus, it is clear that Congress crafted the standard deduction to be a proxy for allowable deductions (i.e., itemized deductions), including the MID.
- Taxes paid at the state and local levels to benefit the general public are in nature and purpose similar to the federal income tax in that they both fund essential government services. Therefore, allowing a deduction for these taxes for federal income tax purposes is essential to avoiding double taxation on the same income. According to the Joint Committee on Taxation, 75 percent of the value of real property tax deductions in 2012 went to taxpayers earning less than \$200,000.
- Over recent years, several ideas have been put forward to limit the value of itemized deductions for higher-income taxpayers and to re-target the MID away from its current recipients and toward many who do not claim it. Each idea would adversely affect the value of housing and also would unfairly hit middle-income families. For example, the biggest losers from a cap on itemized deductions would likely be not the so-called rich but younger families living in high cost housing markets who have both larger mortgage interest payments and high state and local tax bills. Other proposals would likely also badly miss their targets – removing the MID for second homes could adversely affect the millions who move each year as well as hurt communities where such homes are prevalent. And lowering the maximum mortgage amount to \$500,000 would unfairly hit those living in high cost areas, who already pay a larger amount of their after-tax income on housing than do other taxpayers.
- The principal residence capital gains exclusion provides substantial simplification to our tax system and allows a great deal of flexibility in the financial and retirement planning for families. At a time when Americans are struggling to save more for retirement, Congress should retain the exclusion and secure its importance for future generations by indexing it for inflation.
- NAR also urges Congress to make mortgage cancellation relief a permanent provision.

About THE NATIONAL ASSOCIATION OF REALTORS®

The NATIONAL ASSOCIATION OF REALTORS® (NAR) is a trade association that represents a variety of real estate professionals engaged in activities including real estate sales and brokerage, property management, residential and commercial leasing and appraisal. NAR has more than one million members, all of whom are members in their personal capacity and not as corporate entities. The business model of REALTORS® is a highly personal, hands-on, face-to-face model, focused on a family's fundamental needs for shelter. Real estate investment and operations provide locations where the commerce that drives the economy is conducted.

NAR Principles for Tax Reform

If one were designing a tax system for the first time, one might come up with something that is very different from what we have today. But we're not starting from scratch, particularly in the context of housing. Some provisions in the tax code, such as the deductions for mortgage interest and state and local taxes paid, have been part of the federal tax code since the income tax was instituted more than a century ago. Thus, the values of such tax benefits are both directly and indirectly embedded in the price of a home. While economists disagree about the best estimates of the value of those embedded tax benefits, they all generally agree that the value of a particular home includes tax benefits.

Real estate is the most widely-held category of assets that American families own, and for many Americans, the largest portion of their family's net worth, despite the price declines of the Great Recession. Therefore, while NAR agrees that reform and revision to different portions of the individual tax code may be warranted, and that the law should be simplified, we remain committed to preserving the current law's incentives for homeownership and real estate investment.

NAR believes that individual tax rates should be as low as possible while still providing for a balanced fiscal policy. NAR further believes that there should be a meaningful differential between the rates paid on ordinary income and capital gains on investments. However, NAR does not endorse a particular rate, nor does it believe that long established provisions in the code should be changed or eliminated solely to lower marginal tax rates. When Congress last undertook major tax reform in 1986, it eliminated or significantly changed a large swath of tax provisions, including major real estate provisions, in order to lower rates, only to increase those rates just five years later in 1991. Most of the eliminated tax provisions never returned and in the case of real estate, a major recession followed. Congress must be mindful that eliminating widely-used and simple tax provisions can have harsh and dangerous unintended consequences, particularly if the sole purpose of eliminating non-abusive provisions is to obtain a particular marginal tax rate. NAR also notes that American homeowners now pay between 80 and 90 percent of all federal income taxes. Congress should avoid further raising taxes on homeowners in a quest for additional revenue while federal spending is still at record highs. Congress must first look to reduce spending in order to get our nation's fiscal house in order.

Homeownership and American Culture

Policymakers should not dismiss or underestimate Americans' passion for homeownership, notwithstanding the most recent economic crisis. Calling homeownership the "American Dream" is not a mere slogan, but rather a bedrock value. Owning a piece of property has been central to American values since Plymouth and Jamestown. Homes are the foundation of our

culture, the place where families eat and learn together, and the basis for community life. The cottage with a picket fence is an iconic part of our heritage.

Research has consistently shown the importance of the housing sector to the economy and the long-term social and financial benefits to individual homeowners. The economic benefits of the housing market and homeownership are immense and well documented. The housing sector directly accounted for approximately 16 percent of total economic activity in 2014. Household real estate holdings totaled \$20.4 trillion in the third quarter of 2014. After subtracting mortgage liabilities, net real estate household equity totaled \$11.0 trillion.

In addition to tangible financial benefits, homeownership brings substantial social benefits for families, communities, and the country as a whole. These benefits include increased education achievement and civic participation, better physical and mental health, and lower crime rates.

Our tax system does not “cause” homeownership. People buy homes to satisfy many social, family and personal goals. Rather, the tax system *facilitates* ownership. The tax system supports homeownership by making it more affordable. While it is true that only about one-third of taxpayers itemize deductions in any particular year, it is also true that, over time, substantially more than one third of taxpayers receive the direct benefit of the mortgage interest deduction. Over time, mortgages get paid off, other new homeowners enter the market and family tax circumstances change. Individuals who utilize the mortgage interest deduction (MID) in the years right after a home purchase are, over time, likely to switch to the standard deduction.

Arguably, the standard deduction gives non-itemizing taxpayers a “better” answer than utilizing the mortgage interest deduction, so it is not clear that non-itemizers have been put at a disadvantage. Indeed, in *proportional* terms, the standard deduction can be characterized as a *deeper* subsidy than itemizing taxpayers receive because the standard deduction (\$12,600 for married couples filing jointly in 2015) likely represents an amount that is significantly larger than the couple’s total itemized deductions. In essence, the standard deduction, for many, becomes “free” money.

When academics talk about the MID and refer to it as an expenditure, they are speaking in the language of macroeconomics. In reality, the billions of tax dollars they see as an expenditure are the individual savings of millions of families. Every time homeowners make a mortgage payment, even in today’s uncertain housing market, they are generally creating non-cash wealth. Many of our seasoned REALTORS® describe their satisfaction in helping a family secure its first house and then a larger home(s) for raising families. The most satisfying of a long-term series of transactions is helping a couple buy its last house *without a mortgage*. Those couples are able to make this “last” purchase because ownership over a long term of years has resulted in savings sufficient to meet their needs.

