NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

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October 14, 2005

The Honorable Connie Mack, Chairman
The Honorable John Breaux, Vice-Chairman
President's Advisory Panel on Tax Reform
1440 New York Ave., N.W.
Washington, DC 20220

Dear Senators:

Earlier this year the NATIONAL ASSOCIATION OF REALTORS® submitted comments to the Panel expressing our views on important tax provisions related to housing and commercial real estate, including the mortgage interest deduction and other housing-related provisions, depreciation of investment and commercial real estate and the special considerations that apply to self-employed persons. Following your October 11 public meeting, we wish to supplement those comments with observations about several points covered in your discussion of the mortgage interest deduction and other tax benefits associated with owner-occupied housing.

This letter is intended to make you aware of concerns you may wish to take into account as you prepare your final recommendations.

Housing and American Culture

Never dismiss or underestimate Americans' passion for homeownership. 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, the basis for community life. The imagery of Tom Sawyer, the great American icon, painting a picket fence and engaging his pals to get the work done is a statement about the central notion of having a place to call one's own and of keeping it up to preserve a family's standing in the community. Do not take such imagery or passion lightly.

The tax system does not "cause" homeownership. The tax system *facilitates* ownership. The result has been that our nation has achieved remarkably high rates of homeownership. The tax system supports homeownership by making it more affordable. While it is true that only about one-third of taxpayers itemize deductions, it is also true that, over time, more than one third of taxpayers receive the benefit. Over time, mortgages get paid off, other new homeowners enter the market and family tax circumstances change. Arguably, the standard deduction gives non-

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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.

The federal policy choice to support homeownership has been in the Internal Revenue Code since its inception. We see no valid reason to undermine that basic decision.

The Panel's Proposals

As President of the NATIONAL ASSOCIATION OF REALTORS® I have already received reports from our members describing consumer uncertainty about the Panel's recommendations. The news reports have created a perception that mortgage interest benefits may be eliminated. The public may be misconstruing the news reports, but the fact remains that the news reports and public perception are already chilling some parts of the marketplace, particularly in high cost areas. The Panelists must understand that limiting or eliminating tax benefits will have an adverse impact on housing markets and the value of housing.

The housing market, while large, is a fragile, delicate instrument. For more than five years, housing has been the most lively and vibrant sector in the economy and fueled much of the 2001 – 2002 economic recovery. Some panelists expressed concern about real estate speculation and about the size of houses. *We believe that penalizing current homeowners by reconfiguring the mortgage interest rules is a completely inappropriate mechanism for curtailing abusive lending practices or defeating local land use decisions.*

In addition to the chilling effect news reports have created, we note as well the lack of clarity about the specifics of your proposal. Our own counsel, who attended the October 11 meeting, could discern no clear articulation of either the amount by which the current law $1.1 million cap would be reduced or what the effective tax rate for mortgage deductions would be under a tax credit type of proposal. The limitation amounts have been reported in the media as ranging from $300,000 to $350,000. The lack of specificity is confusing to us, to our members and, most of all, to consumers. It is unwise to create uncertainty of that magnitude in any marketplace, much less in a high-priced, active but delicate housing market.

The following are our comments on the various concepts put forth at the October 11 meeting.

Converting the Mortgage Interest Deduction to a Credit

We believe that any change of this type will create winners and losers. For a benchmark, we have undertaken research projects assessing the impact of a tax credit measured against the current deduction rules. Our emerging conclusion is that, over time, there would be more losers than winners unless the credit rate is comparable to the higher brackets of the tax system. In all events, we believe that the value of the existing stock, particularly in high cost areas, would be diminished.

The Tax Reform Act of 1986 provided ample evidence that when the tax benefits associated with real estate ownership are curtailed, the value of real estate declines. A substantial decline in residential values would likely occur with a conversion to a credit that reduced the economic

benefit of tax deductions. The 1986 Act provided 5-year transition relief for owners of investment real estate, but *even with the benefit of transition rules,* the loss of value in the commercial real estate sector was 30%. Observers would likely find it ironic that, in today's era of low savings, a change to the tax laws could sharply erode the equity savings of homeowners. We can identify no justification for diminishing the savings families have in their homes.

