

Who Benefits from Mortgage Deductions?

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The Tax Reform Act of 1986 ended personal deductions for interest on credit card debt and other types of loans, but continued the home mortgage interest deduction, a popular tax expenditure. Supporters claim it makes home ownership more affordable for low- and middle-income families. Critics argue it subsidizes high-income earners who would have bought homes even without the tax advantages. How do different income groups benefit from this and other mortgage-related deductions? And could these tax incentives be structured to better achieve their objectives?



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Types of Mortgage Deductions. Most mortgage-related tax deductions are for interest paid on a home loan. But homebuyers are also eligible to deduct payments for points. Borrowers purchase points for each 1 percent of their loan balance they pay at closing in addition to the down payment, typically in exchange for a 0.25 percent reduction in their interest rate. For example, a homebuyer taking out a \$300,000 mortgage with an interest rate of 4.25 percent could pay an additional \$3,000 at closing and the lender would lower the interest rate to 4 percent.

In addition, unlike homeowner's insurance, borrowers can deduct payments for the private mortgage insurance (PMI) they are required to purchase if their down payment is less than 20 percent of the home value. PMI protects lenders if borrowers default, but it is not required after a homeowner reaches 20 percent equity, either through appreciation of the home or by paying down the loan balance. Congress made PMI payments deductible in 2007 to boost the housing market, but must reauthorize this tax break annually.

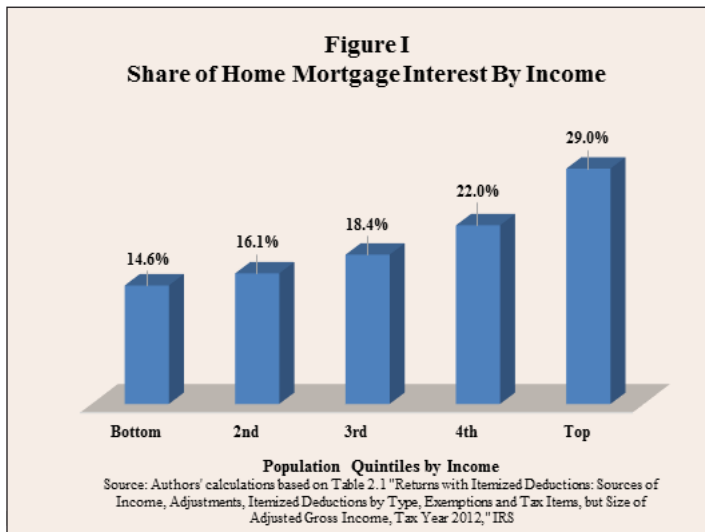
What Income Groups Benefit from Which Mortgage Deductions? A common argument for maintaining the deductibility of mortgage-related expenses is that it helps the middle class, but different income groups are the main beneficiaries of specific deductions.

Mortgage Interest. In 2012, for example, based on adjusted gross incomes:

- More than half the total value of home mortgage interest deductions, or nearly \$100 billion, was claimed by the top 40 percent of households, with incomes of \$100,000 or more.
- Those in the bottom quintile (fifth), with incomes of less than \$45,000, only claimed 14 percent of the interest deduction's value, or less than \$50 billion [see Figure I].
- The average deduction for the top 20 percent of households was \$13,824, while the average for the bottom 20 percent was \$6,964.

This disparity would likely be even greater if the deduction were not limited to home loans of \$1,000,000 or less. (Currently, total deductions for higher income earners phase out due to the so-called Pease limitation.)

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Points Deduction. As with mortgage interest, this deduction is mostly claimed by higher earners. In 2012, the top fifth of all returns deducting for points, and 27 percent of the value of those deductions, were claimed by those making more than \$200,000 a year, and 60 percent of all claims for a points deduction were by taxpayers with incomes of \$100,000 or more [see Figure II]. The average deduction for the top quintile household was \$823, and for the bottom quintile was \$558. The bottom income quintile for points deduction ranges from \$0 to \$60,000, and receives 18 percent of the value of the deduction.

PMI Deductions. The PMI deduction is the most equally distributed of the mortgage deductions by adjusted gross income:

- Those in the bottom quintile, with incomes of less than \$40,000, receive 22 percent of the total value, higher than the 18 percent claimed by those in the top quintile, earning more than \$100,000.
- The average deduction for the top quintile household was \$1,208, and for the bottom quintile was \$1,432.

Since private mortgage insurance is required for buyers with less than 20 percent home equity, it is not surprising that lower income earners are more likely to claim it, since they tend to make smaller down payments [see Figure III]. However, an unknown number of homebuyers do not claim this deduction because they do not itemize.

Do Home Mortgage Deductions Encourage Home Ownership? Federal and state governments provide all kinds of incentives for home ownership. But economist Andrew Hansen of Marquette University found that the home mortgage interest deduction has no significant

effect on the decision to rent versus buying a home. For those already planning to buy a home, however, it encourages the purchase of an 11 percent to 18 percent larger house. In terms of the home as an investment, the deduction skews buyers toward putting all of their eggs in the housing basket, and fewer into stocks, bonds and other investments. The home is often cited as the largest asset by many households who rely on it for future retirement income. As evidenced by the 2008 housing crisis, this is a risky strategy.

Conclusion. Mortgage-related deductions benefit homebuyers who itemize, and income tax itemizers tend to be middle and higher income earners. However, these tax benefits could be tailored to reduce the cost of home ownership for families in the lowest income quintiles by making a limited tax credit available to non-itemizers.

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