The federal policy choice to support homeownership has been in the Internal Revenue Code since its inception. We see no valid reason to reverse or undermine that basic decision. Indeed, we believe that the only *viable* tax system for America is one that would continue to nurture homeownership.

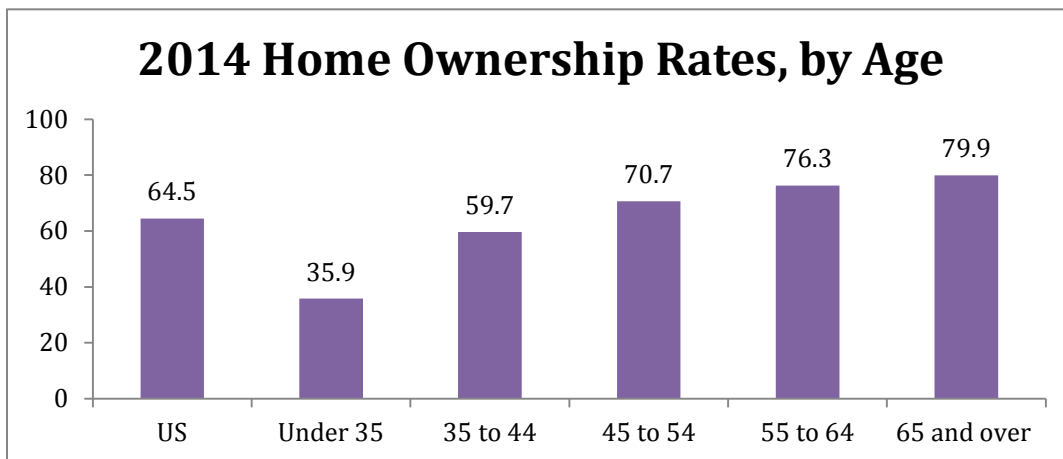
Current State of the Housing Market

In 2014 the Census Bureau estimated that there were 133 million housing units in the United States. The vast majority of these housing units—nearly 115 million—are occupied by

households while the remaining 18 million are vacant for a variety of reasons¹. Since 1965, the homeownership rate has fluctuated between 63 and 69 percent, and in 2014 was 65 percent. That translates to 74 million owner-occupied households and roughly 41 million renter households.

In any given year, a good number of households are in transition. In 2014, 4.94 million existing homes and an additional 437,000 new homes were sold for a total of 5.4 million properties for which ownership transitioned. While all homeowners interact with the tax code, the transition of ownership leads to additional tax interactions. Measured by sales activity, the housing market has recovered substantially but not quite fully since the housing and economic crisis. Total sales in 2014 for new and existing properties exceeded 5 million whereas from 1999 to 2008 existing home sales alone exceeded 5 million every year, in spite of the fact that there were 5 to 10 million fewer households. In addition to additional tax considerations as a result of a transition of ownership, research shows that additional economic activity is generated, making a healthy housing market a foundation of economic health. For example, the Harvard Joint Center for Housing Studies reports that 60 percent of owner-occupant purchasers made improvements averaging \$11,100, and investor purchasers spent more per unit on average².

Homeownership is often referred to as the American Dream, and the realization of this dream takes some time. A strong correlation between the homeownership rate and age of the household head is the result—the older the head of household, the more likely the household is to own a home. Further, the median or typical age of a first-time home buyer in the US was 31 in 2014 and has ranged between 30 and 32 for the last decade³. Because homeownership delivers current consumption value—it provides shelter—and investment value, roughly 90 percent of home buyers finance their home purchase, and younger buyers are more likely to finance the home purchase. These trends are long-standing and were little-affected by the recession.



Source: Census Bureau

¹ Roughly a third of these vacant properties are in some form of transition or being marketed for transition and a quarter are seasonal properties not intended for year-round occupancy. Census Bureau, 2014 Housing Vacancy Survey

² Harvard Joint Center for Housing Studies. *The US Housing Stock: Ready for Renewal*. January 23, 2013. <http://www.jchs.harvard.edu/research/publications/us-housing-stock-ready-renewal>

³ National Association of REALTORS®. *Profile of Home Buyers and Sellers*, various years.

Residential Real Estate Tax Provisions

There are a number of tax provisions that affect residential real estate in one form or another. These range from relatively small temporary provisions to major provisions of the tax code utilized by millions of taxpayers. While NAR generally supports tax provisions that encourage sustainable homeownership and that incentivize investment and improvement of real estate, we will focus here on the most prominent and widely used provisions for individual homeowners.

The Mortgage Interest Deduction

The deduction for mortgage interest paid has been part of the federal income tax code since its inception in 1913. Despite more than a century of additions, modifications, deletions, and overhauls of the tax code, Congress has left the mortgage interest deduction in place. Current law allows a homeowner to deduct the interest on up to \$1 million in total acquisition debt for a principal residence and a second, non-rental, home. Homeowners are also allowed to deduct the interest on up to \$100,000 in home equity debt.

Prior to 1986 there was no limit on the amount of home mortgage interest that could be deducted. The Tax Reform Act of 1986 imposed the first limitation on the MID, allowing it for allocable debt used to purchase, construct or improve a designated primary residence and one additional residence (Second home).

The Omnibus Budget Reconciliation Act of 1987 further limited the deduction to interest allocable to up to \$1 million in acquisition debt. This limit is not adjusted for inflation. Factoring in the impact of inflation, the value of the cap has eroded by half since 1987; in 2014 dollars, the original cap would be equal to over \$2 million today had it been indexed.

Who Benefits from the Mortgage Interest Deduction?

The mortgage interest deduction (MID) is often criticized on two fronts – that it favors wealthier taxpayers at the expense of those with more modest incomes, and that it benefits only those relatively few taxpayers who are eligible to itemize their deductions. Since taxpayers who itemize are often those with higher incomes, these criticisms are related.

In 2012, the tax year for which the most complete data are available, 34.8 million tax filers claimed a deduction for mortgage interest. There are many ways to frame this number in context, and the conclusions drawn about the importance of the mortgage interest deduction (MID) are strongly affected.

