Income taxes are the main source of revenue of the federal government, and make up a substantial part of state revenues as well. The sting of the income tax is eased somewhat by deductions that cut down on the tax bill. This Hot Topic Alert looks at two of the deductions that have the greatest impact on the real estate industry: the mortgage interest deduction, and the deduction for state and local taxes. Both of these popular deductions have come under attack at both the state and federal level.

Background and History – How We Got Here

For the first 137 years of its history, the main source of revenue for the United States government was a collection of excise taxes, tariffs, customs duties, and public land sales. With the exception of temporary income taxes imposed during the Civil War, there was no direct tax based on a taxpayer’s income. The revenues from these sources proved unreliable and insufficient for the rapidly expanding power that the United States was becoming, so in 1913, the 16th Amendment to the U.S. Constitution was ratified. That
Amendment gives Congress the power “to lay and collect taxes on incomes, from whatever source derived.” The first permanent modern income tax law, the Revenue Act of 1913, allowed taxpayers to deduct from their gross income “all interest paid within, the year by a taxable person on indebtedness,” and also allowed a deduction for “all national, State, county, school, and municipal taxes paid within the year.”

Mortgage Interest. The original interest deduction was probably not intended to help homeowners. When the Revenue Act was passed, few homes, other than farm homes, were mortgaged. Interest on debt was regarded as a cost of doing business, not a part of ordinary consumer transactions. Over the years, the debts of individuals started to include credit card or other personal debt, all of which was deductible. The deduction was not limited to mortgages until the Tax Reform Act of 1986 limited the interest deduction available to consumers to interest on home loans, student loans, loans to purchase investment property, and interest on business debts.

The mortgage interest deduction today provides that mortgage interest is deductible from a taxpayer’s gross income if the taxpayer itemizes deductions and if the property the mortgage is placed on is owned by the taxpayer. Interest on home equity loans or lines of credit will be deductible only if the money borrowed is used to buy, build, or make substantial improvements to the property that secures the loan.

State income tax laws, and the deductions allowed, tend to mirror federal income tax laws. Thus, in most of the forty-two states that impose an income tax, mortgage interest will be deductible to some extent. Many states, however, impose limits on the deductibility of mortgage interest. In North Carolina, for example, taxpayers may deduct no more than $20,000 per year for mortgage interest. In Maine, the total amount of all itemized deductions, except for medical and dental expenses, may not exceed $28,350. Other states reduce the dollar amount of all deductions for certain taxpayers. In the District of Columbia, the itemized deductions for taxpayers with annual incomes greater than $200,000 are reduced by 5% of the excess of the taxpayer’s adjusted gross income over $200,000.

The mortgage interest deduction is a popular one. It is estimated that 34 million taxpayers claimed the deduction in 2017. After new rules went into place, however, that number went down to 15 million taxpayers in 2019. The jurisdiction with the highest share of homeowners claiming the deduction was Washington, DC, where 52% of homeowners claimed it. The lowest share was in West Virginia, where only 5% of homeowners claimed the deduction. In 2018, the average amount of the deduction claimed was $12,652.

State and Local Taxes (SALT). The deduction for state and local taxes, or SALT deduction, has been in the income tax laws since the beginning. The first U.S. income tax law, the Revenue Act of 1861, provided that “all national, state, or local taxes upon the property, from which [the taxpayer’s] income is derived shall first be deducted” from the calculation of the taxpayer’s taxable income. The 1913 Revenue Act, the precursor to the current Internal Revenue Code, provided a deduction for “all national, State, county, school, and municipal taxes paid within the year.” When that law was enacted, state taxes consisted mostly of property taxes. In the following years, states developed new revenue
sources including sales taxes. The **first sales tax** was enacted in Mississippi in the 1930’s, at a time when property values were too low to provide sufficient tax revenue. Other states followed suit, so that today, forty-five states and numerous local jurisdictions impose some kind of sales tax. Sales taxes were added to the list of taxes that could be deducted in 1942. The Revenue Act of 1964 changed the deduction again, to provide that only state and local real property taxes, personal property taxes, income taxes, general sales taxes, and gasoline and other motor fuel taxes could be deducted. The deduction for gasoline and fuel taxes was repealed in 1978. The deduction for sales taxes was repealed in 1986, but partially reinstated in 2004 to give taxpayers the option of deducting either state income or sales taxes.

