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HOT TOPIC ALERT

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State Mortgage Interest Deduction

One of the few popular features of the income tax laws is the deduction for mortgage interest. The deduction has been a feature of the federal law since the income tax was first adopted. Its use increased as homeownership spread after the Second World War, and has become one of the most frequently used deductions available. According to the Urban Institute and Tax Policy Center of the Brookings Institution, "by the time the Treasury and congressional agencies began publishing annual lists of tax expenditures in the 1970s, the mortgage interest deduction had become one of the largest single preferences in the tax law." The deduction is popular at the state level, as well. Of the forty-five U.S. jurisdictions that impose a personal income tax, thirty-five allow a deduction for mortgage interest. The deduction for mortgage interest is credited with making homeownership more affordable for more families.

As popular as it is, the deduction has been under increasing attack in recent years. A frequently-repeated criticism is that the benefits of the deduction are reaped primarily by upper income homebuyers. Proposals have been made to abolish the deduction, to convert it to an income tax credit, or to limit all itemized deductions in other ways. You may recall that, during the 2012 presidential election campaign, both President Obama and Governor Romney proposed new limits on the deduction. The Chairman of the House Ways and Means Committee, Rep. Dave Camp (R-MI), recently proposed limiting the mortgage interest deductions to residential mortgages with a principal of no more than $500,000 (the current maximum loan amount is $1 million).

Limiting the deduction is an idea that has taken hold in some state legislatures as well. New caps on the amount or the calculation of the deduction went into effect in North Carolina and Puerto Rico. In North Carolina, the interest deduction is now capped at $20,000 for tax years beginning January 1, 2014. In Puerto Rico, the mortgage interest deduction is limited to $35,000 per year for residential property. These two jurisdictions join the five others—Delaware, District of Columbia, Maine, Minnesota, New York—that allow the deduction, but that place some cap or limitation on all itemized income tax deductions.

The caps on deductions take different forms. Maine enacted a tax "reform" law in 2013 that provided that the total of all itemized deductions may not exceed $27,500. Other jurisdictions limit the amount of itemized deductions that may be taken by taxpayers with higher incomes by means of a formula. In Minnesota, high-income taxpayers, defined as a married taxpayer filing separately with an income of $90,575 or more, or any other taxpayer with an income of $181,150 or more, must subtract from their itemized deductions either three percent of their income that is more than the threshold or 80 percent of most itemized deductions, whichever is less.

The District of Columbia reduces itemized deductions by five percent of the amount by which the taxpayer's income exceeds $200,000 (or $100,000 for married taxpayers filing separately). New York also reduces the federal itemized deductions for taxpayers with incomes of more than $200,000 (or $100,000 for single taxpayers, or married taxpayers filing separately). In Delaware, the itemized deductions allowed under the federal Internal Revenue Code are reduced by 12 percent for all taxpayers, not just for high-income taxpayers.

The idea of limiting—if not abolishing—the mortgage interest deduction seems to be gaining some traction. The gains are coming slowly, with only three states actually enacting caps or limitations in the past two years. Nevertheless, an idea that was regarded as unthinkable is being discussed by policymakers and pundits at both the federal and state level. In 2007 in California, a report by the Legislative Analyst's Office floated the idea of changing

From the beginning, federal income tax law allowed a deduction for interest paid -- the deduction originally was for any interest paid by a taxpayer. The reasoning was that interest payments then were typically a business expense incurred to earn income. The deduction was not commonly taken before World War II, because relatively few people had incomes high enough to pay income tax.

the mortgage interest deduction to a tax credit. That proposal was not enacted into law. In 2012, Maryland Governor Martin O'Malley proposed reducing the amount of the mortgage interest deduction that could be claimed by taxpayers with incomes of more than $100,000. The Maryland Association of REALTORS®, with support from NAR's Issues Mobilization program, defeated the proposal with a statewide ad campaign using newspapers, radio, website ads and social media.

In December of 2012, the Kentucky Blue Ribbon Commission on Tax Reform issued a report that suggested, among other things, limiting the mortgage interest deduction to mortgages on two homes, with a maximum purchase debt limit of $1 million, but the proposal has not been enacted into law. In 2013, an Oregon bill, H 2456, as passed by the House, would have phased out itemized deductions for high-income taxpayers. The bill was amended in the Senate, but did not pass.

2013 was also the year in which Kansas Governor Sam Brownback revived an unsuccessful proposal he made in 2012 to eliminate the mortgage interest deduction. The proposal fared no better in 2013 than it did in 2012, due largely to the efforts of the Kansas Association of REALTORS®, which in both years, with assistance from NAR Issues Mobilization grants, implemented multifaceted campaigns that included polling, Call for Action, newspaper ads, online ads and social media.

Proposals for restricting, rather than eliminating, the deduction for mortgage interest have often been directed towards targeting the deduction to middle- or moderate-income taxpayers. Proposals of this type include caps on the amount of the deduction, limits on the amount of the mortgage for which the deduction may be taken, or eliminating the benefit for second homes or vacation residences.

Finally, the Vermont House Ways and Means Committee proposed eliminating the deduction in the early part of the 2013 session. After strong opposition, including a campaign by the Vermont REALTORS®, the Committee dropped that proposal and introduced H 528, a bill that would limit state income tax deductions to 2.5 times the state's standard deduction. As of March, 2014, H 528 remains in a House-Senate conference committee.

Where are the taxpayers who take the deduction? According to the Pew Charitable Trusts, in 2010, ***Maryland*** *was the state with the highest percentage (36.8%) of taxpayers who take the federal deduction. The states with the lowest percentage (15%) were* ***North Dakota*** *and* ***West Virginia****. The state with the highest average dollar amount of the deduction taken was* ***California,*** *where the average mortgage interest deduction was $15,755 per claimant.*

It seems clear that limiting the amount or the reach of the mortgage interest deduction is a proposal that shows no signs of going away anytime soon. The question is, why? The deduction is popular, even among those who do not take it. Why do legislators and governors continue to bring the issue up?

A big part of the answer to this question is politics. Although the mortgage interest deduction is called the "third-rail" of tax policy, many voters recoil against the idea of a billionaire being allowed to write off the interest he pays on the mortgage for his mansion. The populist argument would seem to be misplaced, since seventy percent of homeowners with a mortgage claim the deduction.

The populist language can obscure the real issue. These days, state and local governments seem to be in a permanent financial shortfall. At the same time, raising taxes is another way for an elected official to say "don't vote to re-elect me." Chipping away at deductions is a way to increase revenue without raising taxes.

Unfortunately, the consequences of raising revenue by limiting the mortgage interest deduction may backfire. As the National Association of

Home Builders points out, eliminating the deduction will make homes more expensive, and that will in turn reduce demand for houses. While state treasuries might reap some short-term gain from the elimination of a tax deduction, the other costs do not justify the change.

It is likely that there will be attempts to change the mortgage interest deduction in the coming years at both the state and federal levels. The State Issues Tracker provides information on the status of the Mortgage Interest Deduction in all 50 states plus four territories (DC, GU, PR, and VI) and is updated annually.

For more information visit the NAR State Issues Tracker.

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