Tax filers claiming the MID account for only about a quarter of the total number of tax returns filed; however, returns claiming the MID represent roughly half of owner-occupied households and roughly three-quarters of home-owners whose homes are mortgaged⁴. How can these statements all be true? When examining the question of who benefits from the mortgage interest deduction, it is helpful to keep in mind that households are not the same thing as tax-units and multiple tax filers can and do come from the same household. In 2012, for example, there were roughly 114 million households and 145 million individual income tax returns or more than 30 million tax returns filed by those in a household with another tax filer⁵. Further, the MID would

⁴ National Association of REALTORS® Calculations of IRS and Census Bureau data.

⁵ Taking households that do not file taxes into account would push this number up while taking into account taxes filed for those who are deceased would decrease this figure. Filing for the economic stimulus boosted the number of returns filed in 2007 vs 2006 or 2008 by roughly 15 million while roughly 2.5 million individuals passed away in 2012.

only apply directly to the tax situations of the roughly 75 million homeowners and more specifically to the roughly 50 million homeowners nationally who have a mortgage or other debt on their residence. The tables below detail these shares by state which vary due to state differences in homeownership rates, incidence of mortgage debt, and the incidence of other itemized deductions. In some states, more than 90 percent of the target population of homeowners with a mortgage claims the MID.

By income, we see that the MID is valuable to households across the spectrum. 58 percent of those claiming the MID in 2010 earned less than \$100,000 and 89 percent earned less than \$200,000 in Adjusted Gross Income⁶. Breaking down the benefits of the MID by age, we see further evidence of the lifetime it takes to achieve the American Dream. Roughly half of those claiming the MID and half of the amount claimed went to households under the age of 45⁷.

Some claim that since the economic downturn has reduced interest rates, we should look at data from the economically stronger years preceding the recession. Fair enough. A look at 2007 indicates a very similar finding. Eighty-two percent of the value of the MID in 2007 went to those making under \$200,000, and this group represented 91 percent of all tax filers that year.

Furthermore, it is important to realize that MID utilization data offer just a snapshot in time. Over the course of an owner's tenure in a home, an individual may itemize in the early years of homeownership, when the interest expense is high relative to the principal paid, but then not itemize in later years. Mortgages get paid off, other non-MID deductions rise and fall, individuals down-size, divorces occur, a spouse dies or needs to simplify living arrangements. These and other life events may convert itemizers into standard deduction taxpayers. Thus, in any given year, we may not see the full contingent of homeowners who use the MID.

Taking a longer view shows the real picture. Of the nearly 76 million homeowners in 2007, 62 percent had a mortgage on their home. However, about 85 percent of homeowners took out a mortgage when they purchased the home. Of course, many taxpayers eventually pay off their mortgages. Only a fourth of homeowners with heads of household age 65 and over have a mortgage. Of households that still had one in 2007, almost 90 percent claimed the MID. NAR estimates that over 70 percent of homeowners will utilize the MID over their lifetimes, regardless of whether they own or rent a home in a particular year. This greatly exceeds the 37 percent of households that claimed the MID in 2007.

⁶ National Association of REALTORS® calculations of IRS data.

⁷ Jeff Curry and Jonathan Dent, "Individual Income Tax Returns, by Age of Primary Taxpayer, Tax Years 1997 and 2007," Statistics of Income (SOI) Bulletin, Spring 2011.

Mortgage Interest Deduction Claimers as a Share of Various Target Groups

	2012 MID Claimers as a Share of		
	Tax Filers	Home Owners	Mortgaged Home Owners
UNITED STATES	23.7%	46.4%	70.6%
ALABAMA	21.3%	34.4%	59.0%
ALASKA	20.4%	46.6%	71.4%
ARIZONA	24.5%	45.3%	68.4%
ARKANSAS	17.8%	28.7%	49.7%
CALIFORNIA	25.6%	63.8%	86.4%
COLORADO	29.5%	56.5%	76.5%
CONNECTICUT	32.5%	62.3%	88.0%
DELAWARE	28.5%	51.3%	73.5%
DISTRICT OF COLUMBIA	24.2%	71.6%	91.0%
FLORIDA	17.6%	34.4%	56.3%
GEORGIA	26.5%	51.2%	73.7%
HAWAII	22.0%	57.5%	84.8%
IDAHO	24.4%	41.6%	61.3%
ILLINOIS	26.2%	50.2%	74.1%
INDIANA	20.5%	36.0%	53.0%
IOWA	22.7%	36.7%	59.4%
KANSAS	22.2%	39.8%	63.6%
KENTUCKY	22.2%	36.4%	59.8%
LOUISIANA	17.3%	30.7%	55.4%
MAINE	23.7%	37.9%	59.3%
MARYLAND	34.4%	68.6%	91.2%
MASSACHUSETTS	29.6%	61.6%	86.2%
MICHIGAN	23.0%	39.3%	61.8%
MINNESOTA	30.1%	52.3%	76.1%
MISSISSIPPI	16.8%	28.2%	53.3%
MISSOURI	22.4%	38.5%	60.0%
MONTANA	21.9%	38.8%	67.0%
NEBRASKA	22.2%	39.7%	62.9%
NEVADA	20.6%	48.1%	67.1%
NEW HAMPSHIRE	27.7%	51.1%	74.6%
NEW JERSEY	30.3%	62.7%	89.5%
NEW MEXICO	19.3%	33.8%	57.9%
NEW YORK	21.9%	52.9%	82.1%
NORTH CAROLINA	26.0%	45.7%	69.3%
NORTH DAKOTA	13.8%	25.8%	48.2%
OHIO	23.2%	42.3%	64.1%
OKLAHOMA	18.5%	31.2%	54.0%
OREGON	29.1%	55.1%	80.7%
PENNSYLVANIA	23.7%	42.5%	68.4%
RHODE ISLAND	27.9%	57.7%	80.8%
SOUTH CAROLINA	23.0%	39.3%	64.3%
SOUTH DAKOTA	13.5%	25.8%	45.1%
TENNESSEE	17.7%	30.9%	49.9%
TEXAS	18.1%	37.5%	61.4%
UTAH	30.1%	56.7%	77.8%
VERMONT	22.7%	39.7%	60.5%
VIRGINIA	31.0%	58.7%	82.2%
WASHINGTON	27.4%	54.0%	76.3%
WEST VIRGINIA	14.2%	20.9%	43.3%
WISCONSIN	27.0%	48.6%	73.2%
WYOMING	17.2%	33.6%	58.5%

The Enigma of the Standard Deduction

While it is true that a taxpayer must itemize in order to claim the mortgage interest deduction, it is not true that who do not itemize get no value from the MID. In order to appreciate this conundrum, one must look at the history of our modern tax system. In 1913, Congress and the President enacted the income tax. The original tax law provided for both a deduction for interest paid and for state and local taxes paid (including for property taxes). These two deductions, plus the deduction for charitable contributions, which was added to the tax law in 1917, together comprise the great majority of itemized deductions that are claimed each year.

