

Tax Policy Center
Urban Institute and Brookings Institution

THE TAX POLICY

BRIEFING BOOK

*A Citizens' Guide for the
2008 Election and Beyond*

HOME OWNERSHIP

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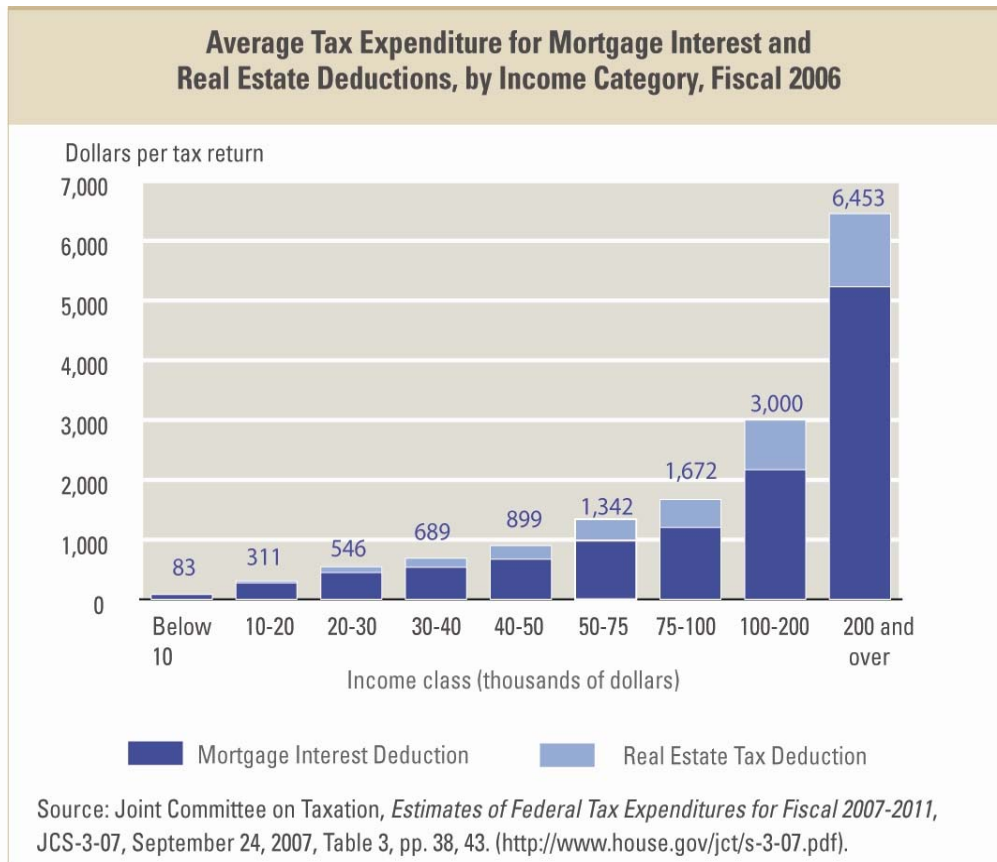
Home Ownership: What are the tax benefits?

The tax code provides a number of benefits for people who own their homes. Homeowners may deduct both mortgage interest and property tax payments as well as certain other expenses from their federal income tax. They do not have to count the rental value of their homes as taxable income, even though that value is just as much a return on investment as are stock dividends or interest on a savings account. Finally, homeowners may exclude, up to a limit, the capital gain they realize from the sale of a home. All of these benefits are worth more to taxpayers in higher-income tax brackets than to those in lower brackets.

