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on
Tax Reform and Residential Real Estate

Mr. Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss tax reform and residential real estate.

I would like to begin with some comments on overall tax reform, because the congressional debate indicates that interest in tax expenditures associated with residential real estate is part of a general investigation of broadening the income tax base to either permit a lower rate, or to prevent rates from rising if additional revenue is needed. Then I would like to discuss the tax expenditures associated with residential real estate in that context. The most significant provisions affecting housing, measured by potential revenue gain, are associated with owner-occupied housing.

General Tax Reform Issues

In considering the general context of tax reform, I would like to discuss three points. First, it is difficult to identify base broadening provisions that realistically might be considered to allow significant rate reductions. Secondly, it is even more difficult to identify provisions that would allow significant reductions of the top rate, while maintaining the current distribution of tax burdens. Finally, if the goal of lowering tax rates is to lower marginal rates to encourage supply side responses, base broadening will increase effective marginal tax rates and offset in part or in full, or even more than offset (depending on the provision) the incentive effects of lowering statutory tax rates.

A recent CRS study outlined the challenges to base broadening and elimination of tax expenditures that would permit significant individual income tax rate reductions, such as the often-cited objective of lowering the top rate to 25%.[1] One way of examining the potential for rate reduction is to convert the base broadening provisions into an across the board reduction in rates, and calculate the new rate. This report estimated that if all individual income tax expenditures were eliminated, individual income tax rates could be reduced around 43% and the top rate could be reduced to a little less than 23% in a revenue neutral revision.

However, when the specifics of tax expenditures are considered, the outlook appears less than promising. For example, about 30% of tax expenditures relate to savings incentives (such as lower rates on capital gains and dividends, and retirement subsidies). Repealing these provisions would raise taxes on savings and are probably not likely to be considered, given the objectives of tax reform. Some of these provisions and some others are likely to present significant technical problems such as imputing income for employer fringe benefits provided in kind. For example, employer provided health insurance accounts for 14% of all tax expenditures. Some provisions affect lower and

[1] CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

moderate income taxpayers so significantly they may not be likely to be considered, such as the earned income credit, exclusion of Medicare benefits from income, or the deduction of catastrophic medical expenses, which together account for another 13% of total tax expenditures. The child credit might also fall into this category, and account for 4% of tax expenditures. And of the remaining provisions that might be considered, among them itemized deductions, many of these are popular, present difficult transition issues, and may have some important justifications.

The challenges to lowering the top statutory rate become greater if proposals intend to maintain the current progressivity of the tax system. This report identified a handful of major tax expenditures that are likely to be important to taxpayers subject to the top rates: pension benefits, lower rates on capital gains and dividends, exclusion of capital gains at death, tax exempt bond interest, and itemized deductions for state and local income taxes and charitable contributions. Of these, over 70% of the revenue is from provisions that are subsidies for saving.[2]

Finally, the trading off of base broadening for lower tax rates may be more apparent than real when considering supply side effects, such as labor supply and saving. Broadening the base, in most cases, has the same kinds of effects on marginal incentives as raising rates. Whereas the statutory rate is set in law, the effective tax rate at the margin is the share of an additional dollar of income that is paid in taxes. If part of an additional dollar of earnings is spent in a way that generates a tax deduction, it reduces the marginal effective tax rate. If that deduction is eliminated, then the effective marginal

[2] These provisions are employee pensions, lower rates on capital gains and dividends and exclusion of capital gains at death.

tax rate rises. It is the effective marginal tax rate—not the statutory tax rate—that economic theory indicates would provide disincentives for the supply of labor or savings.

The most straightforward example of this effect is the itemized deduction for state and local income taxes. According to IRS statistics in 2010, the value of the average deduction on itemized returns for state and local income taxes was 5.5% of income for those with an AGI of $200,000 or greater.[3] Since most state income tax rates are progressive, income taxes paid as a share of income would be even higher at the margin. Using an example of a 6% state income tax rate, if the federal statutory income tax rate is 39.6%, and the state income tax is deductible, the total effective marginal tax rate is 39.6% plus 6% minus the value of the tax deduction (0.396 times 6%), or 43.2%. If the state and local income tax deduction is eliminated or capped, the effective marginal tax rate rises to 45.6% (39.6% plus 6%). On average then, disallowing the state income tax deduction is the equivalent of raising the effective marginal tax rate by 2.4 percentage points for those tax filers that would otherwise claim the deduction. Or put another way, retaining the state and local deduction and simply raising the federal statutory rate to 42.1% for this bracket would achieve the same effect.[4]