For many years, the tax law provided that taxpayers who paid interest, state and local taxes, and/or made charitable contributions, could take a deduction for them. A few other deductions, such as for casualty and theft losses or for medical expenses, were also allowed. However, in order to qualify for these deductions, taxpayers actually had to incur these expenses and keep track of them.

This changed in 1944, when Congress decided to simplify the tax law by providing for the standard deduction. Legislative history (both original and subsequent) shows that the standard deduction was based on a composite basket of typical deductions that taxpayers claimed, including the MID, taxes paid, charitable contributions made, and so forth. The simplification came about by Congress deeming that all individuals were to receive a certain amount of generic deductions, represented by the standard deduction. Taxpayers claiming the standard deduction did not need to prove that any amounts were actually paid in order to take the standard deduction. Congress simply designated that all taxpayers could claim the standard deduction whether they made the deductible expenditures or not.

In enacting the standard deduction, Congress did not modify the deductions themselves. Rather, taxpayers who paid deductible expenditures in excess of the standard deduction were allowed to claim the actual amounts as what was (from then on) called itemized deductions. Taxpayers with deductions totaling an amount below the standard deduction threshold could simply claim the standard amount and not worry about even keeping track of what was actually paid. This represented a huge step toward simplifying the lives of millions of American taxpayers.

What is often not recognized today is that the standard deduction represents a tax giveaway for virtually all taxpayers who claim it. This is because if a taxpayer has deductions in excess of the standard deduction, he or she may claim the higher amount. But those who have actual deductions less than the standard are given the benefit of the standard deduction amount whether or not they actually incurred the expenses. Thus, the giveaway equals a range of as much as the standard deduction for taxpayers who have absolutely no deductions, on the high end, to as little as \$1 for taxpayers whose actual deductions come just \$1 short of the standard deduction amount, on the low end.

For example, assume a married couple's actual amounts for state and local tax, mortgage interest, and charitable contributions for 2015 total \$12,000. With the standard deduction for a couple currently at \$12,600, this family would be receiving an extra tax deduction for \$600 in expenditures they never made. If they were in the 28 percent bracket, this would amount to a \$168 tax "freebie" ($\$600 \text{ excess} \times 28\%$). Suppose another couple had just \$2,000 of state and local taxes, but no mortgage interest and no charitable contributions. This family would also get to take the standard deduction of \$12,600, for a subsidy of \$10,600 ($\$12,600 - \$2,000$), which would be worth \$2,968, assuming they were also in the 28 percent tax bracket ($\$10,600 \times 28\%$).

The point is that whether a taxpayer is being subsidized a little bit (as with the first couple), or a lot (as with the second couple), or not at all (as with the case of a couple who has enough deductions to itemize), each couple is benefitting from the mortgage interest deduction. Just because the standard deduction does not specifically indicate which portion of it is attributable to the mortgage interest deduction (or any other deduction), does not mean that the MID is not part of the benefit being given.

When Congress first established the standard deduction in 1944, more than 82 percent of taxpayers were able to utilize this simplification tool, meaning that just 18 percent itemized. According to the Joint Committee on Taxation (JCT), by 1969 this proportion had dropped to 58 percent. In explaining the reason for Congress increasing the standard deduction in the Tax Reform Act of 1969, JCT stated that since 1944, “higher medical costs, higher interest rates, higher State and local taxes, increased homeownership, and more expensive homes have made it advantageous for more and more taxpayers to shift over to itemized deductions.”

Thus, it is clear that even though no specific portion of the standard deduction is tied to the MID, Congress crafted the standard deduction to be a proxy for allowable deductions (i.e., itemized deductions), including the MID, and when the underlying amount of these deductions increase, Congress has believed that it is appropriate for the standard deduction to also increase. It is also clear that Congress intended that very few people would have to itemize (18 percent in 1944) and when this proportion was eroded by inflation and other factors, Congress increased the standard deduction to keep it closer to its original percentage.

Arguments that the mortgage interest deduction benefits only those who itemize simply do not hold water.

The Real Property Tax Deduction

The income tax system of the United States has provided a deduction for state and local taxes, including property taxes, since its inception. To do otherwise would violate two fundamental and widely accepted principles of good tax policy – the avoidance of double taxation and the need to recognize the taxpayer’s ability to pay.

Taxes paid at the state and local levels to benefit the general public are in nature and purpose similar to the federal income tax in that they both fund essential government services. Therefore, allowing a deduction for these state and local taxes for federal income tax purposes is essential to avoiding double taxation on the same income (or a tax on a tax). Our federal tax law follows this same principle in connection with the payment of taxes to other nations. In the case of foreign taxes, however, the law goes even further and provides taxpayers with a choice of claiming a deduction for foreign taxes paid, or taking a credit, which is a dollar-for-dollar reduction in tax owed.

While state and local taxes vary greatly, two aspects of them that do not change are that they are ubiquitous throughout the nation, in one form or another, and they are largely involuntary. It is true that we can exercise some degree of choice over how much we pay in state and local taxes by deciding where we live and what we buy. However, avoiding these levies altogether is not a practical option. Obviously, paying taxes to state and local governments leaves taxpayers without the income used to pay the taxes. The extraction of state and local taxes is tantamount to the money never being earned by the taxpayer in the first place. Our tax system recognizes this fact by providing a deduction for the payment of these taxes.

Eliminating the deduction for state and local taxes would fly in the face of these fundamental tax policy principles that have been ingrained in our income tax law from its beginnings.

Along with other state and local taxes, the Internal Revenue Code has provided a deduction for real property taxes paid since its enactment in 1913. To be deductible, a real property tax must be levied for the general public welfare. Thus, taxes paid for local improvements such as sidewalks and similar betterments that directly benefit the property are not deductible.

