Submission of the

National Association of Home Builders

Before the
United States Senate Finance Committee's
Working Groups on Individual and Business Tax Reform

April 15, 2015

On behalf of the 140,000 members of the National Association of Home Builders (NAHB), we appreciate the opportunity to share with the Senate Finance Committee our broad research into the interactions of the tax code and housing. NAHB is a Washington, D.C.-based trade association whose broad mission is to enhance the climate for housing, homeownership and the residential building industry. We represent builders and developers who construct housing ranging from single-family for-sale homes to affordable rental apartments and remodelers. About one-third of NAHB's members are home builders and/or remodelers. The others are associates working in closely related specialties such as sales and marketing, housing finance, and manufacturing and supplying building materials.

The Internal Revenue Code currently provides numerous housing-related rules and incentives covering both owner-occupied and rental units. There are key tax provisions geared toward rental housing, which help facilitate the production of new rental housing and also specifically target affordable rental housing. These include the Low Income Housing Tax Credit (LIHTC); accelerated depreciation; Section 142 multifamily rental bonds; and carried interest.

There are also a number of owner-occupied housing tax incentives that help make owning a home affordable and accessible to millions of Americans. These include the mortgage interest deduction; the deduction for local property taxes; the principal residence capital gains exclusion; and mortgage revenue bonds.

NAHB has spent years researching the housing tax incentives to determine how they affect builders, remodelers, homebuyers, homeowners, and renters. Many assumptions are made about various housing policies. NAHB has sought to move away from assumptions to a fact-based approach as we evaluate these tax incentives in preparation for tax reform. Our submission explores the lessons learned from that research.

Balance Between Rental Policies and Owner-Occupied Policies

Questions are frequently raised whether there is a balanced policy between rental and owner-occupied housing. There exist justifiable reasons to support both forms of housing with policy – be it to ensure the availability of high quality, affordable rental housing or support homeownership and enable its benefits for families and communities. However, there is, in some circles, an assumption that renters are getting the short end of the stick.

NAHB has looked at the tax and spending policies that impact both rental and owner-occupied housing: the mortgage interest deduction; the real estate tax deduction; capital gains exclusion; mortgage revenue bonds; Section 108 relief; and HOME, CDGB, USDA, and other appropriations. According to numbers published by the Joint Committee on Taxation (JCT) and the Congressional Research Service (CRS) for Fiscal Year 2012, federal owner-occupied housing support totaled $120 billion.

NAHB also looked at policies supporting rental housing: Low Income Housing Tax Credit; preferential rate on capital gains; accelerated depreciation on rental housing; bonds; like-kind exchanges; the historic credit; tenant-based and project-based Section 8; public housing funding; and other appropriations such as HOME, CDBG, and USDA. According to numbers published by the Joint

Committee on Taxation (JCT) and the Congressional Research Service (CRS) for Fiscal Year 2012, rental housing support totaled $61.6 billion.

To determine if the appropriate policy balance has been struck, it is necessary to look at the U.S. population share living in each type of housing. Based on the numbers above, 66.1 percent of the policy support goes towards owner-occupied housing; 65.35 percent of the U.S. population lives in owner-occupied housing, according to the 2010 American Community Survey. In comparison, 33.9% of the policy support is targeted to rental housing; 34.65% of the U.S. population lives in rental housing.

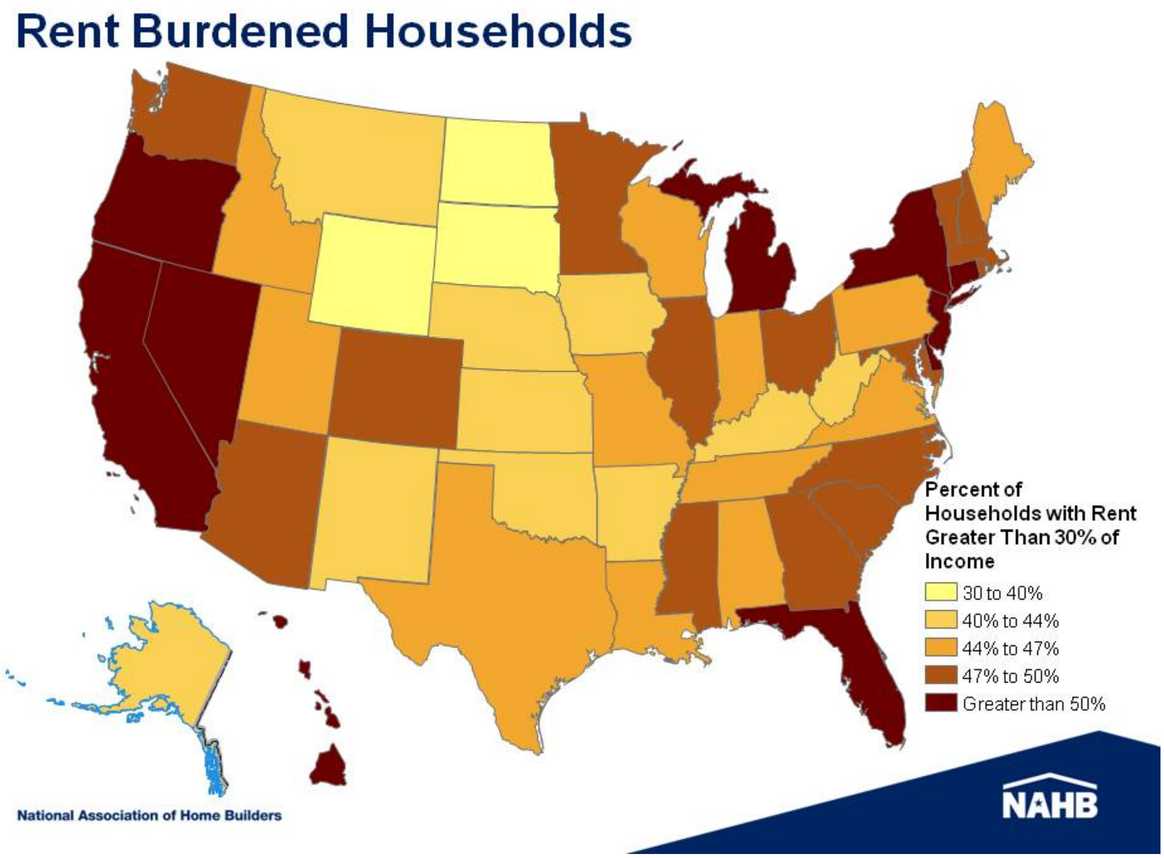
Based on the population living in each type of housing, the data indicate that policy support—both tax and spending—between rental and owner-occupied housing is evenly balanced.

