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GOVERNMENT AFFAIRS DIVISION
Jerry Giovaniello, Senior Vice President
Gary Weaver, Vice President
Joe Ventrone, Vice President & Deputy Chief for Regulatory Affairs
Scott Reiter, Vice President
Jamie Gregory, Deputy Chief Lobbyist

500 New Jersey Ave., NW
Washington, DC 20001-2020
Ph. 202-383-1194; Fax 202-383-7580
WWW.NAR.REALTOR

July 17, 2017

The Honorable Orrin G. Hatch
Chairman
Senate Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Hatch:

In response to your recent invitation seeking recommendations and advice from stakeholders on how the Senate can craft the most effective tax reform legislation, I submit the following on behalf of the over 1.2 million members of the National Association of REALTORS®.

NAR applauds your leadership and that of the Senate Committee on Finance in seeking to develop ideas for comprehensive tax reform in a thoughtful, collaborative way. We also recognize the tremendous effort required to analyze deficiencies in the current law, study the various options for reforming the system, and consider the tremendous ramifications and trade-offs of various policy choices on different constituencies. This is a very tough challenge, and the Association appreciates the opportunity to provide input on how tax reform could affect real estate in our Nation, and especially on the present time-honored tax incentives for purchasing and owning a home.

These comments are respectfully submitted on the following key topics relating to the taxation of residential and investment real property:

I. NAR Principles for Tax Reform
   a. Homeownership and Tax Simplification
II. Homeownership and American Culture
III. Residential Real Estate Tax Provisions
   a. The Real Property Tax Deduction
   b. The Mortgage Interest Deduction
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V. Tax Reform Proposals to Limit the Tax Benefits of Home Ownership
   a. Capping Itemized Deductions
   b. Converting the Mortgage Interest Deduction to a Tax Credit
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VI. Additional Real Estate Tax Provisions
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I. NAR Principles for Tax Reform

NAR's recommendations are centered on three guiding tax policy principles:

- Our income tax system, despite its many flaws, has supported a homeownership system that is unequaled in the world. Tax reform must build on the positive aspects of our current system so that it continues to encourage and support homeownership.
- While some aspects of our current tax system are mind-numbingly complex, the housing and real estate tax rules create no undue or significant complexity burdens. A quest for simplicity must not be allowed to override common sense.
- Income-producing real estate is vital for strong economic growth and job creation, and great care must be taken in tax reform to ensure that current provisions that encourage those results not be weakened or repealed. Further, the tax system needs to be improved to better incentivize the construction of low-income housing, encourage more investment in income-producing real estate by the middle class, and to help families save for retirement security.

If one were designing a tax system for the first time, one would likely devise 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, the Association remains 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[1] of all federal income taxes. Congress should avoid further raising taxes on homeowners.

Many concepts of tax reform are based on the idea of lowering tax rates and broadening the tax base. This paradigm often leads to the conclusion that tax reform needs to "close loopholes." However, those "loopholes" have not been

[1] National Association of REALTORS® estimates.

identified. NAR firmly believes that the tax provisions that support homeownership are not loopholes. As 64 percent of American households are owner-occupied[2], homeownership is not a "special interest," but is rather a "common interest."

NAR believes that tax reform must first do no harm to real estate.

Homeownership and Tax Simplification

NAR supports the goals of simplification and structural improvements for the tax system. Nonetheless, we are unwavering in our support for the mortgage interest and property tax deductions and believe that other favorable housing provisions should be retained. These rules are among the most easily understood and widely supported in the entire tax system, so compliance is easily achieved.

The mortgage interest and property tax deductions sometimes come under fire because, in any particular year, only about one-third of taxpayers itemize their deductions. This criticism overlooks two essential points. First, even though the percentage of taxpayers who itemize has remained relatively constant over the past 25 years, the individuals who comprise the universe of itemizers changes from year to year. Younger taxpayers purchase their first home, older mortgages get paid off, a family's charitable contributions fluctuate, state and local tax burdens vary from state to state, and in some years, families face deductions for large medical expenses or casualty losses. In short, circumstances change.

