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STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

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HEARING REGARDING

TAX REFORM OPTIONS: INCENTIVES FOR HOMEOWNERSHIP

OCTOBER 6, 2011

The NATIONAL ASSOCIATION OF REALTORS® (NAR) is a trade association that represents a variety of real estate professionals engaged in activities including real estate sales and brokerage, property management, residential and commercial leasing and appraisal. NAR has more than one million members, almost all of whom are members in their personal capacity and not as corporate entities. A REALTOR's business is a highly personal, hands-on, face-to-face model, focused on a family's fundamental needs for shelter. Real estate investment and operations provide locations where the commerce that drives the economy is conducted.

If one were designing a tax system for the first time, one might come up with something that is remarkably different from what we have today. But we're not starting from scratch, particularly in the context of housing. The tax system has featured a deduction for mortgage interest from the inception of the system nearly 100 years ago. Thus, its value is deeply embedded in the price of a home. While economists agree that there is no accurate measure of the value of those embedded tax benefits, they all generally agree that the value of a particular home includes tax benefits.

The mortgage interest deduction (MID) is among the most simple and straightforward of all the provisions commonly utilized on Form 1041 and its Schedule A. The deduction is familiar enough that during the current discussion about tax reform any description of a new proposal, whether in the media or in other setting, uses the mortgage interest deduction as a metaphor for the dimensions of sweeping change.

The NATIONAL ASSOCIATION OF REALTORS remains committed to preserving current law incentives for homeownership. Moreover, REALTORS emphasize that there could not be a worse time for even *considering* changes to these incentives. Neither the housing market nor the housing finance system has recovered from the horrors of the market crash that began in 2007. We can identify no benefit to the economy if the market slump is exacerbated by tax law changes.

These comments are a response to proposals that have been put forward recently to reduce the fiscal impact of the mortgage interest deduction. We will also respond to critics' allegations that we believe misrepresent incentives for homeownership. We note that real estate is the most widely-held category of assets that American families own, so changes to its tax treatment will have far-reaching impact in the economy.

Finally, we emphasize that any change that would erode the value of the tax incentives to homeownership becomes a tax increase and often would often cause a further diminution in the values of homes.

Three Basic Approaches

Over the past ten months, at least three approaches for modifying and/or reducing the mortgage interest deduction (MID) have been launched. These three approaches illustrate fundamental modes of change. Even if some of the details were changed (such as amount of a credit or certain dollar amounts), all would limit the value of the deduction and/or have a negative impact on the value of housing.

We again emphasize in the strongest possible terms that any change to the benefits associated with the mortgage interest deduction would undermine a housing recovery. Any limitation would further erode confidence in a market where confidence in the future is essential.

The three proposals that have come forward would all cause harm. Worse, they confuse consumers who fear that they can predict neither the nature nor the impact that changes would have on them. This uncertainty and confusion have a chilling effect in the market.

The three proposed changes include President Obama's proposal to limit itemized deductions for taxpayers above the current 28% bracket, the Bowles-Simpson proposal to convert all mortgage interest deductions to a tax credit and another Bowles-Simpson proposal that would reduce the cap on mortgages eligible for mortgage interest deductions from $1 million to $500,000. Enactment of any of these proposals would be a tax increase felt most keenly by working families, not by that category broadly referred to as "the rich."

<u>*The President's 28% limitation proposal*</u> is exceptionally complex and cannot be planned for. An individual, particularly one who owns a business or who is self-employed, may be in different tax brackets from year to year. These individuals have a particularly difficult time estimating their tax payments and their incomes, particularly in today's uncertain economic climate. They do not need added burdens of complexity or unanticipated tax increases. A reduction in the mortgage interest deduction (MID) would further complicate their family finances.

