What are the tax benefits of homeownership?

Q. What are the tax benefits of homeownership?

A. The main tax benefit of owning a house is that the imputed rental income homeowners receive is not taxed. Although that income is not taxed, homeowners still may deduct mortgage interest and property tax payments, as well as certain other expenses from their federal taxable income if they itemize their deductions. Additionally, homeowners may exclude, up to a limit, the capital gain they realize from the sale of a home.

The tax code provides several benefits for people who own their homes. The main benefit is that the owners do not pay taxes on the imputed rental income from their own homes. 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. It is a form of income that is not taxed.

Homeowners may deduct both mortgage interest and property tax payments as well as certain other expenses from their federal income tax if they itemize their deductions. In a well-functioning income tax, all income would be taxable and all costs of earning that income would be deductible. Thus, in a well-functioning income tax, there should be deductions for mortgage interest and property taxes. However, our current system does not tax the imputed rental income that homeowners receive, so the justification for giving a deduction for the costs of earning that income is not clear.

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.

IMPUTED RENT

Buying a home is an investment, part of the returns being the opportunity to live in the home rent free. Unlike returns from other investments, the return on homeownership—what economists call "imputed rent"—is 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 US Department of the Treasury, Office of Tax Analysis (OTA) estimates that the exclusion of imputed rent reduced federal revenue by nearly 121.3 billion in fiscal year 2019.

Key Elements of the U.S. Tax System

What are the tax benefits of homeownership?

MORTGAGE INTEREST DEDUCTION

Homeowners who itemize deductions may reduce their taxable income by deducting interest paid on a home mortgage. Taxpayers who do not own their homes have no comparable ability to deduct interest paid on debt incurred to purchase goods and services.

The Tax Cuts and Jobs Act (TCJA) trimmed this important tax break for homeowners. Prior to the TCJA, the deduction was limited to interest paid on up to $1 million of debt incurred to purchase or substantially rehabilitate a home. Homeowners also could deduct interest paid on up to $100,000 of home equity debt, regardless of how they used the borrowed funds. The TCJA limited the deduction to interest on up to $750,000 of mortgage debt incurred after December 14, 2017, to buy or improve a first or second home.

The OTA estimates that the mortgage interest deduction cost about $25.1 billion in fiscal year 2019. Prior to enactment of the TCJA, OTA estimated that the cost of the mortgage interest deduction would have been $74.5 billion in fiscal year 2018. The estimated cost fell largely because other provisions of TCJA resulted in many fewer taxpayers itemizing their deductions and in small part because of the lower cap on deductible mortgage interest. The Urban-Brookings Tax Policy Center estimates that only about 8 percent of tax units benefited from the deduction in 2018, compared to about 20 percent in 2017, prior to the TCJA.

PROPERTY TAX DEDUCTION

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 jurisdictions 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 OTA estimates that the deduction saved millions of homeowners a total of $6 billion in income tax in fiscal year 2019. The cost of that deduction went way down because of the TCJA, as many fewer homeowners itemized and because the TCJA put an overall cap of $10,000 on the state and local taxes that taxpayers can deduct.

PROFITS FROM HOME SALES

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 homes if they satisfy certain criteria: they must have maintained the home as their principal residence in two out of the preceding five years, and they generally may not have claimed the capital gains exclusion for the sale of another home during the previous two years. The OTA estimates that the exclusion provision saved homeowners $43.6 billion in income tax in fiscal year 2019.

EFFECT OF DEDUCTIONS AND EXCLUSIONS

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 37 percent top tax bracket $740, but saves a taxpayer in the 22 percent bracket only $440. Additionally, even though they only represent about 26 percent of all tax units, those with income of $100,000 or more received over 90 percent of the tax benefits from the mortgage interest deduction in 2018. That difference results largely 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.

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Q. Do existing tax incentives increase homeownership?