Second, the standard deduction serves as a generous proxy for itemizing. It provides, in relative terms, a greater tax benefit for the taxpayers who use it than itemizing would give them. For example, today's standard deduction on a joint return is $12,700. If a family's total of mortgage interest expense, state and local taxes, charitable contributions and medical expenses were, for example, $8,700, they would pay no tax on $4,000 ($12,700 - $8700). The standard deduction thus generally has the effect of sheltering some income from taxation. This is because taxpayers itemize only when allowable deductions exceed the standard deduction (please see *The Enigma of the Standard Deduction*, below).

NAR supports the current standard deduction. For most taxpayers, it is a substantial and significant simplification device that also, by sheltering some income from tax, adds progressivity to the system. Those who itemize receive no such benefit. As with standard deduction taxpayers, itemizers are found in all tax brackets. If they are in higher tax brackets, they do receive more tax benefit per dollar spent than itemizers in lower brackets. What critics often overlook, however, is that higher bracket taxpayers also pay more tax on each dollar of income than those in lower tax brackets.

Some recent tax reform plans feature a much higher standard deduction than is offered under the current system. This change is justified by touting the additional simplification that could result from far fewer taxpayers itemizing. However, this simplification would come at a high price. Doubling or tripling the standard deduction, as some reformers suggest, destroys the incentive value of itemized deductions, as taxpayers would receive the same tax benefit whether or not they engaged in the behavior the deduction is designed to encourage, whether it is to purchase a home or to donate to a charitable cause. Past increases in the standard deduction were justified on the grounds that the underlying itemized deductions had grown in value compared with an unindexed standard deduction. But under the current law, the standard deduction is adjusted each year for inflation, leaving little or no policy reason to increase it. ***Because of this, NAR opposes tax reform plans that significantly increase the standard deduction.***

II. 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

[2] U.S. Census Bureau, January 2017.

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

The Nation's commitment to homeownership as a foundation of our society is not misplaced. Now, more than ever, homeownership does and should remain in the forefront of our cultural value system.

The fundamental assumptions about the social benefits of housing and homeownership remain essentially unchanged. NAR polling and focus group research confirm that the public continues to share those assumptions, including those who currently do not own their own home. An overwhelming majority (94 percent) of renters aged 34 and younger aspire to own a home. And among renters of all ages, 83 percent have a desire to own. Seventy-seven percent of them believe that homeownership is part of the American Dream[3]. Remarkably, even after the problems stemming from the 2003-2007 housing run-up, this faith in homeownership persists.

Research has consistently shown the importance of the housing sector to the economy and the long- term social and financial benefits to individual homeowners and communities. 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 2016. Net of mortgage liabilities, real estate household equity totaled $13.7 trillion in the first quarter of 2017[4].

In addition to tangible financial benefits, homeownership brings substantial social benefits for families, neighborhoods, and the Nation as a whole. These benefits include increased education achievement and civic participation, better physical and mental health, and lower crime rates. These economic and societal benefits do not change and will not change, despite the ups and downs and challenges of the housing market.

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 the home ownership cycle, a much higher percentage 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.

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, they are generally creating non-cash wealth for their families. 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.

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[3] *2015 Homeownership Opportunities and Market Experience (HOME) Survey* conducted by the National Association of REALTORS®.
[4] *Housing's Contribution to Gross Domestic Product (GDP),* National Association of Home Builders, nahb.org

III. Residential Real Estate Tax Provisions

There are a number of provisions in the Internal Revenue Code that affect residential real estate in one form or another. These range from relatively minor temporary tax incentives to major provisions 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 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 has always recognized 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.

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, significantly more taxpayers claim the real property tax deduction than claim the deduction for mortgage interest (in 2014, 37.3 million wrote off real property taxes while 32.7 million deducted mortgage interest)[5].

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 below (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

[5] *SOI Tax Stats – Individual Income Tax Returns*, Publication 1304 (Complete Report), updated 8/31/2016

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.[6] 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.