For homeowners, real property taxes represent an unending obligation, at least as long as they own their homes. The other major deduction for most homeowners, the mortgage interest deduction, does not continue after the mortgage is paid off, and it usually diminishes as the mortgage is being paid. Property taxes, on the other hand, often increase over the years, as assessments on property increase and as local governments increase their levy rates. For these reasons, the deduction for real estate property taxes is often the one most-claimed by homeowners. In fact, more taxpayers claim the real property tax deduction than claim the deduction for mortgage interest (in 2012, 39.3 million wrote off real property taxes while 34.8 million deducted mortgage interest).

As with the mortgage interest deduction, critics sometimes claim that the deduction for property taxes is misguided because it gives the lion's share of its benefit to the wealthy and little to the rest of us. However, this is just not the case.

Much of this criticism is centered on the fact that taxpayers must itemize in order to take the deduction. As discussed above (please see *The Enigma of the Standard Deduction*), taxpayers who claim the standard deduction also benefit from the property tax deduction.

Further, because real property taxes are assessed based on property values, one would expect the deduction to be much more utilized at higher incomes. Moreover, most local governments grant real property tax relief to lower-income taxpayers.

Surprisingly, however, 75 percent of the value of real property tax deductions in 2012 went to taxpayers with incomes of less than \$200,000, according to an estimate prepared by the staff of the Joint Committee on Taxation. The typical real estate tax deduction beneficiary has an adjusted gross income of \$87,000.

In addition, the tax law already includes a provision designed to limit the tax benefit of the real property tax deduction to the "wealthy." Specifically, the deduction is disallowed for purposes of the alternative minimum tax.

**Estimated Tax Savings by State from Mortgage Interest and Property Tax Deductions at
a 25% Marginal Rate**

	Average MID Claim	Estimated Tax Savings	Average Real Estate Tax	Estimated Tax Savings
UNITED STATES	9,500	2,380	4,400	1,100
ALABAMA	7,950	1,990	1,300	330
ALASKA	10,250	2,560	4,050	1,010
ARIZONA	9,950	2,490	2,450	610
ARKANSAS	7,100	1,780	1,700	430
CALIFORNIA	13,900	3,480	4,950	1,240
COLORADO	10,450	2,610	2,450	620
CONNECTICUT	9,700	2,430	7,050	1,760
DELAWARE	9,750	2,440	2,400	600
DISTRICT OF COLUMBIA	13,250	3,320	4,050	1,010
FLORIDA	10,050	2,510	4,350	1,080
GEORGIA	8,600	2,150	2,650	670
HAWAII	13,750	3,440	1,900	480
IDAHO	8,500	2,130	2,150	530
ILLINOIS	8,550	2,140	6,150	1,540
INDIANA	7,000	1,750	2,100	520
IOWA	6,400	1,600	3,150	790
KANSAS	7,050	1,760	3,150	790
KENTUCKY	6,800	1,710	2,150	530
LOUISIANA	8,150	2,040	2,050	510
MAINE	7,550	1,890	3,850	960
MARYLAND	11,050	2,760	4,150	1,040
MASSACHUSETTS	10,200	2,550	5,500	1,380
MICHIGAN	7,450	1,870	3,550	890
MINNESOTA	8,650	2,160	3,450	860
MISSISSIPPI	7,100	1,770	1,900	480
MISSOURI	7,500	1,870	2,750	690
MONTANA	8,200	2,050	2,550	640
NEBRASKA	6,650	1,670	3,800	950
NEVADA	10,600	2,650	2,700	680
NEW HAMPSHIRE	9,200	2,300	6,700	1,670
NEW JERSEY	10,150	2,530	8,750	2,180
NEW MEXICO	8,950	2,240	2,350	590
NEW YORK	9,600	2,400	7,850	1,970
NORTH CAROLINA	8,200	2,050	2,650	660
NORTH DAKOTA	7,450	1,860	3,400	850
OHIO	6,800	1,690	3,700	920
OKLAHOMA	7,100	1,770	2,300	570
OREGON	9,400	2,350	3,550	880
PENNSYLVANIA	7,950	1,990	4,700	1,170
RHODE ISLAND	8,550	2,140	5,050	1,260
SOUTH CAROLINA	8,200	2,050	1,950	480
SOUTH DAKOTA	7,800	1,950	3,500	870
TENNESSEE	8,600	2,150	2,550	630
TEXAS	8,400	2,100	5,400	1,340
UTAH	9,100	2,280	2,150	540
VERMONT	7,750	1,940	5,200	1,300
VIRGINIA	11,300	2,820	3,600	900
WASHINGTON	11,250	2,810	4,100	1,030
WEST VIRGINIA	7,400	1,850	1,500	370
WISCONSIN	6,900	1,730	4,500	1,130
WYOMING	9,600	2,400	2,300	580

NAR calculations based on IRS Data

Proposals to Eliminate or Modify Itemized Deductions

Over the past several years, different plans have emerged proposing the reduction, modification, or complete elimination of itemized deductions. Each of these proposals would limit the value of the deduction and/or have a negative impact on the value of housing. In many cases, the largest impact would be felt by middle-class families, not necessarily by the individuals or families categorized by the media as “the rich.” The following is an examination of each of these proposals.

Capping Itemized Deductions

Two proposals have repeatedly been floated to cap the value of all itemized deductions. The first is a proposal made each year in President Obama’s budget to cap itemized deductions for upper-income taxpayers at 28 percent. As itemized deductions follow taxpayers’ top marginal rate, this would have the effect of lessening the value of all itemized deductions for individuals in the 33 percent, 35 percent and 39.6 percent brackets. It is important to note that many of these taxpayers have already had the value of their deductions limited by the reinstatement of the complex and burdensome “Pease” limitation that now applies to individuals with adjusted gross income above \$250,000 (\$300,000 for couples) as part of the American Taxpayer Relief Act of 2012.

The 28 percent cap focuses on the tax filer’s income, rather than the total dollar amount of itemized deductions. This proposal adds, rather than removes, complexity from the tax code and would be hard to plan for. An individual, particularly one who owns a business or who is self-employed, may be in different tax brackets from year to year. These individuals have a particularly difficult time estimating their incomes and tax liability, especially in today’s uncertain economic and legislative climate. They do not need added burdens of complexity or unanticipated tax increases. A reduction in the mortgage interest deduction (MID) would further complicate their family finances.

Some will say that putting a limitation on the deductions of upper income taxpayers would cause no harm for those in lower brackets. However, when reduced tax benefits reduce the value of a home, the value of all homes decreases. A collapse or reduction in home values at the top end of the market causes downward pressure on all other homes. That is, when the value of my neighbor’s house declines, then the value of my house declines, as well.