Reducing the $1 Million Cap on Indebtedness

The $1 million cap on mortgage indebtedness ($1.1 million when home equity debt is included) as a measure of allowable mortgage interest deductions was adopted in 1987. NAR supported that change from prior law, as it was a substantial simplification over the mortgage interest limitations that had been included in the 1986 Tax Reform Act. The $1.1 million cap has not been modified or indexed for inflation since 1987. Given inflation, the overall real growth in the economy, the substantial increase in the cost of housing and growth in the homeownership rate since 1987, we were startled that the Panel would even consider *reducing* that cap.

Moreover, we believe that it is facile to say that the cap should be reduced to the FHA loan limit amount. We would ask, "Which FHA loan limit?" Those loan limits range today from $172,632 to $312,895, depending on geographic location. (Note these limits can go as high as about $469,344 in Alaska and Hawaii, but not in any other high cost state.) Worse yet, FHA limits vary within a state. In California alone, more than a dozen FHA limits are in effect in various parts of the state.

We share Senator Breaux's expressed concerns about the very uneven regional and community application of any proposal that would reduce the current law $1 million cap, particularly to levels as low and as complex as the FHA loan limits. It is unclear how using the FHA community-based mechanism, measured based on Metropolitan Statistical Areas, could be transposed fairly into the federal income tax system. We believe that grafting the FHA system into the tax system would result in extraordinary complexity. Moreover, we note that a $350,000 home in Indiana would be significantly different in size and possibly in quality from a $350,000 home in high cost areas such as Miami and New York and even in a smaller community such as Charlottesville, Virginia.

Note, as well, that bipartisan legislation is pending in the House that would *raise* the Fannie Mae and Freddie Mac loan limits to mitigate financing challenges in high cost states. The FHA limits are generally less than the Fannie Mae and Freddie Mac conforming limits, but the formula for computing the FHA limits takes the Fannie and Freddie limits into consideration. Thus, the clear trend of the financial market policy makers is to make *more* capital available to lenders. Any proposal that undermines the tax treatment of that capital flies in the face of that intent and seems to send contradictory signals to housing markets.

Reducing the Cap and Converting to a Credit

The Panel's discussion was unclear about the relationship, if any, between reducing the $1 million cap and converting a deduction into a tax credit. If the Panel were to propose that Congress make *both* of these changes, the likely adverse impact on housing, and the attendant

erosion of family savings, would be staggering. We are compiling for your staff a list of the states and Metropolitan Statistical Areas (MSAs) that have median prices above $300,000 to illustrate just how very far reaching this type of proposal would be.

<u>Other Housing-related Issues</u>

The Panel did not discuss the impact of this proposal on the second home market. We bring to your attention that this is one of the more vibrant sectors of the housing market. Historically, it has been the general pattern that at least one Congressional district in every state (except Connecticut, where second homes are not concentrated in any particular district), has a lively REALTOR® second home/vacation property market.

The Panel's discussion concerning the $250,000/$500,000 exclusion on the sale of a principal residence was inconclusive. This provision, enacted in 1997, is among the simplest, most taxpayer-friendly provisions in the Code. We urge you to retain that provision. In addition, that provision was not indexed for inflation, so any reduction of the caps would be particularly troubling.

In his presentation, Professor Poterba stated that if less money were invested in owner-occupied housing, more money would be invested in "more productive" assets such as stocks and equipment. We note that stock or equipment ownership does not provide the foundation for community life, does not provide an impetus to encourage good schools, does not foster lower crime rates and does not contribute to the tax base of local governments. Housing does those things. Moreover, it is not a foregone conclusion that individuals who purchase residences for their families would necessarily have the requisite skills to choose and purchase stocks or other securities. Similarly, no family is likely to acquire manufacturing equipment to improve their community or schools. Professor Poterba stated that if families bought smaller houses they might buy more stock. We do not believe it is the function of the tax system to determine the size of a house for any family or its method of saving.

We look forward to receiving your report and to continuing this dialogue.

Sincerely,

Al Mansell, President
National Association of REALTORS®