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 benefits only those relatively few taxpayers who are eligible to itemize their deductions, and that it favors wealthier taxpayers at the expense of those with more modest incomes. Since taxpayers who itemize are often those with higher incomes, these criticisms are related.

In 2015, the most recent tax year for which IRS data are available, 32.7 million tax filers claimed a deduction for mortgage interest[7]. While tax filers claiming the MID account for less than a quarter of the total number of tax returns filed, returns claiming the MID represent closer to half of owner-occupied households and roughly two-thirds of home-owners whose homes are mortgaged.

Furthermore, the percentage of homeowners claiming the benefits of the MID at some stage of the home ownership cycle is much higher. 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 will not see the full contingent of homeowners who use the MID at some stage over the time they own their homes.

As to the charge that the deduction predominately favors the wealthy, statistics show that this is simply not the case. Rather, the MID is valuable and utilized by households across the income spectrum. Fully half of those claiming the

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[6] *Present Law and Background Information Related to Federal Taxation and State and Local Government Finance*, Joint Committee on Taxation, March 15, 2013, JCX-7-13

[7] *Individual Income Tax Returns, Preliminary Data, Tax Year 2015*, Internal Revenue Service, Statistics of Income Bulletin, Spring 2017.

MID in 2015 earned less than $100,000 and 85 percent had Adjusted Gross Incomes of less than $200,000. Further, 83 percent of the value of the MID in that year went to those earning under $250,000 per year8.

IV. 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. 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, 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 enacting 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 exceeding 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 was 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 actual deductions less than the standard, the taxpayer is 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 2017 total $12,000. With the standard deduction for a couple currently at $12,700, this family would be receiving an extra tax deduction for $700 in expenditures they never made. If they were in the 28 percent bracket, this would amount to a $196 tax "freebie" ($700 excess x 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 claim the standard deduction of $12,700, for a subsidy of $10,700 ($12,700-$2,000), which would be worth $2,996, assuming they were also in the 28 percent tax bracket ($10,700 x 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 and property tax deductions. Just because the standard deduction does not specifically indicate

[8] *Ibid.*

which portion of it is attributable to the MID or property tax (or any other deductions), does not mean that these deductions for homeownership are 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.[9]"

Thus, it is clear that even though no specific portion of the standard deduction is tied to the MID and property tax deduction, Congress crafted the standard deduction to be a proxy for allowable deductions (i.e., itemized deductions), including the MID and state and local tax deductions, 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 most taxpayers would claim the standard deduction (82 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 and real property tax deductions benefit only those who itemize simply do not hold water.

V. Tax Reform Proposals to Limit the Tax Benefits of Home Ownership

In recent years, a variety of tax reform ideas have been proposed that would limit the ability of certain taxpayers to claim the mortgage interest and/or the property tax deductions, or in other ways reduce the incentive effect of these provisions. Each of these proposals would limit the value of the deductions and 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 that was included in several of President Obama's budgets 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 applies to individuals with adjusted gross income above $250,000 for singles and $300,000 for couples (adjusted for inflation) 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 and state and local tax deductions 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

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[9] *Summary of H.R. 13270, The Tax Reform Act of 1969*, Joint Committee on Internal Revenue Taxation and the Committee on Finance, August 18, 1969.

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 could be impacted, according to the Tax Policy Center (TPC). TPC further estimated 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[10].

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 struggling to exempt most middle class taxpayers from the AMT, it would seem odd Congress might consider falling into a similar quagmire again. Further, a dollar cap would add one more layer of complexity to the tax code and would be 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 reflects 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 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 a dollar of income, 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 subsequently proposed a 12 percent non-refundable tax credit along with its proposals to eliminate the deduction for second homes and capping 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 on 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.

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[10] *On the Distributional Effects of Base-Broadening Income Tax Reform*, Urban-Brookings Tax Policy Center, August 1, 2012.

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. Also, the loss of the tax benefit would almost certainly result in the drop of value of all homes, as discussed above in the analysis regarding the proposal to cap itemized deductions. 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 proposals for tax reform, including Simpson-Bowles, 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 often 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 so they can 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. Over the past decade, the median price of a second home has always trailed the median price of a principal residence.