The second proposal to cap itemized deductions comes in the form of a hard dollar cap on all itemized deductions. Most prominently proposed by Republican nominee Mitt Romney during the 2012 Presidential election, a dollar cap would disallow deductions above a certain dollar figure regardless of income.

As the cap is not based on income, but rather the amount of deductions claimed, this proposal would potentially raise taxes on Americans of all income levels regardless of where the dollar amount of the cap was set. For example, if the cap on total deductions were set at \$25,000, households with cash incomes as low as \$30,000 would be impacted, according to the Tax Policy Center (TPC). TPC further estimates that 35 percent of households with cash incomes between \$100,000 and \$200,000 would see a tax increase averaging almost \$2,500 if itemized deductions were capped at \$25,000.

Not only does a dollar cap affect taxpayers of all income levels, it penalizes those who live in areas with higher housing costs or higher state and local taxes. Taxpayers living in these areas have somewhat “fixed” deduction costs when it comes to their mortgage and tax levels. Their property tax levels are directly tied to the value of their property and the local tax rate. While, in theory, they can pay down their mortgage amount and reduce their interest paid if they have the financial ability to do so, neither the mortgage nor the tax amount paid are discretionary, as is a charitable donation. Therefore, while it is widely viewed that charities would take the biggest hit from a dollar cap on total itemized deductions, one could argue the biggest losers would be younger families living in high cost housing markets who have both larger mortgage interest payments and high state and local tax bills. Their tax increase would be the most pronounced and painful, despite the idea that a dollar deduction cap is designed to simply make “the rich” pay their fair share.

If a dollar cap were implemented on itemized deductions, no matter the dollar amount, more and more taxpayers would be subject to it if Congress failed to index that amount for inflation. This would create the same kind of tax nightmare that came about as a result of the Alternative Minimum Tax, as more and more middle class taxpayers became subject to the cap as home values and taxes paid rose, simply because of inflation. After spending years trying to exempt most middle class taxpayers from the AMT, it would seem odd Congress would choose to proactively introduce another one. A dollar cap further adds one more layer of complexity to the tax code and seems a rather blunt instrument to raise revenue.

Converting the Mortgage Interest Deduction to a Tax Credit

Many economists have traditionally favored tax credits over tax deductions because tax credits provide more benefit to those in lower tax brackets. This ignores the reality that, in a progressive tax system like ours, an individual in the 15 percent bracket receives only 15 cents of tax reduction for each dollar of interest deducted, while an individual in the 35 percent bracket receives a tax benefit of 35 cents on the dollar. The mathematics of this assertion is correct, but asymmetrical: The tax benefit analysis of a deduction ignores the balance between tax rates and individual income taxation. An individual in the 15 percent bracket pays only 15 cents of tax on the dollar, while an individual in the 35 percent bracket pays tax of 35 cents on the dollar. Thus, tax rates balance, rather than distort, the value of deductions.

In 2005, President Bush’s tax reform advisory council proposed converting the deduction to a 15 percent non-refundable tax credit. The Simpson-Bowles Commission proposed a 12 percent non-refundable tax credit along with its proposals to eliminate the deduction for second homes and cap the total deduction at \$500,000. Others have proposed credits of different amounts and with different limitations on the total amount of mortgage debt that could be claimed or the number of homes. In order to more carefully weigh the pros and cons of converting the deduction to a credit, NAR commissioned outside research in 2005 to study the effects of such a conversion.

While the conclusions are now somewhat dated, they present a striking contrast with the 12 percent or even 15 percent credit proposals. In 2005, NAR asked its consultants to design a revenue-neutral tax credit based on data then currently available. (Revenue-neutrality was intended as a design under which the total amount of the tax expenditure associated with mortgage interest was neither increased nor decreased.) That analysis showed that in 2005, a revenue-neutral rate for a credit would have been 22 percent – markedly more beneficial to taxpayers than a 12 percent or 15 percent credit.

The amount of the credit percentage would greatly affect the number of winners and losers in any conversion. However, different studies have consistently shown that the tax increases for the losers would be far greater than the tax savings experienced by the winners. Furthermore, a conversion to a credit would upend 100 years of established tax law. The effects that drastic of a change would have on consumers and the real estate markets is unknowable. In this case we think Congress would be well advised to adopt the mantra of “do no harm.”

Eliminating the Deduction for Second Homes

Several recent proposals for tax reform, including Bowles-Simpson, have included a proposal to eliminate the deduction for second homes. Critics of the second home deduction argue that it primarily benefits rich owners of expensive vacation homes in resort areas like Aspen or Cape Cod. In reality those taxpayers are not the beneficiaries of the deduction.

When a Second Home is not a “Second Home”

One overlooked reason for the code allowing a deduction for mortgage interest paid on a second home in a tax year is the most fundamental part of residential real estate: buying and selling. If a family has a mortgage on their primary residence, and then sells that residence in order to purchase another home in the same tax year, they have owned two homes in that year. Removing the deduction for second homes would only allow the family to deduct the interest for one of those residences and essentially introduce a tax on moving. Families move for many different reasons: more space for a growing family, downsizing once the kids are gone, economic challenges, or a new job. NAR estimates that as many as three million households take part in a move that would qualify them for a “second home” deduction in a tax year even though none of those families would consider themselves second home owners.

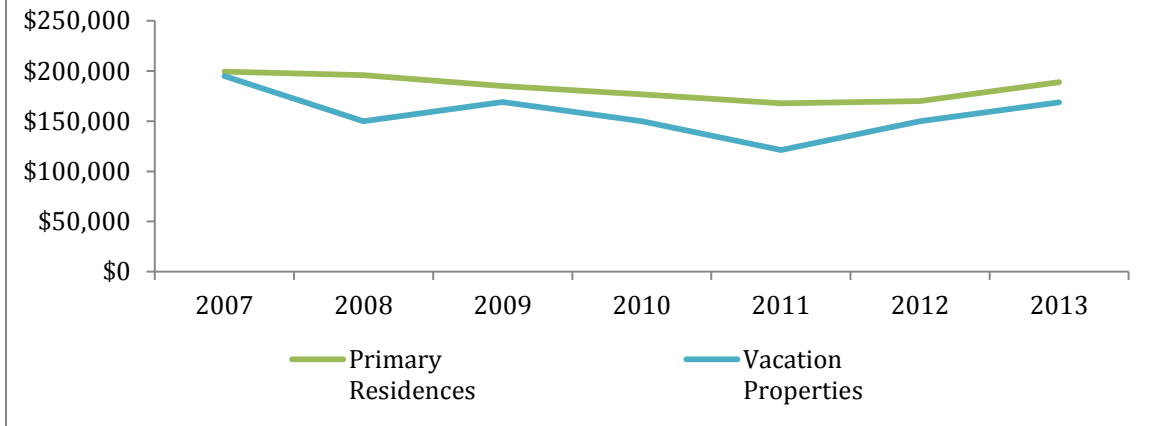
Second Homes are both Geographically Concentrated and Diverse

While the image conjured up by critics of a second homes is a multi-million dollar property in a tony resort area, most of those homes are bought with cash. In reality, second homes nationally have a lower median sales price than principal residences.