Rental-focused Tax Policies

Low Income Housing Tax Credit

According to Census data, over 40 percent of renters are rent-burdened, and the need for affordable rental options remains acute. One of the major corporate tax provisions is the Low Income Housing Tax Credit (LIHTC). The Low Income Housing Tax Credit (LIHTC) was created as part of the Tax Reform Act of 1986 as a more effective mechanism for producing affordable rental housing. We urge Congress to maintain this critical affordable rental housing program.

The Low Income Housing Tax Credit is the most successful affordable rental housing production program in U.S. history. Since its inception, the LIHTC has produced and financed more than 2 million affordable apartments. As LIHTC properties must generally remain affordable for 30 years, they provide long-term rent stability for low-income households around the country. But the demand for affordable housing is acute and exceeds the availability of financing through the LIHTC program. We believe that the solution is not to eliminate the most successful affordable housing program in the country, but to provide it with the resources necessary to meet the nation’s affordable housing needs.



As the preceding map of 2010 American Community Survey data shows, every state has a large population of rent burdened households. Correspondingly, demand for credits greatly outstrips the resources available. According to the most recently available annual survey released by the National Council of State Housing Agencies (NCSHA), state housing finance agencies generally receive $2 in requests for every $1 in LIHTCs available. In 2012, state agencies received applications for nearly $2 billion in credits. Total allocations were $755 million, $917,428,932, which means that for every tax credit allocated, there was a demand for approximately 2.7 tax credits.[1]

Demand does vary somewhat by state. In 2012, New York saw about $2.20 in requests for every $1 allocated; Vermont experienced nearly $1.17 in requests for every $1 allocated; Texas had $3.11 in requests for every $1 allocated; and Wisconsin saw demand of $3.86 for every $1 allocated.

Nationally, demand varies somewhat from year to year but generally remains high. It is useful to compare the 2012 national numbers against 2008. 2008 was the height of the financial crisis, and multifamily development generally was at a low point. Many traditional investors in LIHTC projects were not investing during this time period, which made putting together deals much more challenging. Nationally, there were applications for $1,873,311,018 in credits. Allocated in 2008 were

[1] State HFA Factbook: 2012 NCSHA Annual Survey Results, Table 2, pg 93-94

$939,924,853 in credits. [2] At this point, demand fell, but was still double the amount of available credits, even in what was one of the most challenging times for real estate development.

Again, looking back to better times in 2006, there were applications for $1,509,779,928 in credits. Credits allocated were $691,073,326. [3] 2006 had approximately $2.20 in credit requests for every $1 available. We can see over several years in different economic environments, demand for tax credits remained steady at double or more of the available credits.[4]

LIHTC development remains stable over time because the need for affordable housing is significant. The consistent demand for credits also reflects the advantage of creating this credit in the tax code. Investors have confidence in the predictability of the tax code, which allow LIHTC developments to continue even during economic downturns. The LIHTC enables a fairly constant supply of affordable housing, as well as a financing mechanism that ensures long-term operation of affordable housing. In fact, low income housing tax credit projects outperform the rest of the multifamily housing sector in one key measure. These properties are very well managed, with an annualized foreclosure rate of less than one tenth of a percent.[5] This is a third of the rate for other multifamily properties. The success of these projects reflects, in part, the ever-present threat that the government can recapture tax credits if the project fails.

A key component to the LIHTC success story is the flexibility the state agencies have to target specific types of affordable housing developments. For example, a state with a large population of seniors may offer a developer bonus points on an application for focusing on senior housing. Nationally, in 2010, approximately 26% of LIHTCs were directed to senior housing.[6] Other targeted projects include assisted living; family housing; homeless; and housing for the disabled. Veterans housing is also increasing in focus in some states. By allowing the states to direct tax credits, the program allows each state to determine what types of affordable housing are best suited to the demographics of their state, rather than applying a single, national standard. Ultimately however, a great deal of need remains unmet as the demand simply outstrips the availability of credits.

The LIHTC is a unique private-public partnership. The benefits of this structure are evident in the quality of the projects. Moreover, NAHB estimates that on average the LIHTC annually produces 95,700 new, full-time jobs, adds $9.1 billion into the economy, and generates approximately $3.5 billion in federal,

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[2] State HFA Factbook: 2008 NCSHA Annual Survey Results, pg 92

[3] State HFA Factbook: 2006 NCSHA Annual Survey Results, pg 88

[4] These numbers represent all LIHTC credit types. There are several different types of credits: credits used for new construction or for substantial rehabilitation (sometimes referred to as the 9% credit), which are design to provide 70% of the cost of construction; and a credit used for acquisition and light rehabilitation (sometimes referred to as the 4% credit), which is designed to cover 30% of the cost of acquiring the property or for light rehabilitation. The amount of credits available for each use is set in law. The data does not break out demand for the 9% and 4% credits separately, but anecdotally, NAHB hears from developers that the competition for 9% credits is the fiercest. Demand for 9% credits is likely much higher than double the amount of available credits.