NAR data show that in 2016 the median income of a second homeowner was $89,900[11]. While that income level is above the national median, it is certainly not the definition of "rich" that many consider when debating tax changes to "soak the wealthy."

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

[11] *2017 NAR Investment & Vacation Home Buyer's Survey*

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 more than half in 30 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.

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.

Increasing the Standard Deduction and Repealing Most Itemized Deductions
More recently, Republicans on the House of Representatives have put forward a tax reform plan called "A Better Way," which is informally known simply as "The Blueprint."

While we laud the goals of this tax reform plan, and marvel at its boldness, we have great concern with one aspect of the Blueprint. This concern is that the interaction of two features of the plan, which are designed to simplify the tax system, would have the unintended consequences of nullifying the long-standing tax incentives of owning a home for the great majority of Americans who now are, or who aspire to become, homeowners.

Specifically, the Blueprint calls for the standard deduction to be almost doubled from its current levels. The plan also includes the repeal of the deduction for state and local taxes paid, as well as the elimination of most other itemized deductions. Either of these monumental changes alone would marginalize the value of the current-law tax incentives for owning a home. Unfortunately, the combination of these two revisions would cripple the incentive effect of the federal tax law for all but the most affluent of taxpayers.

We anticipate two potentially devastating problems in the aftermath of these modifications. First, the impact on the first-time homebuyer could be enormous. For many, the current-law tax incentives make the crucial difference in being able to afford to enter the ranks of homeowners. At a time when the rate of first-time home-buying is well below the average of the past few decades, this could be particularly debilitating for the housing industry and the entire economy.

Second, the decimation of the mortgage interest and real property tax deductions would very likely cause a significant plunge in the value of all houses. At a time when the housing sector has not fully recovered from the thrashing it took during the Great Recession, this drop, even if temporary, could be calamitous. Millions of homeowners could again wake up to learn that the value of their largest financial asset has dived below the amount of debt that is owed on it.

The combination of these two problems could have further ramifications that could produce a vicious spiral. Should home values drop due to the decrease in value of homeownership incentives, revenues to state and local governments would surely follow suit because of lower assessed property values. Further, public pressure on these same governments to lower tax rates because these tax payments would no longer be deductible could greatly exacerbate the situation. The overall result could be a disastrous downturn in the quality of many neighborhoods and communities, and especially our most vulnerable ones.

Even if the hoped-for economic growth from the Blueprint materializes, it will take years for the full effects of these changes to permeate through the economy and for the effects to offset the deleterious short- to mid-range effects mentioned above. And many homeowners, particularly those who are middle-aged or older and are planning to use the equity in their home for retirement or to pay for the education of their children, simply will not have time to wait for the recovery.

VI. Additional Residential Real Estate Tax 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 and with a relatively small amount. 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, 2016. 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. The Preventing Americans From Tax Hikes (PATH) Act of December 2015 extended the provision through the end of 2016. However, the provision has not been extended this year.

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.

VII. 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 the Senate Committee on Finance, 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 would never be 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 extremely ill- advised.

VIII. Commercial and Investment Real Estate Tax Provisions

Section 1031 Like-Kind Exchanges

NAR strongly believes that the like-kind exchange provision in current law is vital to a well-functioning real estate sector and a strong economy and must be preserved in tax reform. The like-kind exchange is a basic tool that helps to prevent a "lockup" of the real estate market. Allowing capital to flow more freely among investments facilitates commerce and supports economic growth and job creation. Real estate owners use the provision to efficiently allocate capital to its most productive uses. Additionally, like-kind exchange rules have allowed significant acreage of environmentally sensitive land to be preserved.

Section 1031 is used by all sizes and types of real estate owners, including individuals, partnerships, LLCs, and corporations. Moreover, a recent survey of our members indicated that 63 percent of REALTORS have participated in a 1031 like-kind exchange over the past four years.