- Homeowners who itemize deductions may reduce their taxable income by deducting any interest paid on a home mortgage. The congressional Joint Committee on Taxation (JCT) estimates that the deduction saved more than 35 million homeowners an average of over \$1,850 in income tax in fiscal 2006. The deduction is limited to interest paid on up to \$1 million of debt incurred to purchase or substantially rehabilitate a home. Homeowners may also deduct interest paid on up to \$100,000 of home equity debt, regardless of how they use the borrowed funds. Taxpayers who do not own their home have no comparable ability to deduct interest paid on debt incurred to purchase goods and services.
- Homeowners who itemize deductions may also reduce their taxable income by deducting property taxes they pay on their homes. That deduction is effectively a transfer of federal funds to governments that impose a property tax (mostly local but also some state governments), allowing them to raise property tax revenue at a lower cost to their constituents. The JCT estimates that the deduction saved more than 40 million homeowners an average of nearly \$600 in income tax in fiscal 2006.
- Buying a home is an investment, part of the returns from which is the opportunity to live in the home rent-free. Unlike returns from other investments, the return on homeownership—what economists call “imputed rent”—may be excluded from taxable income. In contrast, landlords must count as income the rent they receive, and renters may not deduct the rent they pay. A homeowner is effectively both landlord and renter, but the tax code treats homeowners the same as renters while ignoring their simultaneous role as their own landlords. The Office of Management and Budget estimates that the exclusion of imputed rent reduced federal revenue by nearly \$29 billion in fiscal 2006.
- Taxpayers who sell assets must generally pay capital gains tax on any profits made on the sale. But homeowners may exclude from taxable income up to \$250,000 (\$500,000 for joint filers) of capital gains on the sale of their home if they satisfy certain criteria: they must have maintained the home as their principal residence in two out of the preceding five years and generally may not have claimed the capital gains exclusion for the sale of another home during the previous two years. The JCT estimates that the exclusion provision saved homeowners more than \$24 billion in income tax in fiscal 2006.
- Buying a home is an investment, part of the returns from which is the opportunity to live in the home rent-free. Unlike the situation for other kinds of investment, homeowners exclude the value of those returns—what economists call “imputed rent”—from taxable income. In contrast, landlords who rent homes must count the rent they receive as income while renters cannot deduct the rent they pay. A homeowner is effectively both landlord and renter. The tax code treats

him the same as a renter in his renter role but does not tax the imputed rent he earns in his landlord role. The Office of Management and Budget estimates that the exclusion of imputed rent over and above housing expenses like interest reduced federal revenues by nearly \$29 billion in fiscal year 2006.

- The deductions and exclusions available to homeowners are worth more to taxpayers in higher tax brackets than to those in lower brackets. For example, deducting \$2,000 for property taxes paid saves a taxpayer in the 35 percent bracket \$700 but saves a taxpayer in the 15 percent bracket only \$300. In combination, the mortgage interest and property tax deductions reduced taxes for homeowners with income above \$200,000 by an average of about \$6,500 in fiscal 2006; in contrast, homeowners with income between \$50,000 and \$75,000 saved an average of about \$1,300 (see figure). That difference results from three factors: compared with lower-income homeowners, those with higher incomes face higher marginal tax rates, typically pay more mortgage interest and property tax, and are more likely to itemize deductions on their tax returns.



See Also

Homeownership: Do existing tax incentives increase homeownership?

Homeownership: How could the tax incentives be improved?

Data Sources

Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011, JCS-3-07, (September 24, 2007).

Office of Management and Budget, Fiscal Year 2008 Budget, Analytical Perspectives, Table 19.1, p. 288.

Author: Robertson Williams
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Further Reading