Some will say that putting a limitation on upper income taxpayers would cause no harm for those in lower brackets. When reduced tax benefits reduce the value of a home, the value of all homes decreases. A collapse or reduction in home values at the top end of the market cause downward pressure on all other homes. ***That is, when the value of my neighbor's house declines, then the value of my house declines, as well.***

<u>*Converting the deduction to a 12% credit*</u> that is smaller than all but the lowest tax bracket (10% under current law) would be particularly harmful to the lower and middle segments of the income spectrum. After all, the 10% bracket applies only to income between $0 and $8375 on a single return ($16,750 on a joint return). ***All individuals with income in excess of these modest amounts would experience a tax increase.***

In 2005, NAR commissioned outside research on the impact of changing the mortgage interest deduction to a tax credit. While the conclusions are now somewhat dated, the contrast with the Simpson-Bowles 12% credit is nonetheless striking. NAR asked its consultants to design a *revenue-neutral* tax credit based on data then currently available. (Revenue-neutral was intended as a design under which the amount of the tax expenditure associated with mortgage interest was neither increased nor decreased.) That analysis showed that in 2005, a revenue-neutral rate for a credit would have been 22% -- fully ten percentage points *above* the amount of the Simpson-Bowles proposal***. Thus, both mechanically and analytically, the Simpson-Bowles 12% tax credit recommendation becomes a substantial tax increase for all but the lowest income individuals.*** Even the Bush Tax Reform Panel's recommendation of converting the deduction to a 15% tax credit would have been a substantial tax increase for most. (Note that NAR will soon have data on the rate under current law for a revenue-neutral tax credit.)

Many economists have traditionally favored tax credits over tax deductions because deductions provide higher tax benefits to upper-income taxpayers. In other words, in a progressive tax system like ours, an individual in the 15% bracket receives only 15 cents of tax reduction for each dollar of interest deducted, while an individual in the 35% bracket receives a tax benefit of 35 cents on the dollar. The mathematics of this assertion are correct, but asymmetrical: The tax benefit analysis of a deduction ignores the balance between tax rates and individual income taxation. An individual in the 15% bracket pays only 15 cents of tax on the dollar, while an individual in the 35% bracket pays tax of 35 cents on the dollar. ***Thus, tax rates balance, rather than distort, the value of deductions.***

<u>A $500,000 cap</u> has very harsh application in high-cost parts of the country. The geographic distribution of such a limitation is particularly uneven and unfair. After all, a $500,000 home in a medium-size Midwestern city is likely to be far more luxurious than a $500,000 home in any densely-populated urban area in the East or West. In most high-cost areas, families pay substantial portions of their family income for housing, even when their residences are modest.

The most recent monthly NAR data on existing home sales (August 2011) show improvement for the first time in several months, but underscore just how fragile the market remains. The rate of existing home sales has been on a seesaw for all of the past 12 months, showing no sustained month-to-month improvement for any period longer than November 2010 – January 2011. Notably, the volume of sales reached its 12-month high in January 2011 and has not yet climbed back to that level. In addition, median prices year over year continue to decline in all regions, with the largest decline occurring in the West. Since the beginning of the 2007 crash, national declines in home values is 30% -- a loss of about $7 Trillion in family wealth.

Clearly the housing market has not yet reached a stable floor. *Any* change to the economics of homeownership, particularly the tax benefits that are embedded in housing values, would further diminish the pace of recovery and have a further chilling effect in the market place.

There can be no economic recovery until the housing market recovers. Thus, we urge you to do no harm and to oppose any change to the tax laws that apply to housing, particularly the mortgage interest deduction. According to data provided to NAR, 85% of taxpayers who would be negatively affected by reducing the cap to $500,000 have AGI of less than $250,000, and roughly 50% of them have AGI below $100,000.

An oversimplified set of examples of the impact of converting the MID to a tax credit and of limiting the value of the MID for those above the 28% bracket is presented in Appendix A.