The deduction for sales taxes has taken on a new importance recently, due to the rapid growth of online sales and remote shopping. In 1992, the U.S. Supreme Court ruled that states could not impose sales taxes on purchases made from retailer with no physical presence in the state. In the case of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the State of North Dakota attempted to collect sales tax from Quill, an office supplies retailer that had no physical presence in North Dakota. The Supreme Court held that this taxation was unconstitutional, meaning that buyers could avoid paying sales taxes on their purchases by ordering from an out-of-state seller. This ruling not only gave an unfair advantage to remote sellers, it also deprived states of sales tax revenue. The revenue lost had an especially harsh impact in states with a large rural population where residents have generally found it more convenient to shop remotely even before internet retailing. The growth of remote retailing led states to challenge the ruling in *Quill*. The Supreme Court revisited *Quill* in 2018, and overruled the case in *South Dakota v. Wayfair*, 585 U.S. ____ (2018). The Court criticized the “physical presence” rule of *Quill*, holding that “[e]ach year, the physical presence rule becomes further removed from economic reality and results in significant revenue losses to the States.” The *Quill* case had become, in effect, “a judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a State’s consumers—something that has become easier and more prevalent as technology has advanced.” The aftermath of *Wayfair* came quickly. Forty-three states and the District of Columbia now have sales tax laws that require collection of the tax from remote sellers.

The long-term impact of *Wayfair* on the SALT deduction is not yet clear. The changes in the SALT and mortgage interest deductions have meant that fewer taxpayers are able to take advantage of these deductions. **Taxpayers who itemize their deductions** are eligible to claim the SALT deduction. This deduction tends to be claimed by higher income taxpayers. However, with more sales tax being collected, it is possible that the SALT deduction will become an option for more taxpayers.

**Recent Legislation and Policy Proposals**

**Tax Cuts and Jobs Act.** The **Tax Cuts and Jobs Act** (TCJA), signed into law by then-President Trump on December 22, 2017, made substantial changes to both the mortgage interest and SALT deductions. The TCJA capped the SALT deduction at $10,000. The cap is not indexed for inflation, and the $10,000 cap is the same for both married
taxpayers filing jointly and single taxpayers. The mortgage interest deduction is limited to interest on mortgages of no more than $750,000 for a married couple filing jointly or a single taxpayer, or $375,000 for a married taxpayer filing separately. These amounts are not indexed for inflation.

The most immediate effect of the TCJA has been a decrease in the number of taxpayers who itemize deductions. The number of taxpayers who itemized deductions fell from 46.2 million in 2017 to 16.7 million in 2018.

The TCJA has also been having an adverse effect on the residential real estate market. Homeownership in counties with high taxes is becoming less attractive; in fact, a working paper published by the Philadelphia Federal Reserve Bank showed that house prices in counties with a high tax burden grew at a rate 3.5 percentage points below that of counties with a below-median tax burden. Listings in high-tax counties took longer to sell, on average, than properties in low-tax-burden counties. Higher tax counties also saw slower growth in construction-sector jobs.

Just as the cap on the SALT deduction impacts homeowners in high tax areas the most, the lowered limit on the mortgage interest deduction will help deter buyers from moving into those areas. The median home price in California is $813,980 in April of 2021. In New York City, the median listing price is $800,000. The inability to deduct all of the interest on mortgages securing these homes may make buyers think twice before entering these markets.

The cap on the SALT deduction is scheduled to expire in 2025. Proposals have been advanced to repeal the cap sooner. A bipartisan group of members of Congress, mostly from high tax states such as California, Illinois, New Jersey, and New York, has formed the SALT Caucus. The goal of the Caucus is to repeal the cap on the SALT deduction, and Caucus members have threatened to hold up President Biden’s proposed infrastructure package unless the SALT cap is repealed. The Caucus has been active in promoting its goals. Recently, members proposed revising the SALT cap, and have continued to link the preservation of the SALT deduction to their support for other legislative priorities. Senate Budget Committee Chair Bernie Sanders (I-VT) has said that he is open to restoring the SALT deduction, but wants it limited to taxpayers who earn less than $400,000 per year.