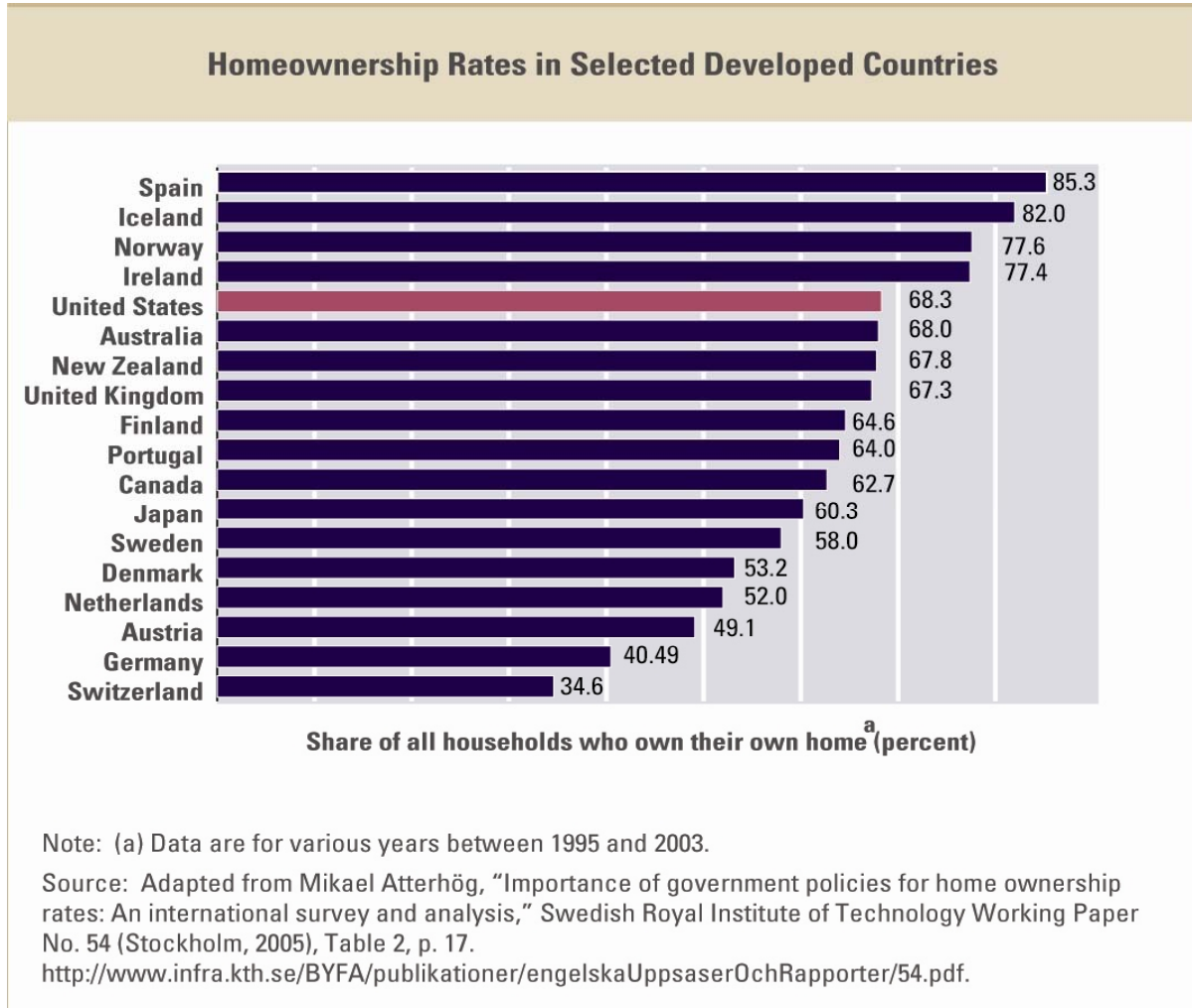
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Gale, William G., Jonathan Gruber, and Seth Stephens-Davidowitz, "Encouraging Homeownership Through the Tax Code," *Tax Notes*, (June 18, 2007), p. 1171-89.

Homeownership: Do existing tax incentives increase homeownership?

The federal government spends more than \$150 billion each year to subsidize homeownership yet the U.S. rate of homeownership differs little from that in countries that provide no similar subsidies. The bulk of the subsidies go to middle- and upper-income households who would likely own their homes anyway; thus these subsidies simply facilitate the consumption of more housing. In addition, evidence suggests that the tax subsidies raise housing costs, thus dissipating their effectiveness in helping people buy their own homes.