Answering the Critics

Critics: Only a third of taxpayers itemize deductions. While it is true that in any particular year only about a third of individuals itemize deductions, this figure is a snapshot. Over the course of an owner's tenure in a home, an individual may itemize in the early years of homeownership, when the interest expense is high relative to the principal paid, but then not itemize in later years. Mortgages get paid off, other non-MID deductions rise and fall, individuals down-size, divorces occur, a spouse dies or needs to simplify living arrangements. These and other life events may convert itemizers into standard deduction taxpayers.

NAR recently (August 31 – September 2, 2011) asked the Harris polling organization to determine the public's (homeowners only) understanding and utilization of MID. That survey showed that 54% of those homeowners surveyed currently utilized the MID, but an additional 16% had taken it in the past. Thus, over time, at least 70% of homeowners have used the MID.

One could just as easily argue that those who utilize the standard deduction – both homeowners and renters – are actually receiving a proportionally deeper subsidy than those who itemize. For example, a married couple's total state and local tax, mortgage interest and charitable contributions might be $10,000. With the standard deduction currently at about $12,000, this couple would be receiving tax benefits for $2000 in expenditures they never made. If they were in a 28% bracket, that would amount to a $560 tax "freebie." ($2000 excess x 28%).

Critics: Second Homes are all palaces owned by rich people. Some argue that the government does not have a role in helping to finance second homes. Again, if we were starting from scratch, the tax model for second homes might indeed be different. Notably, however, a mortgage interest deduction for second homes has been allowed for as long as any mortgage interest has been in place. Therefore, the MID is just as deeply embedded in the value of second homes as the deduction for interest on a principal residence. In fact, until 1986, a mortgage interest deduction was allowed for ALL the residences an individual owned and without a dollar limitation.

Presently, second homes account for about 10% of all home sales each year. During the past decade, sales of second homes have been no more than 12% of all sales. The tax returns of second home owners show that more than half – 54% -- are in income classes below $200,000. In fact, the largest single category of second home owners is in the $100,000 - $200,000 AGI range – comfortable, to be sure, but unlikely to own a palace by the sea. NAR data show that **the median income of a second homeowner is $99,000.**

NAR has routinely surveyed the purchasers of second homes for nearly a decade. Over that period, the median price of a second home has always trailed the median price of a principal residence. Moreover, **the median price of a second home has *decreased* over the past decade.** In 2003 (the first year of the NAR survey), the median price of a second home was $190,000. Medians peaked in 2004 at $204,100. Currently, the median price of a second home is $150,000 – nearly 25% less than it was at the top of the 2004 market.

NAR's second-home survey also shows that the age of second-home purchasers is increasing. After remaining flat (at around age 45) during the period 2004 – 2008, the average age of second home buyers in 2010 was creeping toward 50, suggesting that owning a second home is as much a retirement strategy as it is a recreation proposition. In fact, NAR research shows that 34% of second home purchasers in 2010 intended to use that property as a principal residence in the future.

Finally, NAR has compiled data identifying all US counties in which more than 10% of the housing stock is second homes. Currently, about 900 of the nation's 3068 (roughly 30%) fall into this group. In some counties with very small populations, second homes can represent about 40% of the housing stock. In Meagher County, Montana, for example, the population is only 1,891 people, but second homes represent 42% of the housing stock. That area is doubtlessly dependent on the jobs and property taxes generated by those second homes.

Thus, about 30% of US counties have a stake in retention of the mortgage interest deduction for second homes. Those properties generate valuable jobs and property and sales taxes for the communities. To reduce or eliminate the MID for second homes would have at least as dramatic an impact on those communities as it would the taxpayer/owners themselves.

<u>*Critics: Only rich people get hurt if the mortgage cap is reduced form $1 million to $500,000:*</u> It was not until the Tax Reform Act of 1986 that the MID was limited in any way. Before that, *all* interest on *all* mortgages on an *unlimited* number of residences could be deducted. In 1987, the current $1 million dollar limitation was put in place, along with the restriction that the $1 million of debt qualifying for an interest deduction was limited to a principal residence and only one other. Note that the $1 million figure was not indexed for inflation, so, in fact, the value of the deduction has been substantially eroded over the past 24 years.