While Congressional leadership has not dismissed outright the idea of repealing the cap on the SALT deduction, their enthusiasm for the repeal is not strong. House Speaker Pelosi has been reported as having reservations about lifting the cap, but has also publicly referred to the cap as “mean spirited” and “politically targeted,” and designed to hurt taxpayers in “blue” states with higher taxes. The uncertain enthusiasm for lifting the limit may mean that taxpayers will have to wait for the scheduled repeal of the cap in 2025.

Proposed Federal Legislation. Apart from the activity of the SALT Caucus, there has been little federal legislative action on either the SALT deduction or the mortgage interest deduction. One bill has been introduced by Senator Cruz (R-TX) to make the limitation
on home mortgage deduction and the cap on the SALT deduction permanent. That bill, S. 126, was introduced on January 28. It was referred to the Senate Finance Committee, and no further action has been taken on the bill. Three Senators (Sen. Braun, R-NC, Sen. Ernst, R-IA, Sen. Inhofe, R-OK) have signed on as cosponsors; however, no companion to this bill has yet been introduced in the House of Representatives. Given the unpopularity of the provisions of law the bill seeks to make permanent, the prospects of the bill becoming law are marginal, at best.

Proposed State Legislation. The mortgage interest deduction has also been addressed in legislation at the state level. There are several state bills relating to the deduction that have been introduced or acted upon in 2021.

A bill in Oregon, H.B. 2838, would eliminate the mortgage interest deduction. Instead of the deduction, mortgage interest would be a credit against income tax. The credit would be limited to taxpayers with a federal adjusted gross income of less than $100,000 for a single taxpayer, or $200,000 for taxpayers who file a joint return. H.B. 2838 was introduced on January 11, 2021, and did not pass out of committee before sine die adjournment of the Oregon Legislature on June 26. The bill will not carry over to the next legislative session.

Two other Oregon bills, H.B. 2578/S.B. 852, would not repeal the deduction, but would cap the income of taxpayers eligible to claim the deduction. Taxpayers with incomes up to $200,000 would be able to claim the full deduction, while taxpayers with incomes between $200,000 and $250,000 would be able to claim only a portion of the deduction. No deduction would be allowed for taxpayers with incomes over $250,000 per year. The bills would also bar taxpayers from deducting the interest paid on second homes. The revenue realized from the limitation of the deduction would be deposited in Oregon Housing Opportunity Account and used to fund programs that promote affordable home ownership and prevent homelessness. Oregon REALTORS® opposed both bills, and offered testimony against S.B. 852. Both bills were heard by committees, but neither bill passed before adjournment of the Legislature.

Bills in other states would also repeal or limit the deduction for mortgage interest paid on second homes. Three bills in Hawai‘i – H.B. 1388, S.B. 202, and S.B. 723 – would repeal the deduction for second homes, and deposit the revenue realized by the elimination of the deduction into the state’s Rental Housing Revolving Fund. The Revolving Fund is used to provide low interest loans for the development, acquisition, or rehabilitation of affordable rental housing units. One purpose of the repeal is that it was said to be a way of encouraging owners to sell their second homes, “which would increase the housing supply for Hawaii residents who could use the home as their primary residence.” The Hawai‘i Association of REALTORS® gave testimony in opposition to the repeal in the House Committee on Finance. None of the three bills to repeal the deduction became law, but all three will carry over and may be considered in the 2022 legislative session.

Two bills to eliminate the mortgage interest deduction for second homes were introduced in the Minnesota Legislature. H.F. 2229/S.F. 2369 would limit the mortgage interest
The bills would also make unspecified appropriations for fiscal years 2022 and 2023 to the Minnesota Housing Finance Agency for the home ownership assistance program. Neither bill advanced out of committee prior to adjournment, and both bills will carry over to the 2022 session.