A. Probably not. The US homeownership rate is lower than in many other developed countries that do not offer similar tax subsidies for homeownership. Beyond a base level, US subsidies mainly support larger homes and second homes. Additionally, evidence suggests that the subsidies raise housing costs, thus dissipating their effectiveness in helping people buy their own homes.

Contrary to popular belief, the mortgage interest deduction was not added to the tax code to encourage home ownership. The deduction existed at the birth of the income tax in 1913—a tax explicitly designed to hit only the richest individuals, a group for whom homeownership rates were not a social concern.

The federal government provided $196 billion of tax benefits to subsidize homeownership in fiscal year 2019. The bulk of US subsidies go to middle- and upper-income households that likely would 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.

65 percent of all US households owned their homes in 2019. Most were middle-aged or elderly households, since the homeownership rate for those under age 35 is only 37 percent. As expected, homeownership rates also increase with income, rising up to 80 percent for those with family income over the national median. Disparities are particularly large by race or ethnicity: under 50 percent of Hispanic and non-Hispanic Black households owned their homes in 2019, compared with 73 percent of non-Hispanic White households.

The US homeownership rate is lower than that of many other industrialized countries. Some provide similar tax benefits for ownership as the US while others do not. For example, Canada, with a homeownership rate slightly above that of the US, provides tax relief similar in scale to the US as a percentage of GDP (OECD 2019); the United Kingdom, with a homeownership rate close to that of the US, provides much higher tax relief for homeowners as a percentage of GDP than does the US. Like the US, both Canada and the UK exempt the proceeds from the sale of a primary residence from capital gains tax. Unlike the US, neither Canada nor the UK have a tax deduction for mortgage interest, but they both provide tax relief for first-time home buyers. For example, Canada provides a tax credit to first-time homebuyers and allows them to make tax-free withdraws from retirement savings accounts to purchase their home. Many factors other than tax subsidies affect homeownership rates, including the ease of obtaining a mortgage, home prices, and cultural patterns, making cross-country comparisons difficult.

TAXES AND HOMEOWNERSHIP

Do existing tax incentives increase homeownership?

TABLE 1

Homeownership Rate by Demographics

Calendar year 2019

	Share of households who own their homes (%)
All	65%
Family income	
Under national median	51%
Equal to or over national median	78%
Age	
Under 35	37%
35–44	60%
45–54	70%
55–64	75%
Above 65	79%
Race and ethnicity	
Asian, Native Hawaiian and Pacific Islander	58%
Black	42%
Hispanic	47%
White	73%

Sources: U.S. Census Bureau. Housing Vacancies and Homeownership (CPS/HVS). Historical Tables 16, 17, and 19. January 30, 2020.