Research conducted on behalf of NAR shows that individuals in *every* adjusted gross income (AGI) class -- even as low as $10,000 -- have mortgage debt in excess of $500,000. Those in the lower income ranges likely include those who are self-employed with minimal income after expenses, those who are business owners with significant losses or retired individuals with other tax-exempt income. No matter what the income category, however, reducing the cap would make their economic positions worse, particularly where there have been losses.

Among those who itemize and claim MID, the AGI classes below $100,000 comprise 56% of all tax returns. These are primarily working families. Moreover, the AGI classes below $200,000 represent almost 90% of all itemized returns. **Thus, the overwhelming majority of tax returns with MID are certainly NOT in so-called "Warren Buffett" territory.**

Notably, taxpayers with AGI above $200,000 have far more resources with which to reduce their mortgage debt than do those with AGI of less than $200,000. Ironically, a $500,000 cap thus becomes *less* punitive for very high income taxpayers than it would be for working families – even fairly well-compensated ones with AGI around $200,000. These families have more constraints on their liquidity and cash flow than the very high income families.

A $500,000 cap has wildly divergent geographic implications. The burden of the cap would be disproportionately borne by taxpayers in high costs areas, even though they might not be categorized as "rich" and even though they may have fairly modest homes. NAR would resist any effort to make the cap on the MID contingent on the taxpayer's place of residence. Such a change would impose significant complexity on what is currently a very simple provision.

Critics: A 25% rate would compensate for loss of mortgage interest deductions: For at least the past 30 years, a continuing emphasis on tax rates (rather than the tax base) has obscured the fact that the hardest compliance challenges individuals face is the determination of income – not the tax rate applied to it. The economic goal of a broad base taxed at the lowest rates has been the Holy Grail. In fact, in 1986, rates were reduced to their lowest point (28%) in the post-WWII era. That rate was achieved only because of the loss of many tax benefits, particularly those associated with some forms of investment real estate.

Since 1986, the tax base has been modified with nearly every major tax bill. As the chart in Appendix B shows, tax rates have, over the past 30 years, gone up and gone down. In fact, tax rates over the more recent thirty years (1981 – 2011) have proven far more unstable than they were during the previous 30 years (1950 – 1980). In addition, as the columns labeled "Dollar Threshold – Top Rate" show, the dollar threshold for reaching the maximum rate has varied enormously, whether adjusted for inflation or not. There is no reason to think that tax rates, dollar thresholds or the tax base itself will be any *more* stable over the coming years than they have over the past 30.

Even if a 25% tax rate could be achieved without doing any violence to the MID and other important housing incentives, there is no reason to believe, given recent history, that tax rates would remain at the 25% maximum that some seek. Similarly, if the MID and/or other housing incentives were eroded or done away in the context of the current fiscal debate, there is no reason to believe that tax rates would remain fixed at 25% permanently. Similarly, there is no reason to believe that a housing incentive, once curtailed or eliminated, would be restored in the future. There is little available evidence that a tax benefit, once taken away, would be restored, particularly in the real estate industry.

Additional Observations

Capital Gains Exclusion on the Sale of a Principal Residence -- Prior to 1997, the tax rules that governed the sale of a principal residence were complex and largely ignored (Section 1034 of the Internal Revenue Code). The general rule was that there was no recognition of gain, so long as the seller purchased a home of the same or greater value within a specified time. (This was a particular disadvantage to individuals who relocated from a high cost area to a lower cost area.) The deferred gain from the sale reduced the basis of the new home. Other elaborate rules required taxpayers to track the adjusted basis of the homes they owned so that, in the event that they did not purchase a replacement home (or purchased a replacement home of lesser value), the gain on that sale became taxable, as measured from the adjusted basis. Few taxpayers had adequate understanding of the law or sufficient records to enable them to comply with these rules.