A 2015 study[12] found that in contrast to the common view that replacement properties in a like-kind exchange are frequently disposed of in a subsequent exchange to potentially avoid capital gain indefinitely, 88 percent of properties acquired in such an exchange were disposed of through a taxable sale. Moreover, the study found that the estimated amount of taxes paid when an exchange is followed by a taxable sale are on average 19 percent higher than taxes paid when an ordinary sale is followed by an ordinary sale.

If one of the goals of tax reform is to boost economic growth and job creation, any repeal or limitation of the current-law like-kind exchange provision is a step in the wrong direction.

[12] *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exhchanges in Real Estate*, David C. Ling and Milena Petrova, March 2015, revised June 22, 2015.

Investment in Income-producing Property

NAR maintains a firm commitment to affordable housing goals. We continue to support the modernization and improved utilization of the low-income housing tax credit. This provision, enacted in 1986, has proven to be a key feature that has permitted construction and development of rental housing for many low-income individuals and families. The current shortage of rental housing in all income categories underscores the particular importance of the low-income housing credit in serving the needs of those who seek decent and affordable housing.

Barriers to investment in income-producing real estate must be removed. The confusing and largely counterproductive alternative minimum tax should be repealed. The passive loss rules must, at a minimum, be modified to encourage more wealth building by the middle class. Economic opportunity could be enhanced at lower income levels if the so-called "small investor" provisions of the passive loss rules were modified to reflect the inflation that has occurred since 1986. This small change would attract small investors back to residential real estate rental activities. Repealing the passive loss rules would provide an even stronger investment incentive. Investors in today's real estate market are seeking cash flow and appreciation, not tax shelter.

The real estate depreciation system must also be modernized to more accurately reflect economic reality. The 39-year life for non-residential real estate should be shortened, not lengthened, as some recent tax reform proposals have recommended. An analysis of a recent landmark study on the economic depreciation of real property by PwC shows that the required tax life to match economic depreciation as shown in the MIT study would be about 19 years.

Improved capital cost recovery rules can also be viewed as an engine for job creation. Rules based on economic reality would provide significant incentives to update older buildings and upgrade existing properties. Even buildings constructed in the early part of this century are now becoming technologically obsolete. Future growth in the economy can only occur in technologically smart buildings and workplaces, and our tax system should recognize and support this fact.

However, recent tax reform proposals to allow all productive real property assets (except land) to be immediately expensed need further study and analysis. This revolutionary idea could have wide-reaching ramifications that could lead to negative results. The Economic Recovery Tax Act of 1981 included a provision reducing the real estate recovery period to just 15 years, with an accelerated method of depreciation. In some areas of the Nation, this led to the construction of commercial buildings that were largely based on the tax benefits available rather than the underlying economics. Further, the resulting increase in tax shelter activity led directly to drastic changes to the tax treatment of real estate in the subsequent Tax Reform Act of 1986, which brought about a serious downturn in the real estate sector of the economy.

Another recent tax reform idea also has the potential to cause very serious disruption to the real estate sector. This is the proposal to eliminate the deduction for net investment expense that is included in the House Republican Blueprint. The ability to finance productive investment and entrepreneurial activity with borrowed capital has driven economic growth and job creation in the United States for generations. Since its inception, our tax system has appropriately allowed business interest expense to be deducted as an ordinary and necessary business expense.

Repealing or imposing limits on the deductibility of business interest would fundamentally change the underlying economics of business activity, including commercial real estate transactions. This could lead to fewer loans being refinanced, fewer new projects being developed, and fewer jobs being created. Legislation altering the tax treatment of existing debt could harm previously successful firms, pushing some close to the brink of insolvency or even into bankruptcy. Tax reform must preserve the current tax treatment of business interest. By increasing the cost of capital, tax limitations on business debt could dramatically reduce real estate investment, reducing property values across the country, and discouraging entrepreneurship and responsible risk-taking.

Conclusion

NAR would like to thank the Senate Committee on Finance 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.

Sincerely,

William E. Brown
2017 President, National Association of REALTORS®

cc: U.S. Senate Committee on Finance