[5] "The Low Income Housing Tax Credit: Assessment of Program Performance & Comparison to Other Federal Affordable Rental Housing Subsidies," by Novogradac & Company, LLP, 2011, Page 4
http://www.novoco.com/products/special_reports/Novogradac_HAG_study_2011.pdf

[6] State HFA Factbook: 2010 NCSHA Annual Survey Results, pg 109

state, and local tax revenue.[7] Unfortunately, the supply of private, affordable housing stock cannot meet the current demand. According to a 2013 Harvard study:

> In 2011, 11.8 million renters with extremely low incomes (less than 30 percent of area median income, or about $19,000 nationally) competed for just 6.9 million rentals affordable at that income cutoff—a shortfall of 4.9 million units. The supply gap worsened substantially in 2001–11 as the number of extremely low-income renters climbed by 3.0 million while the number of affordable rentals was unchanged.[8]

And the private marketplace is simply unable to replace those lost units with new construction. An older Harvard study calculated that "[t]he rising costs of construction make it difficult to build new housing for lower-income households without a subsidy."[9] In 2009, the median asking rent for new unfurnished apartments was $1,067; for minimum-wage workers, an affordable monthly rent using the 30-percent-of-income standard is just $377.[10] The study calculates that to develop new apartments with rents affordable to households with incomes equivalent to the full-time minimum wage, the construction costs would have to be 28 percent of the current average.[11]

Without federal assistance, it is financially infeasible to construct new, unsubsidized affordable rental units. It is a critical program, and as noted in the study, "[a]t present, the Low-Income Housing Tax Credit (LIHTC) program is nearly alone in replenishing the affordable stock, supporting both new construction and substantial rehabilitation of existing properties including older assisted developments."[12]

<u>Make the Fixed Floor Rate for 9% and 4% Credits Permanent</u>

Under the Low Income Housing Tax Credit (LIHTC) program, affordable housing developments receive tax credits which are used to attract equity capital. There are two types of tax credits: one credit provides 70% of the financing cost and is used for new construction and substantial rehabilitation; and a second credit that provides 30% of the financing cost which is used to acquire an existing property for rehabilitation. These are often referred to as the 9% and 4% credits respectively because that was the original credit amount when the program was created in 1986.

The *Tax Reform Act of 1986* did not fix those credit rates at 9 and 4 percent, but rather created a floating rate system where the credit rates are adjusted on a monthly basis. The IRS calculates the monthly values of the credits based on the cost of borrowing by the federal government. As a result, today's low federal borrowing costs produce very low credit rates, which reduces the amount of private equity

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[7] The Economic Impact of the Affordable Housing Credit. http://eyeonhousing.org/2014/07/the-economic-impact-of-the-affordable-housing-credit/

[8] America's Rental Housing: Evolving Markets and Needs. Joint Center for Housing Studies of Harvard University, December 9, 2013. Pg. 6

[9] America's Rental Housing: Meeting Challenges, Building on Opportunities. Joint Center for Housing Studies of Harvard University, 2011. Pg 23

[10] Page 23 and 21

[11] Page 24

[12] Page 5

invested in LIHTC development. For April 2015, the 9% credit was only worth 7.48%; the 4% credit was worth 3.21%. These low rates reduce the amount of equity properties could receive by more than fifteen percent, making it more difficult to do LIHTC developments, particularly as state and federal governments cut back on direct spending that is used to fill financing gaps for LIHTC properties. The "floating rate" system also creates uncertainty for owners and investors and complicates state administration of the program.

In response to the declining rates, the *Housing and Economic Recovery Act of 2008* (HERA) set the rate for new construction and substantial rehab credits from each state's allocation at no less than 9 percent, which was the rate when the program was created. The provision was then extended for credits allocated by the end of 2013 through the *American Taxpayer Relief Act of 2012* (ATRA) and again for 2014 credit allocations as part of the *Tax Increase Prevention Act of 2014*.

If this provision is not extended for 2015 credit allocations, developments will need to be underwritten at the floating rate, which would mean a sudden and substantial reduction in the amount of equity that a development could receive for its allocation. Making the fixed floor rate permanent would not increase the number of LIHTCs allocated, as they are capped annually; it just affects how much allocation each project may receive. NAHB strongly supports making the 9 percent credit rate floor permanent.

NAHB also strongly believes that the LIHTC program would benefit greatly by fixing both credit rates. In addition to the 9% LIHTC, states are allowed to provide credits from their capped allocation for the acquisition of existing property, an important tool for affordable housing preservation. Acquisition Housing Credits are currently set by the floating rate system just like new construction. Applying the fixed floor rate for acquisition housing credits at no less than 4 percent would similarly remove the uncertainty and financial complexity of the floating rate system, simplify state administration, and facilitate preservation of affordable housing at little or no cost to the federal government. According to the National Council State Housing Agencies, acquisition housing credits are less than 10 percent of all allocated Low Income Housing Credits so the incremental additional cost of extending the fixed floor rule to acquisition Credits would be minimal.

Carried Interest

The taxation of a capital gain due to a carried interest is an important issue for the real estate industry and particularly for the multifamily housing sector, including both market-rate rental and Low Income Housing Tax Credit. Under present law, a capital gain classified as a carried interest is taxed like any other capital gain. Carried interest has come under attack for how it is used by the hedge fund industry, but broad attacks on carried interest ignore the key role it plays in real estate development.

The use of partnerships and other pass-thru entities is common in the home building industry and the construction sector generally. In a common arrangement, a builder/developer performs the role of the general partner and outside investors act as limited partners, who provide much of the initial equity financing. Typically, the general partner receives a developer's fee (and possibly subsequent fees for owning and operating the property) and the limited partners receive a specified rate of return on their investment. Any residual profits are split between the multifamily builder/developer/property owner and the investors as defined by the partnership agreement. Of course, the particulars differ depending on the nature of the project, the types of developers, and the role of outside investors.

In many cases, the developer's share of the residual profit, if it is realized (uncertain at the time of the deal), is classified as a "carried interest ," which is an allocation of profit that as a share of total profit exceeds the share of the developer's initial equity investment in the project. [13] The carry can be ordinary income or capital gain, but the current policy debate is limited to a carried interest that is due to a capital gain at the partnership level. Carried interest that is paid as ordinary income is unaffected by the proposals being debated in Congress. Capital gain typically arises in such arrangements through the sale of a tangible, depreciable asset that is held for more than one year. For example, this situation would include a building that was constructed, owned and operated for a period of time and then sold to other investors.

Table 1 illustrates this in more detail for a hypothetical partnership with $100 million in initial equity financing ($95 million from outside interests, and $5 million from the home builder), a 10% preferred return for the limited partners, and a 50%-50% division of residual profit. Under this example, the multifamily developer's capital gain income is a carried interest (portion in excess of 5% - the initial equity stake) and would be subject to additional tax under existing proposals.