In 1997, the Clinton Administration, without input from NAR or others in the housing industry, proposed a complete overhaul and simplification of these rules. Rather than require elaborate basis computations on multiple residences over a term of many years, the new rule simply permitted the seller to exclude up to $250,000 ($500,000 on a joint return) of the gain on the sale. Any excess above these amounts would be currently taxable at the capital gains rate for the year of sale. The reinvestment rules were eliminated, so taxpayers gained mobility and flexibility. The exclusion gives them the ability to downsize, buy more than one property, purchase a non-real estate asset or do anything they choose with the proceeds of the sale. The exclusion is restricted to the sale of only a principal residence, and certain qualifications must be satisfied in order to receive the benefit of the exclusion. As with the MID, the $250,000 and $500,000 amounts are not indexed for inflation.

Some have suggested reducing the amount of the exclusion on the rationale that home values have declined so the amount of excludable gain should decline, as well. NAR rejects this reasoning. In fact, homeowners have a very justifiable claim that they made a major contribution to any appreciation in their home, and so should be allowed to retain what, for many, would be the full value of that appreciation.

No data is publicly available that allows either NAR or its consultants to evaluate the impact of possible changes to these rules. No public IRS records present information about Forms 1099 that are filed for home sale transactions, and no capital gains data are separately presented to show the amount of taxable gain reported on homes sales in a particular year. In addition, there is no way to ascertain the value of unrecognized gain that has accumulated in homes that are not currently on the market. Finally, long-term holders are far more likely to have larger appreciation amounts and so should not be penalized for that long tenure.

We note that this provision is among the most taxpayer-friendly sections in the entire Code. When enacted, it was a substantial simplification from prior law. It allows significant flexibility in the financial planning for families. Notably, the gain on the sale of a principal residence is a significant factor in the retirement savings plan of many older Americans. They anticipate downsizing and then using remaining proceeds to supplement any retirement income they have. Prior law penalized individuals over age 55 by making an exclusion a once-in-a-lifetime provision. Today's rules reflect far more accurately the homeownership patterns over a lifetime. They should be retained at their current levels.

Relief for Cancellation of Mortgage Indebtedness -- Under general tax principles, when a lender cancels a portion or all of a debt, including mortgage debt, the borrower is required to recognize the forgiven amount as income and pay tax on it at ordinary income rates. An exception is provided for some mortgage debt that was or will be forgiven between January 1, 2007 and December 31, 2012. When this relief was initially considered in 2007, the Ways and Means Committee reported it as a permanent provision. The final version, however, was temporary and in place only through December 31, 2009. That date was extended through December 2012 as part of the flurry of legislation enacted at the height of the financial crisis.

Regrettably, it presently appears that this relief will be needed beyond 2012. The backlog of short sales and foreclosures shows no sign of clearing. In addition, many individuals are now losing their homes because of unemployment, rather than as a result of irresponsible lending practices that contributed to the financial crisis in 2008. With the unemployment rate still locked in above 9%, there can be no expectation that the housing crisis will have resolved itself by the end of 2012. We therefore urge Congress to make mortgage cancellation relief a permanent part of the Code.

These comments were prepared by Linda Goold, Tax Counsel of the National Association of Realtors. Questions about them can be directed to her at 202 383 1083 or at lgoold@realtors.org.

APPENDIX A -- VALUE OF MORTGAGE INTEREST DEDUCTION OF $10,000

Selected Proposals (Over-simplified)

Tax Bracket	**Range of Bracket Married filing Joint (2010)**	**Current Law**	**Limit to 28% bracket Obama/Jobs Bill**	**Increase in Taxes (Over Current Law)**	**12% Tax Credit Bowles-Simpson**	**Increase in Taxes (Over Current Law)**
25%	$100,000 - $137,300 *Taxable Income**	$2,500 ($10,000 x .25)	$2,500 (Same as current law)	None	$1,200 ($10,000 x .12)	$1,300
28%	$137,300 - $209,250 *Taxable Income**	$2,800 ($10,000 x .28)	$2,800 (Same as current law)	None	$1,200 ($10,000 x .12)	$1,600
35%	$209,250 - $373,650 *Taxable Income**	$3,500 ($10,000 x .35)	$2,800 (Limit to 28% bracket	$700	$1,200 ($10,000 x .12)	$2,300
39.6%	Not Available	Not Applicable	$2,800 (Tentative)**	$1,160 (Tentative)**	$1,200 ($10,000 x .12)	$2,760***