A CRS report in progress considers this effect for the top rate. The study examines the effect of eliminating all itemized deductions. The estimates suggest that this revision would permit a 4.2 percentage point reduction in the top statutory rate, if rates were reduced proportionally across the board, and about 5 percentage points if a revenue neutral and distributionally neutral change were made. However, for a “typical taxpayer,”

[3] Internal Revenue Service, Statistics of Income 2010, Individual Income Tax Returns with Itemized Deductions, at: http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income.
[4] This number is the solution to x in the equation $x+0.06*(1-x) = 0.41$.

facing the top tax rate, estimates indicate that the marginal effective tax rate (largely because of the loss of charitable contributions and state and local tax deductions) would rise by about 4.4 percentage points.[5] Essentially, the effect of base-broadening at the margin offsets the reduction in the statutory rate. Thus if the primary objective of tax reform is to lower the marginal tax rates that drive supply side responses, tax reform may not accomplish its purpose.

Specific Issues Associated With Housing Provisions

How do the provisions affecting residential real estate fit into this framework? This section considers, mapping into the discussion of tax reform in general, whether these provisions might be feasible to revise, how they might affect taxpayers in the top marginal rate, and the consequences for effective marginal tax rates.

The most significant housing provisions are associated with owner-occupied housing. Based on the Joint Committee on Taxation's estimates,[6] the three major provisions associated with owner-occupied housing are mortgage interest ($75 billion in FY2015), real property tax deductions ($30.4 billion in FY2015) and the exclusion of capital gains on owner occupied housing ($26.0 billion in FY2015).[7] The other tax expenditures classified as housing benefits are much smaller, with the low income housing credit (which is largely a corporate tax expenditure) reducing revenues by $7.2

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[5] Based on estimates from IRS Statistics of Income for 2010, indicating these two provisions account for around 11% of income.

[6] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, February 1, 2013.

[7] The Administration also considers another subsidy similar in size to mortgage interest that economists recognize as a tax benefit for owner-occupied housing: the exclusion of imputed net rent on owner occupied housing. Their estimates were prepared before the legislation extending most of the 2001-2003 tax cuts, but they indicate the revenue loss of this provision is about 70% of the size of the home mortgage however. See "Tax Expenditures" in *Analytical Perspectives*, Fiscal Year 2014 Budget of the United States, pp. 242-277. This provision is, for technical reasons, unlikely to be a suitable candidate for base broadening, since it would involve imputing income.

billion in FY2015, accelerated depreciation on rental housing at $4.1 billion in FY2015, private activity bonds at $4.1 billion in FY2015, and rehabilitation credits at $0.9 billion in FY2015. The subsequent discussion will focus on the major owner-occupied housing provisions.

Two of the three major owner-occupied housing provisions are already subject to caps. The home mortgage interest deduction is subject to a cap on the interest that can be claimed, up to a $1 million of mortgages, plus $100,000 of home equity loans. The capital gains exclusion on owner-occupied housing is capped at $500,000 for joint returns and $250,000 for single returns. Note, however, that the so-called itemized deduction phaseout, popularly referred to as Pease, does not generally constrain itemized deductions, but is rather in the nature of an additional tax rate.[8]

Are these provisions desirable candidates for base broadening? Many economists have criticized the provisions for owner-occupied housing as distorting the allocation of resources, diverting capital from other uses, encouraging the overconsumption of housing, and treating renters differently from owner-occupants. The CRS report cited earlier noted that while these provisions would be technically easy to eliminate or cut back and can be viewed as causing distortions, the broad use and popularity of these provisions were potential barriers to major revisions.[9] The report also noted some

[8] Pease is not a true limit on itemized deductions because it is triggered by an AGI threshold—not the amount of deductions claimed. For affected tax filers, the total of certain itemized deductions is reduced by 3% of the amount of adjusted gross income (AGI) exceeding the threshold. The total reduction cannot be greater than 80% of the deductions. A $1.00 increase in AGI will increase taxable income by $1.03 because itemized deductions have been decreased by $0.03. Consequently, the effective marginal tax rate will be 3% higher than the statutory marginal tax rate. For example, a tax filer in the 33% tax bracket faces an effective marginal tax rate of 33.99%—an increase of about 1 percentage point. These effects are not directly linked to deductions: an increase of itemized deductions of $1 will continue to decrease taxable income by $1. Only if the 80% ceiling is reached, which is unlikely, will itemized deductions be reduced.

[9] CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

arguments in favor of these provisions. There may be merits to home-ownership in neighborhood effects (keeping up properties better, being more civically involved, producing more stable neighborhoods) and costs as well (such as exclusionary policies).