Table 1: Illustration of Partnership Income Distributions and Tax Consequences

	Partnership Level	Home Builder: General Partner	Share	Outside Finance: Limited Partners	Share
Equity Invested	$100.00	$5.00	5.00%	$95.00	95.00%
Capital Gains Income: First Distribution	$9.50	$0.00	0.00%	$9.50	100.00%
Residual Capital Gains	$10.50	$5.25	50.00%	$5.25	50.00%
Total Return	$20.00	$5.25	26.25%	$14.75	73.75%
Carried Interest Test under H.R. 4213		26.25% > 5%		73.75% > 95%	
Carried Interest		Yes		No	
Tax Rate under Present Law		15%		15%	
Taxes Paid under Present Law		$0.7875		$2.2125	
Tax Rate under Proposal		35%		15%	
Taxes Paid under Proposal		$1.6375		$2.2125	
Difference in Taxes Paid		$0.8500		$0.0000	

Assumptions:
Dollar amounts in millions
Project yields 20% return over time period
All income is capital gains at partnership level
LPs receive first 10% return
Residual gains beyond first 10% are split 50% each to GP and LPs
Partners face ordinary income tax rate of 35%

Putting aside the tax issues, the carried interest in the above multifamily development example serves two important economic purposes. First, it provides an incentive for the multifamily developer and property owner to control costs and operate the property efficiently in order to generate a profit for the outside investors. This incentive makes the investment more attractive for investors, helping to attract

[13] Note that technically this definition describes both promoted and carried interests. A "promote" is often used to refer to any share of profit allocation greater than the initial equity stake, and a "carry" is a type of promote for which there is little or no equity stake. However, in the current debate, the term "carried interest" now captures all of these scenarios.

investment for multifamily projects, particularly those in higher risk environments, such as economically-distressed areas.

Second, the carried interest transfers business risks associated with the development project to the multifamily builder and owner, who may be more familiar with market conditions and in better position to manage the risks. These risks include changes in administrative expenses, local regulations, and of course local market conditions, which is of particular importance given the existing weakness in many local housing markets. Further, a multifamily developer may assume additional risk by making additional guarantees to the outside investors. For example, the developer can guarantee the completion of the project, or the servicing of debt used to finance the project. Carried interest allows multifamily builders to be compensated for making these guarantees and assuming the risks. Hence, partnerships with carried interest mechanisms are excellent financial arrangements for allowing multifamily developers and outside investors to share business risks efficiently.

Increasing the tax on carried interest for the real estate sector also results in a transfer of tax revenue from state and local governments to the federal government by reducing the value of multifamily investments, thereby lowering property tax collections at the local level.[14] Based on proposals considered by Congress in 2010 which would tax carried interest as ordinary income, NAHB estimated that the total amount of property taxes lost to state and local governments for the real estate sector would be approximately $1.2 billion per year.[15] Given that the federal revenue estimate for the carried interest proposal, at that time, was $24.6 billion, this $12 billion ten-year estimate demonstrates that the proposal generates a significant transfer of tax revenues from state and local governments to the federal government.

NAHB supports the current carried interest tax rules as they apply to commercial and residential real estate. Should Congress decide to make changes to current law, it is absolutely essential that the transitional rules include a grandfathering provision for current contracts. As many multifamily projects are held for years before a gain is realized, a sudden shift in tax policy will have a significant and negative impact on real estate. As a word of caution, Congress failed to include adequate transition rules when it sharply limited the ability of individual taxpayers to claim passive losses in the 1986 tax reform act. As a result, there was a collapse of the commercial and multifamily real estate sectors that ultimately contributed to the S&L crisis.

Depreciation

Rental property can be depreciated on an accelerated timeframe over a period of 27.5 years, versus a 39 year depreciation schedule for commercial real estate. In addition, individual components can be depreciated under various, shorter timeframes through the use of cost segregation rules.

Maintaining a reasonable depreciation period for rental housing is critical. If the period is too long, it will increase costs and make it harder to develop rental housing. Changes to the depreciation schedule

[14] For more detail on how NAHB calculated the impacts, see: http://www.nahb.org/generic.aspx?sectionID=1081&genericContentID=131457#top2

[15] NAHB's analysis was based on H.R. 4213 in the 111th Congress

will impact the financial viability of existing multifamily buildings, which could result in foreclosures and price declines. Depreciation is also a key to attracting outside investors.

For these reasons, NAHB opposes changes to the depreciation rules that would extend the depreciation period of property associated with residential rental property. It is also worth noting that while Congress has enacted and continues to debate the value of various expensing proposals (e.g. bonus depreciation), such rules typically exclude structures such as apartment buildings (property with more than 20 years of economic life).

Owner-Occupied Tax Policies

The Benefits of Homeownership

Homeownership offers a wide range of benefits to individuals and households.[16] These include increased wealth accumulation, improved labor market outcomes, better mental and physical health, increased financial and physical health for seniors, reduced rates of divorce, and improved school performance and development of children. These beneficial financial and social outcomes are due to the stability offered by homeownership, as well as the incentives created by the process and responsibilities of becoming and remaining a homeowner.

An important motivating factor in the pursuit of homeownership is the investment opportunity it offers for many families. Despite recent price declines, equity in a home constitutes a substantial proportion of a typical American family's wealth. According to the 2013 Federal Reserve Survey of Consumer Finances (SCF), the median family net worth of a homeowner is $195,400; for renters, it was $5,400.[17]

Homeownership also provides advantages for seniors. A significant proportion of a household's wealth is in the form of equity of owner-occupied housing, and this wealth provides significant advantages in retirement. Mayer and Simons (1994) indicate that equity in the home and the use of a reverse mortgage could increase liquidity for senior households by as much as 200%.[18]

NAHB analysis of data from the 2010 SCF illustrates the importance of housing wealth, particularly for moderate and low income senior households. For example, for seniors aged 55 to 74 and income of $25,000 to $50,000, total housing assets constituted 48% of household net worth. For those with slightly higher incomes, the importance of housing wealth remained but declines somewhat. Housing is also a significant portion of wealth for seniors above age 75: for those with incomes of $25,000 to $50,000, housing wealth made up 58% of net worth. For lower income seniors above age 75 (incomes below $25,000), housing wealth totaled 55% of net worth.[19]

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[16] R.D. Dietz and D.R. Haurin, The social and private micro-level consequences of homeownership, Journal of Urban Economics 54 (2003) 401-50.
[17] http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf
[18] C. J. Mayer, K. V. Simons, Reverse mortgages and the liquidity of housing wealth, AREUEA Journal 22 (1994) 235-55.
[19] Homeownership Remains a Key Component of Household Wealth. NAHB Economics, 2013.
http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=215073&channelID=311

These data illustrate the importance of housing wealth and suggest caution with respect to policies that would reduce these wealth holdings, based on decisions made over a lifetime, via direct policy changes (such as weakening the section 121 gain exclusion for principal residences) or indirect changes (such as price declines induced by weakening the mortgage interest deduction).