In each of these examples, the impact on any particular individual's *total* tax burden would vary, depending on that individual's overall tax posture. In addition to ordinary income (such as wages, Schedule C), individuals will have varying mixes of lower- taxed income (such as dividends or capital gains), partially- taxed income (such as Social Security Income for some, but not all, recipients) or tax-exempt income (such as state and local bonds).

In addition, the dollar impacts in these examples do not reflect the reality of a progressive tax system.

*Taxable income does NOT include such items as personal exemptions, itemized deductions or tax credits, so adjusted gross income is a larger number than taxable income.

** For comparison only. If Bush tax brackets revert to pre-2001 model, there may not be a 28% bracket. The tentative tax increase shown in the unshaded box is based on the difference between the value of a $10,000 deduction at 39.6% and at a 28% bracket.

*** The difference between a deduction valued at $3960 and a tax credit of 12% or $1200.

APPENDIX B -- TAX RATES: THEY GO UP, THEY GO DOWN[1]

Selected Years -- 1950 – 2011

YEAR	MAXIMUM REGULAR TAX RATE	NUMBER OF TAX BRACKETS	SURTAX RATES[2]	Dollar Amount - Top Rate (Not adjusted for inflation) (Joint Return)	Dollar Amount - Top Rate (Adjusted for inflation – 2011 Dollars)
2011	35	6		$379,150	$379,150
2003	35	6		$311,950	$380,409
2002	38.6[3]	6		$307,050	$382,967
2001	39.1	5		$279,350	$376,732
2000	39.6	5		$288,350	$375,725
1993	39.6	5		$250,000	$388,200
1992	31	3		$86,500	$138,338
1990	28[4]	2		$32,450	$55,709
1988	28	2		$56,427	$30,950
1987	38.5[5]	5		$90,000	$177,766
1986	50	15		$175,250	$358,782
1981	70[6]	16		$215,400	$531,698
1976	70	25		$200,000	$788,681
1970	70	25	2.5%	$200,000	$1,156,596
1969	70	25	10%	$200,000	$1,222,777
1968	70	25	7.5%	$200,000	$1,289,538
1967	70	25		$200,000	$1,343,591
1964	77	26		$400,000	$2,895,221
1963	91	24		$400,000	$2,933,067
1954	91	24		$400,000	$3,336,500
1953	92	24		$400,000	$3,361,492
1950[7]	87.2	21	3%, 7%, 9%, 13%	Not Comparable	Not Comparable

[1] Source: The Tax Foundation, US Federal Income Tax Rates History at taxfoundation.org/publications
[2] Surtaxes were used, in part, to fund World War II and the Viet Nam war.
[3] The so-called Bush Tax Cuts enacted in 2001 to reduce the top rate from 39.6% to 35% were in effect for only part of the 2001 tax year, and were phased in during 2002. The 35% rate was fully phased in by 2003.
[4] Between 1987 and 1990, a so-called "bubble" caused the maximum tax rate to be 33% for certain taxpayers. This occurred because of certain phase-outs of lower brackets for individuals with income between approximately $71,000 and $123,000.
[5] The phase-in of the 28% rate enacted in 1986 was not complete until 1988.
[6] President Reagan's tax cuts, enacted in 1981, became effective in 1982. In 1982, the top rate dropped to 50%, where it remained through Tax Reform Act of 1986.
[7] Before the Internal Revenue Code of 1954, the Internal Revenue Code of 1939 had such a different mode of computing income that the "top dollar" concept is not a helpful analytic tool. It is important, though, to note the high tax rates and surtax rates in effect during the war years.