(It is important to note that for the discussion of second homes we are referring to the traditional definition of a vacation home used for recreational purposes by the owner. Homes rented for more than 14 days in a tax year are considered rental properties and subject to different tax rules.)

Every year NAR conducts an Investment and Vacation Home Buyers Survey. Over the past decade, the median price of a second home has always trailed the median price of a principal residence. Moreover, the median price of a second home has decreased over the past decade. In 2004, the median price of a second home was \$190,000. Medians for second homes peaked in 2005 at \$204,100. Currently, the median price of a second home is \$168,700 – 17 percent less than it was at the top of the 2005 market.

Median Sales Prices of Primary Residences and Vacation Homes



National Association of REALTORS® Investment and Vacation Homebuyers Survey

The tax returns of second home owners show that more than half – 54 percent – are in income classes below \$200,000. In fact, the largest single category of second home owners is in the \$100,000 - \$200,000 AGI range. NAR data show that in 2012 the median income of a second homeowner was \$92,100. While that income level is above the national median, it is not the definition of “rich” that lawmakers targeted in recent tax debates.

NAR’s second-home survey also shows that the age of second-home purchasers is increasing. After remaining flat (at around age 45) during the period 2004 – 2008, the median age of second home buyers in 2012 was creeping toward 50, suggesting that owning a second home is as much a retirement strategy as it is a recreation proposition. While the age of the typical purchaser has come back down to a more normal range, NAR research shows that 31 percent of second home purchasers in 2013 still say that their top reason for purchase was to use the property as a principal residence in the future.

Finally, NAR has compiled data identifying all US counties in which more than 10 percent of the housing stock is second homes. Currently, about 900 of the nation’s 3068 counties (roughly 30 percent) fall into this group. In some counties with very small populations, second homes can represent about 40 percent of the housing stock. In Meagher County, Montana, for example, the population is only 1,891 people, but second homes represent 42 percent of the housing stock. That area is doubtlessly dependent on the jobs and property taxes generated by those second homes.

Thus, about 30 percent of US counties have a stake in retention of the mortgage interest deduction for second homes. Those properties generate valuable jobs and property and sales taxes for the communities. To eliminate the MID for second homes would have at least as dramatic an impact on those communities as it would the taxpayer/owners themselves. Congress needs to carefully consider the economic impact on these communities, often located in rural areas with little other economic resources vs. the amount of revenue that could be raised from eliminating the deduction for second homes. The decline in home values and economic activity in those areas where the economy is driven by second homeowners could very well

eclipse the small amount of revenue that could be gained by increasing taxes on these homeowners.

Reducing the Amount of Qualified Mortgage Debt

Another proposal to “raise revenue” is to lower the cap on the amount of acquisition debt eligible for the mortgage interest deduction from \$1 million to \$500,000. As previously discussed, the \$1 million limitation was put in place in 1987 and is not indexed for inflation. Consequently the value of the MID has eroded by roughly half in 25 years.

Critics of the MID argue that lowering the limitation to \$500,000 would affect a relatively small number of wealthy taxpayers. In fact, research conducted on behalf of NAR shows that individuals in every adjusted gross income (AGI) class, even as low as \$10,000, have mortgage debt in excess of \$500,000. Those in the lower income ranges likely include those who are self-employed with minimal income after expenses, those who are business owners with significant losses or retired individuals with other tax-exempt income. No matter what the income category, however, reducing the cap would make their economic positions worse, particularly where there have been losses.

Further findings from research conducted for NAR shows over half of the taxpayers impacted by imposing a \$500,000 cap on MID have AGI below \$200,000.

Among those who itemize and claim MID, the AGI classes below \$100,000 comprise 56 percent of all tax returns. Moreover, the AGI classes below \$200,000 represent almost 90 percent of all itemized returns. Thus, the overwhelming majority of tax returns with MID are certainly NOT in so-called “Warren Buffett” territory.

Notably, taxpayers with AGI above \$200,000 have far more resources with which to reduce their mortgage debt than do those with AGI of less than \$200,000. Ironically, a \$500,000 cap thus becomes less punitive for very high-income taxpayers than it would be for lower- and middle-income families – even fairly well-compensated ones with AGI around \$200,000. These families have more constraints on their liquidity and cash flow than the very high-income families.

A \$500,000 cap has wildly divergent geographic implications. The burden of the cap would be disproportionately borne by taxpayers in high costs areas, even though they might not be categorized as “rich” and even though they may have fairly modest homes. Those living in high cost areas pay a disproportionately larger amount of their after-tax income toward housing than do taxpayers in other parts of the country. Eliminating part of the MID for them would exacerbate that disparity and in fact make home ownership even less affordable for many families. Some have proposed addressing this geographic issue by tying the limits of the MID to area housing prices in a way similar to formulas used to calculate loan limits for the Federal Housing Administration (FHA). NAR would resist any effort to make the cap on the MID contingent on the taxpayer’s place of residence. Such a change would impose significant complexity on what is currently a very simple provision.

Additional Residential Real Estate Provisions

In addition to the deductions for mortgage interest and property taxes paid, there are two other tax provisions that have a large impact on a family’s ability to sell their home. One of these

provisions is permanent and should be preserved while the other is temporary and should be made permanent.

Capital Gains Exclusion for Sale of a Principal Residence

Prior to 1997, the tax rules that governed the sale of a principal residence were complex and largely ignored (Section 1034 of the Internal Revenue Code). The general rule was that there was no recognition of gain, so long as the seller purchased a home of the same or greater value within a specified time. (This was a particular disadvantage to individuals who relocated from a high cost area to a lower cost area.) The deferred gain from the sale reduced the basis of the new home. Other elaborate rules required taxpayers to track the adjusted basis of the homes they owned so that, in the event that they did not purchase a replacement home (or purchased a replacement home of lesser value), the gain on that sale became taxable, as measured from the adjusted basis. Few taxpayers had adequate understanding of the law or sufficient records to enable them to comply with these rules.