Overall, economists, sociologists and other social scientists have found significant, positive homeownership-related impacts on a large set of outcomes associated with households and communities.[20] For these and other positive impacts, homeownership has and should continue to have a favorable place in the tax code.

Completed Contract Rules

Brief History of the Rules

Under current law, a long-term contract is defined as a building, installation, construction, or manufacturing contract that is not completed by the end of the taxable year in which it is entered into.

Prior to the changes made in the *Tax Reform Act of 1986*, taxpayers could generally elect to account for income and expenses attributable to long-term contracts under the percentage of completion method or the completed contract method. Under the completed contract method, the gross contract price is included in income in the taxable year in which the contract is completed. Under the percentage of completion method, income is taxed according to the percentage of the contract completed during each taxable year.

Certain other limitations and rules applied, and there were additional rules for "extended period" long-term contracts—contracts not expected to be completed within 24 months. An exception to these "extended period" rules was provided for contracts for the construction of real property if the contract was expected to be completed within three years, or if the contractor's average gross receipts for the previous three years did not exceed $25 million.[21]

Changes in the *Tax Reform Act of 1986*

Congress believed that the completed contract method permitted an "unwarranted deferral of the income from those contracts."[22] Specifically, the Joint Committee on Taxation reported to Congress that certain large defense contractors had negative tax rates due to net operating loss carryforwards generated through use of the completed contract method. In response, the *Tax Reform Act of 1986* adopted a modified percentage of completion method that would apply to all long-term contracts.

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[20] Two comprehensive literature reviews detailing the impacts of homeownership are:
W. M. Rohe, G. McCarthy, S. Van Zandt, The social benefits and costs of homeownership: A critical assessment of the research, Research Institute for Housing America, Working Paper No. 00-01 (2000).
R. Dietz and D. Haurin, The social and private micro-level consequences of homeownership, Journal of Urban Economics 54 (2003) 401-50.
[21] General Explanation of the Tax Reform Act of 1986, published by the Joint Committee On Taxation (JCS-10-87), pg. 524-526
[22] Ibid, pg 527

The Act included a modest exception for small construction contracts. Contracts for the construction or improvement of real property, if the contract is expected to be completed within two years, could be accounted for under the previous completed contract rules. However, the exemption was limited to taxpayers whose average gross receipts in the previous three tax years fell below $10 million.

Unintended Impacts on New Home Construction and the Home Construction Contract Exemption

Congress' intent in changing the completed contract rules was aimed largely at defense contractors who were deferring income taxes on projects that had a multi-year contract, such as during the lengthy construction period for an aircraft carrier. Defense contractors generally received substantial progress payments from the government, and taxing these types of contracts under the percentage of completion method is appropriate. In enacting the *Tax Reform Act of 1986*, Congress also attempted to ensure that residential construction was largely unaffected by these changes, as seen by the inclusion of the exception for small construction contracts.

At the time, home builders largely believed these changes did not impact them because their agreements with their customers were viewed as sales contracts, not construction contracts subject to the accounting rules under Section 460. Home sales agreements differed considerably from a typical construction contract, particularly when compared to the contracts a defense contractor entered into with the government. A home sales agreement involves a developer agreeing to sell the home to the buyer in the future, with the developer retaining title to the property and bearing all economic risks until closing, with no progress payments, and typically only backed by a small deposit. Builders normally do not realize any profit until closing, which occurs after the home is constructed.

However, in 1988, the IRS released Advance Notice 88-66, which viewed these sales contracts as long-term construction contracts subject to the new accounting rules. NAHB realized at this time that the protections Congress included through the exemption for small construction contracts fell short.

The IRS was proposing to tax home builders on income they had not yet received. Due to the length of home construction, it is common for a new home to straddle two tax years. This change would mean that home builders would need to significantly alter their business model.

Although buyers put down a deposit, the deposit is generally kept in an escrow account and cannot be used to cover construction costs or tax payments. Moreover, unlike with defense contracts, progress payments are not typical because most homes are financed by a mortgage at closing. If these homes were subjected to the new accounting rules, most builders are very small businesses, so they would be forced to finance the tax payments through a construction loan, which would increase the cost of home construction for the buyer.

The proposed changes would have caused significant cash-flow problems for home builders and imposed a larger barrier for smaller homebuilders who lack the financial means to cover the tax payments. In response, Congress included relief in the conference report for the *Technical and Miscellaneous Revenue Act of 1988* by clarifying in Section 460(e) that "home construction contracts" were not subject to the percentage of completion accounting methods. The conference report describes a home construction contract as one where "80 percent or more of the estimated total costs to be incurred under the contract are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, or improvements to real property directly related to and located on the site of, dwelling units in a building with four or fewer dwelling units[23]."

NAHB believes that Section 460(e) is consistent with both Congress' intent in 1986 to shield the residential construction industry but also with the unique contractual agreements used for home construction. This is a case where a broad definition of "construction" resulted in unintended consequences that were potentially harmful to home builders and buyers alike. NAHB believes that it did not make sense to apply an accounting method to home builders that was really targeted to address other tax problems, and that same rationale continues to support maintaining Section 460(e) as Congress considers tax reform.

Capital Gains Exclusion

<u>Brief History of the Capital Gains Exclusion</u>

Prior to 1997, capital gain due to sale of a principal residence was governed by a complicated set of rollover and exclusion rules.

The *Revenue Act of 1951* allowed a taxpayer to "roll over" the capital gains received from the sale of a principal residence if, within one year, the taxpayer used the gain to acquire a new residence of equal or greater value. The roll over period was later extended to 18 months under the *Tax Reduction Act of 1975* and to 24 months in the *Economic Recovery Tax Act of 1981.* Thus no capital gains taxes were generated until a homeowner purchased a principal residence of smaller value than their previously owned residence or ceased to be an owner of a principal residence.