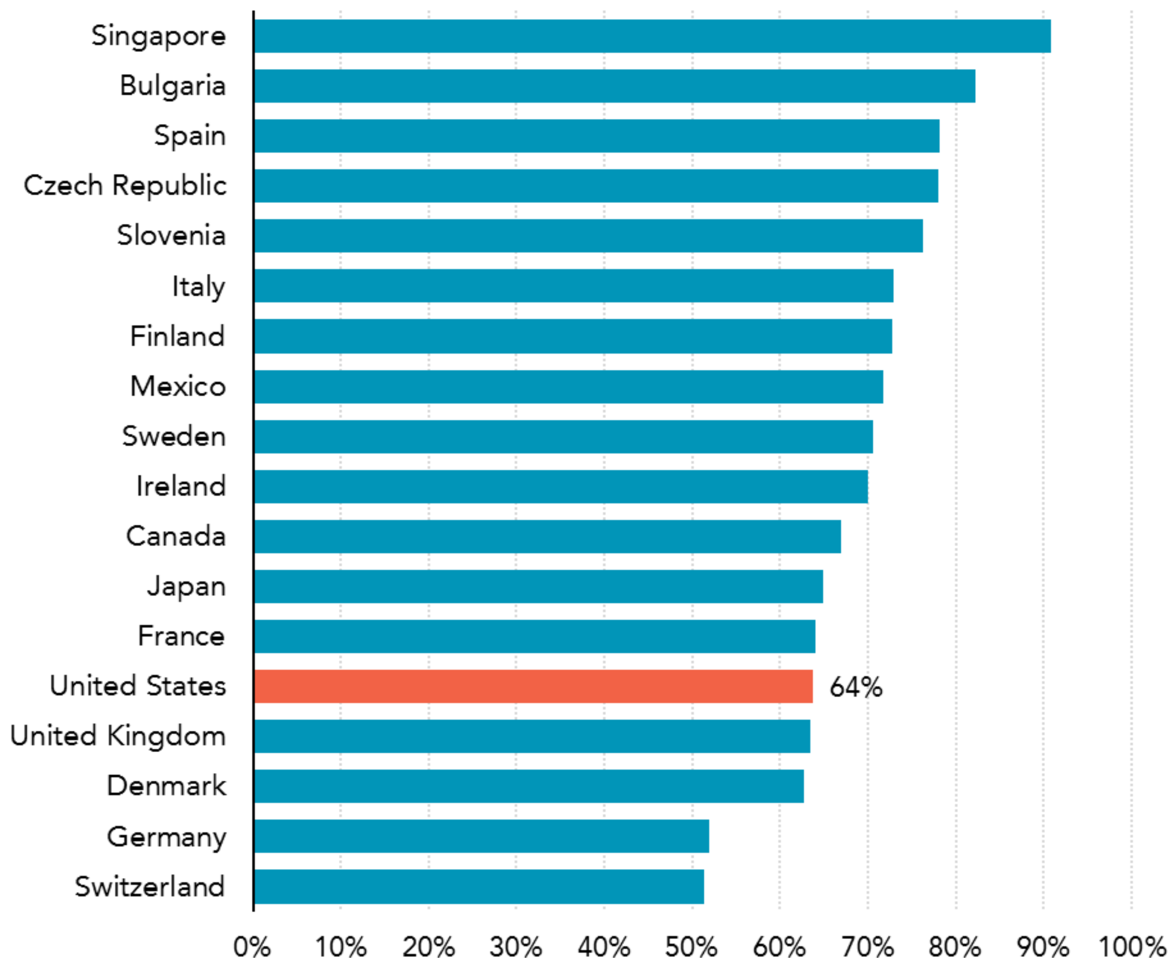
Notes: Average for four quarters of 2019. Age, race, and ethnicity refer to householder responding to the survey.

Because the major tax deductions for homeowners are only available to taxpayers who itemize deductions, currently about 10 percent of all households, and are worth more to high-income households, which face the highest tax rates, the deductibility of property taxes and mortgage interest most helps households that would likely own their own homes even without a tax subsidy. Low-income households, which typically are most in need of aid to afford homeownership, get little or no benefit from that deductibility.

Key Elements of the U.S. Tax System

TAXES AND HOMEOWNERSHIP

Do existing tax incentives increase homeownership?



Source: Laurie S. Goodman and Christopher Mayer. "Homeownership and the American Dream." *Journal of Economic Perspectives*, vol. 32 no. 1 (winter 2018): pg. 31-58.

Beyond a base level, subsidies mainly support larger homes and second homes. In effect, the tax benefits encourage middle- and upper-income households to consume more housing than they otherwise would and to incur greater mortgage debt. Limits on the amount of mortgage debt for which taxpayers may deduct interest costs do, however, constrain those subsidies to some degree.

Housing subsidies reduce the after-tax cost of housing at any given level of housing prices. This reduced cost raises demand for owner-occupied housing and thus drives up the price, particularly where land is 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 rise most in markets where supply cannot easily increase to meet that higher demand.

Key Elements of the U.S. Tax System

Do existing tax incentives increase homeownership?

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