In 1997, the Clinton Administration, without input from NAR or others in the housing industry, proposed a complete overhaul and simplification of these rules. Rather than require elaborate basis computations on multiple residences over a term of many years, the new rule simply permitted the seller to exclude up to \$250,000 (\$500,000 on a joint return) of the gain on the sale. Any excess above these amounts would be currently taxable at the capital gains rate for the year of sale. The reinvestment rules were eliminated, so taxpayers gained mobility and flexibility. The exclusion gives them the ability to downsize, buy more than one property, purchase a non-real estate asset or do anything they choose with the proceeds of the sale. The exclusion is restricted to the sale of only a principal residence, and certain qualifications must be satisfied in order to receive the benefit of the exclusion. As with the MID, the \$250,000 and \$500,000 amounts are not indexed for inflation.

No data is publicly available that allows either NAR or its consultants to evaluate the impact of possible changes to these rules. No public IRS records present information about Forms 1099 that are filed for home sale transactions, and no capital gains data are separately presented to show the amount of taxable gain reported on homes sales in a particular year. In addition, there is no way to ascertain the value of unrecognized gain that has accumulated in homes that are not currently on the market. Finally, long-term holders are far more likely to have larger appreciation amounts and so should not be penalized for that long tenure.

We note that this provision is among the most taxpayer-friendly sections in the entire Code. When enacted, it was a substantial simplification from prior law. Further, it allows a great deal of flexibility in the financial planning for families. Notably, the gain on the sale of a principal residence is a significant factor in the retirement savings plan of many older Americans. They anticipate downsizing and then using the remaining proceeds to supplement any retirement income they have. Prior law penalized individuals over age 55 by limiting an exclusion to just once in a lifetime. Today's rules reflect far more accurately the homeownership patterns over a lifetime. The exclusion functions as a sort of "Housing Roth IRA" in that the gains made over long periods (in many cases with improvements made from after-tax dollars) are free of tax at the time of sale. At a time when policymakers are contemplating changes to entitlement programs and Americans are struggling to save more for retirement, Congress should continue to recognize the important role the principal residence exclusion plays in supplementing retirement savings. NAR urges Congress to retain the exclusion at current levels or secure its importance for future generations of homeowners by indexing it for inflation.

Cancellation of Mortgage Indebtedness for Principal Residence

Under general tax principles, when a lender cancels a portion or all of a debt, including mortgage debt, the borrower is required to recognize the forgiven amount as income and pay tax on it at ordinary income rates. An exception is provided for some mortgage debt that was or will be forgiven between January 1, 2007 and December 31, 2014. When this relief was initially considered in 2007, the Ways and Means Committee reported it as a permanent provision. The final version, however, was temporary and in place only through December 31, 2009. That date was extended through December 2012 as part of the flurry of legislation enacted at the height of the 2008 financial crisis. The American Taxpayer Relief Act of 2012 subsequently extended the expiration date to December 31, 2013, and The Tax Increase Prevention Act of 2014 extended the expiration date to December 31, 2014.

While the volume of short sales and foreclosures has receded from record highs, there are still a significant number of families struggling to keep up with their mortgage payments and banks are still working to conduct loan modifications as a result.

NAR believes the tax code should not discourage homeowners from trying to take proactive steps to avoid foreclosure by taxing them on phantom income, especially when the federal government has devoted considerable resources to help modify mortgages and lessen the impacts of foreclosure.

We urge Congress to make mortgage cancellation relief a permanent provision.

Additional Views on Proposed Tax Systems – The Flat Tax and The Fair Tax

While we recognize the prospect of converting the entire tax code to a completely new system of taxation is not necessarily the goal of this Working Group or of the Committee, we do wish to briefly note our views on the proposed Flat Tax and Fair Tax models to indicate our passion about them.

NAR aggressively opposed the flat tax as it was proposed in 1995 by then-Representative Dick Armey (R-TX) and later during the 1996 Presidential primary campaign of Steve Forbes. The Armey-Forbes flat tax, based on the so-called Hall-Rabushka model, would have repealed all deductions, including the mortgage interest deduction and state and local tax deductions.

Our internal research and the research of outside experts consistently has shown that an overnight or even a phased loss of these deductions would cause the value of existing housing to fall by as much as 25 percent. The average loss of value would be 15 percent. This is simply unacceptable, particularly because our research also has shown that this loss of value is never fully recouped.

Under current law, no federal-level tax applies to the purchase of a house. Thus, we would oppose any new, transaction-type tax on the sale or purchase of a house. We have no formal position on the system set forth in the National Retail Sales Tax (“The Fair Tax”), but we are dismayed that the sales tax rate of that model would likely range between 30 percent and 45 percent of the price on a tax-exclusive basis.

We are unable to imagine how buyers, sellers or housing markets could bear the burden of The Fair Tax. We question whether prudent lenders would or should finance the sales tax cost, as a

long-term financing mechanism would almost certainly require mortgages that would exceed either the fair-market value or the after-tax value of the home.

If a home that had been subject to the sales tax were sold before the sales tax liability had been extinguished (which we believe would be the general case), the owner would likely realize no cash, as the outstanding tax and mortgage liabilities could easily use up most or all of the proceeds from the sale. Short sales would be epidemic. Thus, a tax on home purchases is ill-advised.

Conclusion

NAR would like to thank the Working Group for its open and collaborative process as it seeks to reform our Nation's tax code. In order to devise a fairer and simpler tax code, the input of stakeholders at all levels is imperative to avoid unintended consequences.

The residential and commercial real estate industries in America are large drivers of the economy. The Nation has been led out of four of the last six recessions by a recovery in the housing market. Commercial real estate adds value to the places that we work, conduct commerce, and play.

Despite the price declines, foreclosures, and economic hardship that have befallen our housing market in recent years, Americans remain committed to the principles of homeownership. They continue to hold the vast majority of their personal wealth in their homes. They continue to believe that ownership of real property is part of the American Dream that was envisioned from the very beginning by our Founders. That is why even high numbers of those who rent consistently support tax incentives for home ownership. Congress should continue to support these same ideals as it seeks to reform the tax code.