The *Revenue Act of 1964* introduced the first exclusion of capital gains arising from the sale of a principal residence. Under this law, taxpayers 65 years or older could exclude up to $20,000 in capital gains if they owned the house for at least eight years and lived in the home for at least five. The *Tax Reform Act of 1976* later increased this exclusion to $35,000.

The *Revenue Act of 1978* made a series of additional changes to the tax treatment of capital gains on the sale of principal residence. It lowered the minimum eligible age for the gains exclusion from 65 to 55 and increased the exclusion amount to $100,000. It also allowed a taxpayer to elect a one-time capital gains exclusion on the sale of a principal residence as long as the taxpayer lived in the home for three of the last five years. The *Economic Recovery Tax Act of 1981* increased the $100,000 exclusion to $125,000.

<u>Simplification Arrives: The Changes of 1997</u>

The Taxpayer Relief Act of 1997 vastly simplified the complicated roll over and gains exclusion rules by repealing them and starting over. In their place, Congress allowed a taxpayer to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion could be claimed no more than once every two years. To be eligible for the

[23] H.R. Conf. Rep. No. 100-1104, pg 118

exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange.

These changes represented a significant improvement over what was, according to the Joint Committee on Taxation, "among the most complex tasks faced by a typical taxpayer[24]." As Joint Tax noted, despite the fact that most homeowners never paid tax on the sale of their principal residence due to the previous rollover and exclusion roll rule, it was necessary to keep detailed records of both purchase and sales transactions, but also remodeling expenditures in order to accurately calculate the tax basis of their home. Adding complexity to this recordkeeping requirement was separating expenditures for repair and improvement that added basis to the home and those that did not. Finally, the deferral of gain based on purchasing a more expensive home as a homeowner moved through their lifecycle was also inefficient in that it may have deterred some homeowners from moving from high-cost to low-cost areas.

Congress has adopted one subsequent change that was included in the *Housing and Economic Recovery Act of 2008* (HERA) to prevent speculators from abusing the capital gains exclusion. The 1997 reforms established the "two-of-five" test that defined a principal residence as one where a homeowner had used the home as a primary residence for two years of the five year window prior to sale. This created a scenario whereby an owner of a residence could hold the property for a long period of time, reside in it for two years, and then claim the gain exclusion. While this taxpayer may have owned the residence, they were most likely using it as a rental property for the majority of the years of ownership. This "gaming" of the system was inconsistent with the spirit of the law, which had a focus on principal residence ownership.

The National Association of Home Builders supported the fix Congress passed to prevent a taxpayer from excluding the gain earned during periods of nonqualified use. The HERA change effectively shut down the ability of speculators to use the gain exclusion while protecting the 1997 enacted reduced recordkeeping and calculation requirements.

<u>Impacts from Eliminating the Gains Exclusion</u>

Removing or otherwise weakening the gain exclusion for the sale of a principal residence would have two strongly negative effects for existing homeowners. First, it would lay a direct and unexpected tax bill on homeowners who expected to use housing equity as a source of retirement wealth. Second, weakening the gain exclusion would reduce demand for housing by increasing the lifetime tax burden on principal residences. A reduction in demand would push housing prices down, thereby inflicting a windfall loss on existing homeowners. Of course, since a significant share of homeowner wealth is due to housing equity, eliminating the gains exclusion would have far reaching consequences.

While much of the attention of the tax policy community is on the gain rules for principal residence sales, it is also worthwhile to note the limitations on claiming a tax loss from the sale of a principal residence. In general, a loss incurred on the sale of a personal residence is a nondeductible personal loss

[24] General Explanation of Tax Legislation Enacted in 1997, Joint Committee on Taxation, December 17, 1997, JCS-23-97).

for income tax purposes. It is worth noting this rule is different than losses for the sale or exchange of a financial investment for which the loss can be deducted against capital gains income.

Overall, it is also important to remember that there are various—and sometimes differing—tax benefits and burdens that are levied on investments, both housing and financial. Analysts debating federal tax policy often ignore the state and local government tax burden placed on housing via property tax. Such tax on property value differs from income tax in that the tax is levied on the value of the asset rather than a flow of net income. While housing receives some unique benefits in the tax code, like the capital gains exclusion, housing also faces a tax burden unlike other investments.

With a minimum two year ownership period, the requirement that the home be used as a principal residence, and the closing of the second home loophole in 2008, the gains exclusion is targeted in a manner where real estate speculators or investors seeking a tax shelter will find no benefit. This is a tax benefit aimed exclusively at long-term owners of a principal residence. As a home is typically the largest source of household wealth, the home has become a retirement vehicle for many Americans. In some ways, the capital gains exclusion functions much like a Roth IRA, where the retirement gains are also completely excluded from the taxpayer's income.

State and Local Real Estate Deduction

Brief History of the State and Local Real Estate Tax Deduction

The deductibility of state and local real estate taxes has been part of the tax code since the U.S. income tax code was enacted in 1913. This deduction aligns with a general principle of fair taxation: taxes paid to a local or state government should not be taxed as income by the federal government. If the goal of an income tax regime is to tax changes in wealth, income which is ultimately paid out as a tax does not represent a change in wealth.

Housing is taxed in many ways unlike other investments, particularly via property taxes. While other investments are taxed when sold and the tax is based on their gain in value, housing is the only investment which is taxed annually on the value of that investment, irrespective of any increase in value. This tax burden faced by homeowners is often lost in the federal debate since these revenues are not collected at the federal level. It is not, however, lost on the homeowner paying property taxes. For 2014, total property tax collections by state and local governments summed to $498 billion.[25] NAHB estimates that two-thirds of these collections were due to housing (owner-occupied, rental housing, and land connected to residential development) for a total of more than $300. Data from the Census Bureau and NAHB estimates indicate that the average homeowner pays property tax at an effective tax rate of 1.1% of the home's market value.

Who Benefits from the State and Local Real Estate Deduction?