A bill in North Carolina does not seek to modify or eliminate the deduction, but instead amends the time period that the current version of the deduction will remain in place. The state appropriations act, S.B. 105, would modify the state’s income tax law to conform to the Federal Internal Revenue Code. The cap on the mortgage interest deduction that was set to expire after the 2020 tax year would be continued through the 2021 tax year. S.B. 105 passed the Senate and was referred to committee in the House on June 29, 2021.

The Impact on Real Estate

Mortgage Interest Deduction. Even those economists who oppose the mortgage interest deduction acknowledge that the deduction makes homeownership more affordable by reducing the cost of financing. According to a 2020 report by the Congressional Research Service, the deduction may have a limited impact on the homeownership rate because the primary barrier reported by first time homebuyers is the initial transaction cost, including the down payment and closing costs. However, the deduction can influence the cost of homes which homeowners purchase, because it reduces the overall cost of the monthly mortgage payment. Both of these impacts would be proportionately larger for homeowners who are paying a greater proportion of interest as opposed to principal, such as interest-only adjustable-rate mortgages which were especially common prior to the recession of 2008. Homeowners with mortgages in the early years of their amortization are also in this group.

State and Local Tax Deduction. Similarly, eliminating the SALT deduction entirely would make homeownership more expensive. State and local property taxes are regressive in that they are assessed on the value of the property and not on the wealth or income of the taxpayer. Income taxes, on the other hand, are progressive; assessed at higher rates for higher income earners. Recent research shows that a federal deduction for state and local taxes makes those taxes more progressive. Deductibility leads to a greater reliance by states on income taxes, which tend to be more progressive than other types of taxation. Elimination or reduction of the SALT deduction would also have varying impacts in different states. In states with high property taxes, the eliminating the deduction would have a proportionately large impact on the tax burden of those people who could no longer deduct their high state and local property taxes, increasing the cost of homeownership in those states. On the other hand, there would be proportionately smaller impact on homeownership in those states and localities which impose little to no property tax.
REALTOR® Association Involvement

Preserving the mortgage interest and SALT deductions has, and continues to be, one of NAR’s priorities. The Association has been active in efforts to keep the deductions in place.

When the TCJA was being considered by Congress in 2017, Iona Harrison, the chair of NAR’s Committee on Taxation, testified before Congress on the need to preserve both the mortgage interest and SALT deductions. Ms. Harrison expressed agreement with the legislative goals of tax simplification and fairness but pointed out that the tax rules for housing and real estate are not especially complex for the majority of individuals. As Ms. Harrison put it, “[a] quest for simplicity must not be allowed to override common sense.”

In one particularly memorable part of her prepared remarks, Ms. Harrison noted that “[i]f one were designing a tax system for the first time, one would likely devise something that is different from what we have today.” The tax system we do have today, however, has always had the mortgage interest and deductions for state and local taxes. The values of those tax benefits are both directly and indirectly embedded in the price of a home.

The TCJA, complete with its harsh limitations on the deductibility of mortgage interest and state and local taxes, ultimately passed Congress and was signed into law. Nevertheless, NAR has continued to work for the restoration and preservation of the two deductions. At a February 13, 2019 hearing before the Select Revenue Measures Subcommittee of the House Ways and Means Committee (“How Middle Class Families are Faring in Today’s Economy”), Kevin Brown, a REALTOR from Oakland, California, testified on behalf of NAR. His testimony covered several topics, including homeownership and American culture, and the economic and social benefits of homeownership. Mr. Brown also discussed the economic barriers to homeownership. He set out in detail the negative impact that the TCJA has had on homeownership, particularly in states and communities with higher-than-average home prices. In particular, the impact of the $10,000 cap on the SALT deduction (described as the first encroachment on full deductibility of real estate taxes) landed hardest on taxpayers in only a few states.

