BUSINESS

Mortgage Interest Deduction Could Go On Chopping Block

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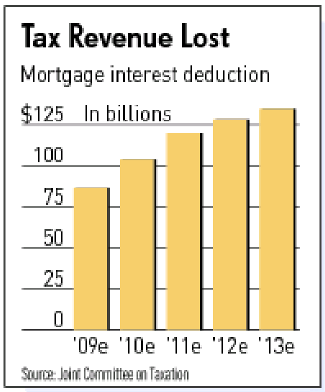

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This month a presidential commission recommended slashing the mortgage interest deduction, by turning it into a limited tax credit, to cut the federal budget deficit. What would be the impact on the housing market? It depends on who you ask.

Research the National Association of Home Builders references at savemymortgageinterestdeduction.com predicts more than a 10% home value decline if the deduction is curtailed. The National Association of Realtors expects a greater drop if lawmakers ditch the deduction.

"If the mortgage interest deduction is eliminated, we believe that there will be a 15% decline in home prices," said Lawrence Yun, chief economist with the NAR.

But "that's an old study," said Mark Calabria, director of financial regulation studies for the Cato Institute. "That 15% conclusion was in a much higher interest-rate environment."

To be sure, losing the interest deduction when mortgage rates were 8% would have more of an impact on taxpayers and the housing market than the current environment, when rates are under 5%.

The National Commission on Fiscal Responsibility and Reform's proposal doesn't entirely eliminate the tax benefit. Instead of writing off the interest on mortgage loans as high as $1 million (plus $100,000 in home equity debt), there would be a 12% tax credit toward interest on the first $500,000 of a mortgage — and just on the taxpayer's primary residence, with no credit for second homes.

Tax Savings Slashed

The impact would be substantial. A $1 million mortgage with a 4.5% interest rate, or $45,000 in interest, would no longer spur a $15,000 tax benefit for someone in the 33% tax bracket. Instead, interest of $22,500 on the cap of $500,000 would generate savings of only $2,700. Going from a tax benefit of $15,000 to $2,700 is an 82% drop in tax savings.

"The negative impact would not just be on the upper-end households," said NAR's Yun. "If upper-end home prices begin to fall, then the homes that need to compete with that segment would also have to lower their price."

Cato's Calabria argues that all along, the mortgage interest deduction has propped up home prices.

"I don't think we should be thinking of how we make life's basic necessities more expensive," he said. "If you believe that removing the interest deduction would drop prices by 15%, then that also means that you must believe that the interest deduction makes prices 15% higher."

When the federal income tax started in 1916, all consumer interest was deductible. In 1986, Congress eliminated all interest deductions except mortgage interest. It is estimated that eliminating the mortgage interest deduction would reduce the deficit by about $80 billion per year.

President Obama talks with Alan Simpson, co-chairman of the fiscal responsibility commission, in April. AP View Enlarged Image

"In my view, nothing will be done, because the people who need to vote on it, members of Congress, have constituents, whereas the commission members don't," Yun said.

Calabria says the deduction primarily benefits high-income taxpayers in pricey real estate markets such as New York and California.

"Half of all homeowners don't even take the mortgage interest deduction because they don't itemize deductions," he said.

The standard deduction for married couples filing jointly is $11,400 in 2010. Itemized deductions including the mortgage interest deduction would have to exceed that number to have any value.

The mortgage interest deduction has been curbed before. In recent years, limits were slapped onto the total itemized deductions that high-income taxpayers were allowed to take — the so-called "haircut." In 2009, those with adjusted gross income above $166,800 were affected.

For example, let's say a taxpayer had an adjusted gross income of $300,000 in 2009. Her only deduction was 5% mortgage interest on an $800,000 loan, or $40,000. Because her income exceeded the phaseout limitation of $166,800 for itemized deductions in 2009, she had to reduce her deduction by 1% of the difference between $300,000 and $166,800, or 1% of $133,200, which equals $1,332. Since she was in the 33% tax bracket, a lost deduction of $1,332 equated to about a $400 increase in tax.

This limitation — 3% in 2007, 2% in 2008 and 1% in 2009 — was phased out in 2010. If Congress reinstated the limitation to 3%, the haircut in the above example would be $4,000, not $1,332, with a resulting increase of about $1,200 in tax.

"The higher a person's income, the greater the increase in tax," said John W. Roth, senior tax analyst for accounting and tax publisher CCH.

Reinstating the haircut would get at the mortgage deduction from a less politically difficult angle.

Plenty Of Options

Another plan that might be palatable is to keep the mortgage deduction, but limit it to the principal residence. Currently, a taxpayer can deduct interest on two homes. Say a person has a $450,000 mortgage on a principal residence and a $550,000 mortgage on a summer home.

"Under current law, you would get to deduct all the interest," Roth said. "But if you could just deduct interest on your principal residence, then you would essentially cut the deduction in half."

Roth formerly practiced law and did real estate closings.

"I know that banks quite often factor in the mortgage deduction when deciding whether to grant a loan," he said. "If you suddenly take this away, then you'll have a lot of borrowers who may no longer qualify."

The Dec. 1 package of proposals that included the idea of swapping the mortgage deduction for a credit failed to get enough fiscal commission votes to send it straight to Congress. But President Obama promised to study specific proposals as he and his economic team develop a new budget and set priorities.