A common criticism of deductions is that taxpayers in higher income brackets realize a higher dollar benefit from the deduction. This leads some critics of the current tax code to suggest that deductions

[25] http://eyeonhousing.org/2015/03/property-taxes-make-up-40-of-state-and-local-tax-revenues/

are inherently unfair. However, looking at tax fairness in nominal dollars ignores that these higher income taxpayers also pay a larger dollar amount in taxes. NAHB believes that the most even-handed approach to looking at the progressivity of a deduction is as a percentage of a taxpayer's adjusted gross income.

Using IRS data, for taxpayers with an adjusted gross income (AGI) of less than $200,000, NAHB calculated that the average real estate deduction is worth 0.7% of AGI. For taxpayers with an AGI above $200,000, the benefit falls to 0.5% of AGI.[26]

Table 5: Real Estate Tax Deduction

AGI	NAHB Estimates *Based on AGI*				
	Returns		Amount		Average RE Tax Benefit, Percentage of AGI
	Number (Ths)	Share	Amount ($M)	Share	
Under $10,000	4	0%	$0	0%	0.6%
$10,000 under $20,000	757	2%	$107	1%	0.9%
$20,000 under $30,000	2,027	6%	$399	2%	0.8%
$30,000 under $40,000	3,340	10%	$739	4%	0.6%
$40,000 under $50,000	3,940	11%	$1,231	6%	0.7%
$50,000 under $75,000	9,366	27%	$3,747	19%	0.6%
$75,000 under $100,000	7,110	20%	$3,889	20%	0.6%
$100,000 under $200,000	7,342	21%	$6,757	34%	0.7%
200,000+	1,103	3%	$2,918	15%	0.5%
Total	34,989	100%	$19,788	100%	0.7%

Source: 2004 Statistics of Income (SOI), IRS, NAHB Estimates

As a result, elimination of this tax provision would result in a higher tax burden, as measured by a percentage of AGI, on middle class taxpayers.

Another way to look at progressivity in the tax code is to measure the share of the benefit flowing to an income class relative to taxes paid. According to the latest estimates by the Joint Committee on Taxation, 63% of the benefit from the real estate tax deduction goes to taxpayers with an economic

[26] Who Benefits from the Housing Tax Deductions?
http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311

income[27] below $200,000.[28] The same taxpayers pay approximately 30% of all income taxes. Because this class of taxpayers receives a larger percentage benefit relative to their actual taxes paid, by this measure, the real estate deduction increases the progressivity in the tax code.

Using 2004 IRS microdata, it can be shown the degree to which these national averages vary across locations. Nationally, for taxpayers with an AGI of less than $200,000, the mean real estate tax deduction was $3,581. There are significant variances on a state-by state basis: those same taxpayers in Texas had an average deduction of $4,265, while in New Jersey their deduction averaged $7,398. But the principle behind the deduction remains valid 100 years after the first income tax code was adopted: real estate taxes paid should not be considered as taxable income.

Mortgage Interest Deduction

Brief History of the Mortgage Interest Deduction

When Congress created the modern income tax code in 1913, Congress recognized the importance of allowing for the deduction of interest paid on debt incurred in the generation of income. In this early code, taxpayers were permitted to deduct a wide-range of interest from business and personal debts, including mortgage interest. The mortgage interest deduction came into its own after World War II, when home ownership became more accessible and a rite of passage for the middle class. Deductions for mortgage interest grew in absolute numbers, homeownership rates increased during this period, and today two-thirds of American households own a home.[29]

In reforming the tax code in 1986, Congress disallowed the deduction of interest payments for certain types of debt but maintained the popular deduction for mortgage interest. In doing so, "…Congress nevertheless determined that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest."[30] Aside from some adjustments in 1987, the mortgage interest deduction remains unchanged since Congress' historic rewrite of the tax code 26 years ago.

Tax Rules for the Mortgage Interest Deduction

Homeowners may deduct interest from up to $1 million of acquisition debt and up to $100,000 of home equity loan debt. Mortgage debt from the taxpayer's principal residence, as well as a second, non-rental

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[27] It should be noted that the income classifier used by Joint Tax for these distribution analyses is economic income, a definition that generates incomes higher than adjusted gross income (AGI) (for example, economic income includes employer-paid health insurance premiums and payroll tax). Accordingly, these estimates understate the benefits collected by the middle class on the more recognized AGI income definition.

[28] Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018, published by the Joint Committee on Taxation, August 5, 2014, (JCX-97-14) https://www.jct.gov/publications.html?func=startdown&id=4663

[29] U.S. Census Bureau: http://www.census.gov/hhes/www/housing/hvs/qtr211/q211ind.html

[30] "General Explanation of the Tax Reform Act of 1986", Joint Committee Print, Prepared by the Staff of the Joint Committee on Taxation, May 4, 1987. Pg 263-264.

home qualifies. Mortgage interest paid for the purposes of acquiring, building, or substantially improving a qualified home may also be claimed against the Alternative Minimum Tax (AMT).

The $1 Million Cap and Limits to the Mortgage Interest Deduction

Starting with the first tax code in 1913, there was no limit on the amount of home mortgage interest that could be deducted. However, the *Tax Reform Act of 1986* imposed limits on the deduction. This law limited the deduction to interest allocable to debt used to purchase, construct or improve (acquisition debt) a designated primary residence and one other residence.

The Omnibus Budget Reconciliation Act of 1987 further limited the deduction to interest allocable to up to $1 million in acquisition debt. This limit is not adjusted for inflation. Factoring in the impact of inflation, the value of the cap has eroded by half since 1987; in 2013 dollars, the original cap would be equal to just over $2 million.[31]

Who Benefits from the Mortgage Interest Deduction

Within the tax policy circles, there are a number of repeated criticisms of the mortgage interest deduction. Some of these claims are misleading, while others ignore the importance of debt, lifecycle, and geography in attainment of homeownership. NAHB has published a number of papers using Internal Revenue Service Statistics of Income data, estimates from the Joint Committee on Taxation, and general housing data from the U.S. Census to examine these claims.

A common, though misleading, criticism of the mortgage interest deduction is that it is claimed by a relatively small number of taxpayers, and the benefits accrue mostly to higher-income taxpayers. When viewed relative to the reporting of taxable income, the distribution of tax liability, and the use of other tax preferences, these claims lack merit. These inaccurate observations also lead to flawed conclusions regarding the distribution of impacts associated with these housing deductions.