- The U.S. homeownership rate is roughly the same as that in many other developed countries like the United Kingdom or Australia, that have no such subsidies, and lower than in some (see figure). Other factors, such as the ease of obtaining a mortgage, home prices, and cultural patterns play significant roles in determining homeownership rates.
- Because tax deductions are worth more to high-income households, who face the highest tax rates, the deductibility of property taxes and mortgage interest gives the most assistance to households that would likely own their own home even without a tax subsidy. Low-income

households, who typically are most in need of aid to afford homeownership, get little or no benefit from that deductibility.

- Beyond a base level, subsidies mainly support larger homes and second homes. In effect, the federal government encourages middle- and upper-income households to consume more housing than they otherwise would. Limits on the amount of mortgage debt for which taxpayers may deduct interest costs do, however, constrain those subsidies to some degree.
- Research suggests that housing subsidies raise housing costs, particularly where land is relatively scarce. By reducing the after-tax cost of housing, the subsidies enable people to pay more than they otherwise would. The resulting increase in demand for housing causes prices to rise and prices rise most in markets where supply cannot easily increase to meet that higher demand.

See Also

Homeownership: What are the tax benefits?

Homeownership: How could the tax incentives be improved?

Data Sources

Atterhög, Mikael. "Importance of Government Policies for Home Ownership Rates: An International Survey and Analysis," Swedish Royal Institute of Technology Working Paper no. 54, (Stockholm: 2005).

Author: Roberton Williams

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Homeownership: How could the tax incentives be improved?

Two kinds of changes could improve the tax incentives for homeownership. The first would redirect the tax subsidies from higher-income households to those with lower incomes to focus assistance on those most in need. The second would simply reduce existing incentives.

- Replacing the existing deductions for mortgage interest and property taxes with a tax credit would shift homeowner subsidies down the income distribution to households more in need. For example, replacing those deductions with a credit of up to \$1,400 for property taxes paid on a primary residence would shift more than 40 percent of the subsidy from households in the top income quintile to other households, with no change in federal revenue (see table). About half of the benefits thus shifted would go to households in the bottom two-fifths of the income distribution.

Effects of Replacing the Mortgage Interest and Property Tax Deductions with a Tax Credit, 2005 ^a						
Income category	Share of tax units receiving tax cut or increase (percent)		Average change in federal tax liability		Share of federal housing tax benefits (percent)	
	Cut	Increase	Dollars	Percent	Current law	As proposed
Bottom quintile	29.8	0.0	-233	-96.9	0.0	8.2
Second quintile	40.1	0.4	-355	-25.8	0.5	13.2
Third quintile	42.6	3.3	-367	-7.5	3.0	16.2
Fourth quintile	46.5	15.8	-280	-2.6	14.6	24.8
Top quintile	32.3	51.3	1,264	2.8	81.9	37.3
All tax units	38.3	14.2	5	0.0	100.0	100.0

Notes: (a) Distribution of benefits by cash income percentile, 2005.
 Source: Adam Carasso, C. Eugene Steuerle, and Elizabeth Bell, "How to Better Encourage Homeownership," Tax Policy Issues and Options No. 12, (Washington: Tax Policy Center, June 2005) (www.taxpolicycenter.org/publications/url.cfm?ID=311193).rban.org/UploadedPDF/311193).

- Making the credit refundable would increase the share of benefits going to households with the lowest incomes.
- The deduction for mortgage interest is currently limited to the interest on no more than \$1 million of mortgage debt. Lowering that limit to \$400,000 would increase federal revenue by \$30 billion between 2008 and 2012 and nearly \$60 billion more over the subsequent five years. Virtually all of the impact of lowering the limit would fall on households at the top of the income distribution. Congress could use the additional revenue to pay for direct subsidies to facilitate homeownership by lower-income households. The change would disproportionately affect households in high-cost housing markets, where prices for a large share of houses could require purchasers to take out large mortgages.

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Carasso, Adam, Elizabeth Bell, Ed Olsen, and C. Eugene Steuerle, "Improving Homeownership Among Poor and Moderate-Income Households." (Washington: Urban Institute, June 2005).

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