Another aspect of owner-occupied housing that may justify encouraging its purchase is that, for many middle income families, it is one of the important sources of assets available in retirement. Subsidies for owner occupied housing are directed at savings, and to the extent that one objective of tax reform is to encourage saving, it may be justified on these grounds. It might be better to save in a more diversified fashion, but to the extent that investment in a home is a form of automatic savings (accumulating equity as the mortgage is paid), that saving may be, in part, an increase rather than a substitute for other saving. For those who favor preserving housing tax benefits to encourage saving, this issue might be relevant.

Also in terms of fairness, homeownership subsidies favor homeowners over renters. However, in the case of the mortgage interest deduction, the provision increases fairness between homeowners who rely largely on mortgages and those who finance out of assets. This argument does not apply to the property tax deduction.

A CRS report also noted some particular justifications for retaining the provision excluding capital gains on owner occupied housing from income.[10] Capital gains taxes, if imposed with no relief on housing, have the potential for several distorting effects that may outweigh any negative aspects from incentives they might have had for originally purchasing owner-occupied housing. Capital gains taxes on home sales discourage labor mobility by increasing the cost of relocating. Capital gains taxes in general cause lock-in

[10] The issues associated with capital gains on owner-occupied housing are addressed in detail in CRS Report RL32978, *The Exclusion of Capital Gains for Owner-Occupied Housing*, by Jane G. Gravelle and Pamela J. Jackson.

effects that may cause portfolio imbalances. Capital gains taxes on owner occupied housing cause lock-in effects with consequences for consumption as well as investment choices, such as discouraging older individuals from scaling down their homes or moving to rental housing, since taxpayers can avoid tax on gains by holding the asset until death. They impose taxes on certain elderly individuals who are forced to sell, for example, for health reasons. And, as in the case of capital gains assets in general, this lock-in effect may significantly reduce the potential revenue to be gained.

Transition issues also arise. Individuals, particularly those in the middle incomes, who have recently entered into large mortgages with the expectations of deductions, may find immediate elimination of these provisions difficult to budget for since they will not likely receive full offsets in rate cuts. If the mortgage interest deduction were eliminated, grandfathering existing mortgages or slowly phasing out the deduction may be needed, either of which reduce the potential revenue gain. Second, given a still-fragile economy and housing market, making changes affecting the demand for housing at the current time may cause wider problems in the economy. Grandfathering existing mortgages would not offset these effects on demand, and phasing in the elimination would nevertheless leave new homebuyers with the awareness that their benefits would not last.

In sum, while the subsidies for owner occupied housing divert investment out of other uses into housing and encourage the over consumption of housing, the costs and benefits of these provisions are not entirely clear.

The second issue discussed above regarding general tax reform relates to the distributional issue and contributions of base broadening in lowering the top rate. Owner-occupied housing subsidies are not generally the tax preferences that are the most significant to those in the top brackets. While the mortgage interest deduction as a share of income for taxpayers who itemized deductions was 7.2% in 2010, the mortgage interest deduction as a share of income for itemizers with $500,000 to $1 million in income was 2.9% and the share for taxpayers with income over $1 million claiming the deduction was 0.6%. A similar, although less pronounced pattern can be found for real estate taxes, where the average deduction is 3.1% of income but those with incomes between $500,000 and $1 million have a deduction of 1.9% of income and those over $1 million have a deduction of 0.8% of income. These patterns are partly because of caps, but also because as incomes become relatively high, spending on housing does not keep up, and because high income taxpayers are less in need of mortgages. In addition, high income individuals probably have a greater ability to avoid increased taxes from housing subsidies by paying off their mortgages and avoiding sale of their homes.

The increase in effective marginal tax rates through eliminating deductions for owner-occupied housing are not likely to be important for taxpayers in the top statutory rate bracket where these deductions are not very important relative to income. They would, however, increase effective marginal tax rates and offset statutory rate reductions for taxpayers in the middle and upper middle income levels. For example, adjusted by the rate of itemization, the mortgage interest is around the same share of income for adjusted gross income from $100,000 to $250,000.[11] This similarity suggests that the mortgage interest deduction has marginal effects through this income range as well as lower income ranges for homeowners who itemize.

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[11] In 2010, according to IRS statistics, mortgage interest was 7.8% of income and 85% of taxpayers itemized in the $100,000 to $200,000 income levels. For the $200,000 to $250,000 income bracket, mortgage interest was 6.3% and 95% itemized.

These observations on marginal effective tax rates suggest that decisions on broadening the base should focus on the merits of the individual provisions rather than their contribution to base broadening to permit lower statutory rates. A review of these provisions suggest the case for eliminating these subsidies is uncertain, and may be quite weak for the capital gains exclusion.