Mr. Brown’s testimony also addressed the indirect negative impacts of the TCJA on homeownership. The TCJA increased the amount of the standard deduction available to taxpayers, meaning that fewer taxpayers would be able to itemize their deductions and thereby claim the mortgage interest or SALT deductions. Before the TCJA increased the standard deduction, 32%, or nearly one-third, of all taxpayers itemized their deductions. After the TCJA went into effect, that number fell to 13% of taxpayers. In other words, seven out of eight taxpayers will not receive the tax benefits of homeownership.

NAR has also put its support behind legislative efforts at tax relief for homeowners who do not itemize. At the 2020 NAR Midyear Meeting, attendees passed overwhelmingly a resolution to support tax policies that provide an incentive to purchase and own a primary
residence through a tax credit for households that no longer itemize deductions. The preferred form of the tax credit would:

- Provide a higher benefit in the first year or years for those purchasing their first home;
- Provide a diminishing tax benefit for a limited amount of time, such as ten years, in order to reflect the declining economic impact of the construction or purchase or sale of a home;
- Be available only if the homeowner does not claim the legacy tax incentives of the mortgage interest and real property tax deductions; and
- Have limits that are adjusted by geographical realities of the U.S. housing market to reflect that homes of median size and value in higher-cost areas of the nation are appraised at several times the amount of such homes in lower-cost areas. A "one-size fits all" approach would be unfair and discriminatory and would not serve the needs of most Americans.

NAR will continue its efforts to restore and preserve both the SALT and the mortgage interest deductions, and to expand tax credits for homebuyers and homeowners. The change in the makeup of Congress, and the new Presidential administration, will pose new challenges, but may also present new opportunities.

State and Local Associations. Most states with an income tax allow for the deduction of mortgage interest. State and local REALTOR associations have been working to preserve that deduction at the state level.

The work of the Hawai’i Realtors Association to push back against the repeal of the deduction for mortgages on second homes has been noted. In Kansas, the battles over the mortgage interest deduction go back several years. Recently, the battles have focused on efforts to decouple Kansas state income tax deductions from federal deductions; that is, a taxpayer who is unable to itemize his or her deductions under federal law could be allowed to itemize deductions on his or her Kansas tax return. Decoupling legislation has been proposed, but has always been vetoed. Finally, in 2021, the efforts of the Kansas Association of Realtors and others were successful. A bill to allow decoupling, S.B. 50, was passed by the Legislature, and vetoed by the Governor. This year, however, the outcome was different: the Legislature voted to override the Governor’s veto. The legislation allowing decoupling was effective July 1, 2021.

Public advocacy. The NAR has produced articles, blog posts, and similar projects in order to inform the public and raise awareness about the mortgage interest deduction and the SALT deduction:

NAR produced an ad placed in several prominent Capitol Hill publications, including: Politico, The Hill, and National Journal laying out the facts of the mortgage interest deduction.
NAR has also produced an article detailing the average SALT deduction by state and an article breaking down the impact of mortgage interest and SALT tax changes by metro area.

In an article published in the Washington Examiner, the NAR defended itself against allegations that it argued against tax cuts due to its advocacy against reducing or eliminating the mortgage interest and property tax deductions.

Other Organizations Working on This Policy

The National Association of Home Builders is in favor of tax reform that focuses on tax credits rather than deductions.

The Community Associations Institute opposes any change to the existing mortgage interest deduction.

Conclusion

It is likely that there will be attempts to change the mortgage interest deduction and the SALT deduction in the coming years at both the state and federal levels. The NAR will continue to keep its members and the public informed and to advocate on behalf of homeowners to preserve these important deductions.
ADDITIONAL STATE & LOCAL RESOURCES

**White Papers:** Comprehensive reports prepared for NAR on issues directly impacting the real estate industry. Examples include: Rental Restrictions, Land Banks, Sales Tax on Services, State & Local Taxation, Building Codes, Hydraulic Fracturing, Foreclosure Property Maintenance, Climate Change, Private Transfer Fees.

**Growth Management Fact Book:** Analysis of issues related to land use and modern growth management topics include density — rate of growth, public facilities and infrastructure, protection of natural resources, preservation of community character, and affordable housing.

All available on REALTOR® Party webpage under the State & Local Issues tab.