The Mortgage Interest Deduction is Progressive

A progressive tax system is one for which low-income taxpayers pay a smaller percentage of their income in taxes than high-income taxpayers pay. A policy that reduces tax liability for low-income taxpayers lowers their average tax rate and thus makes the income tax system more progressive.

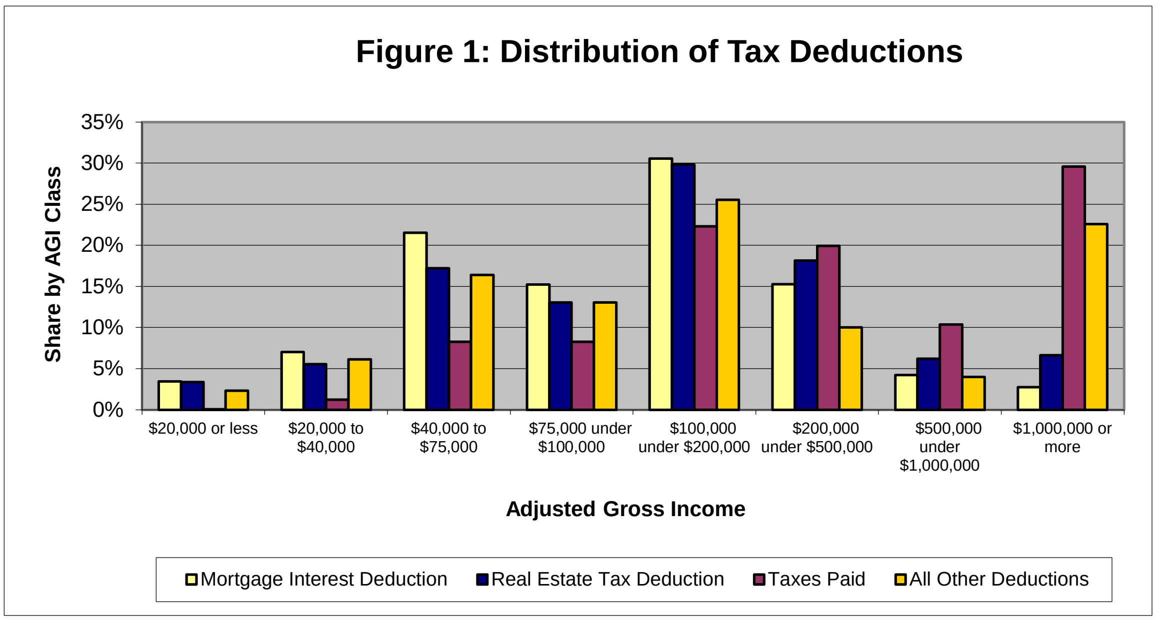
One of the most common erroneous claims we hear is that the mortgage interest deduction is regressive and only benefits the wealthy. Not only is the mortgage interest deduction a middle-class tax break, but it makes the tax code more progressive. According to the distributional tax expenditure estimates from the Joint Committee on Taxation (JCT), 82% of mortgage interest deduction beneficiaries earn less than $200,000 in economic income. And using the JCT estimates and IRS data, NAHB estimates

[31] Bureau of Labor Statistics CPI Inflation Calculator. $1,000,000 in 1987 equates to $2,066,215 in 2015. http://www.bls.gov/data/inflation_calculator.htm

that 75% of the tax benefits are collected by homeowners with economic income of less than $250,000, yet these same taxpayers pay only about 30% of all income taxes.[32]

One way of measuring progressivity is as a percentage of income. Using 2004 IRS data, NAHB calculated that for taxpayers with AGI less than $200,000, the mortgage interest deduction is worth on average 1.76% of AGI. For taxpayers with AGIs above $200,000, it is worth less, only 1.5% of AGI. [33] Not only is the benefit of the mortgage interest deduction realized predominantly by the middle class, but the data clearly shows that the benefit declines in value as a percentage of income as income rises.

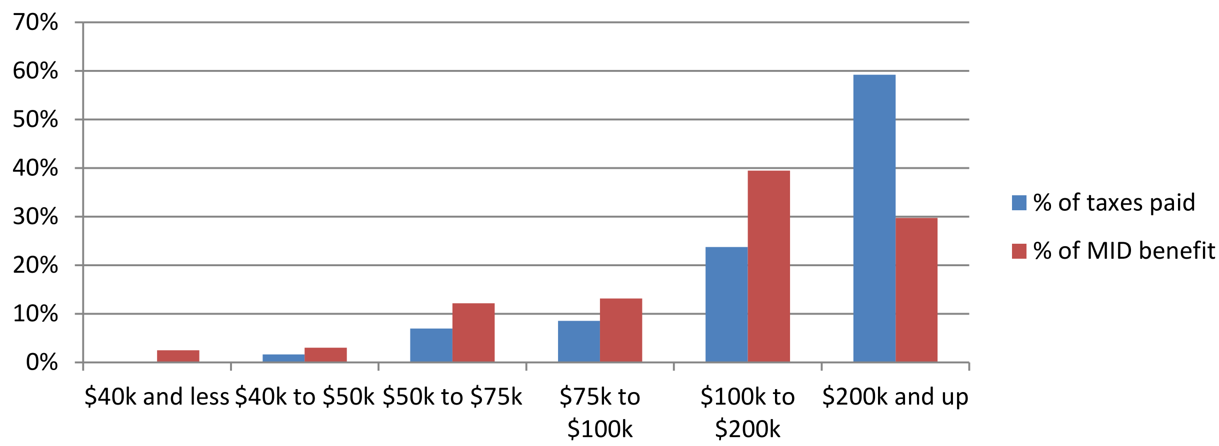
As seen in the chart below, Figure 1, using 2005 IRS data, illustrates the critical point when considering the income distribution of the housing tax deductions relative to other tax expenditures.



The progressive nature of these tax preferences can be seen by noting that claims of the mortgage interest deduction (as well as the real estate tax deduction) exceeds final tax liability for AGI classes up to $200,000. Figure 1 presents deduction amounts, but it can also be seen for the final distribution of tax benefits (i.e. tax expenditures) relative to taxes paid. Figure 2 demonstrates this with 2009 JCT data. Again, the benefit of the mortgage interest deduction exceeds taxes paid for income classes up to $200,000.

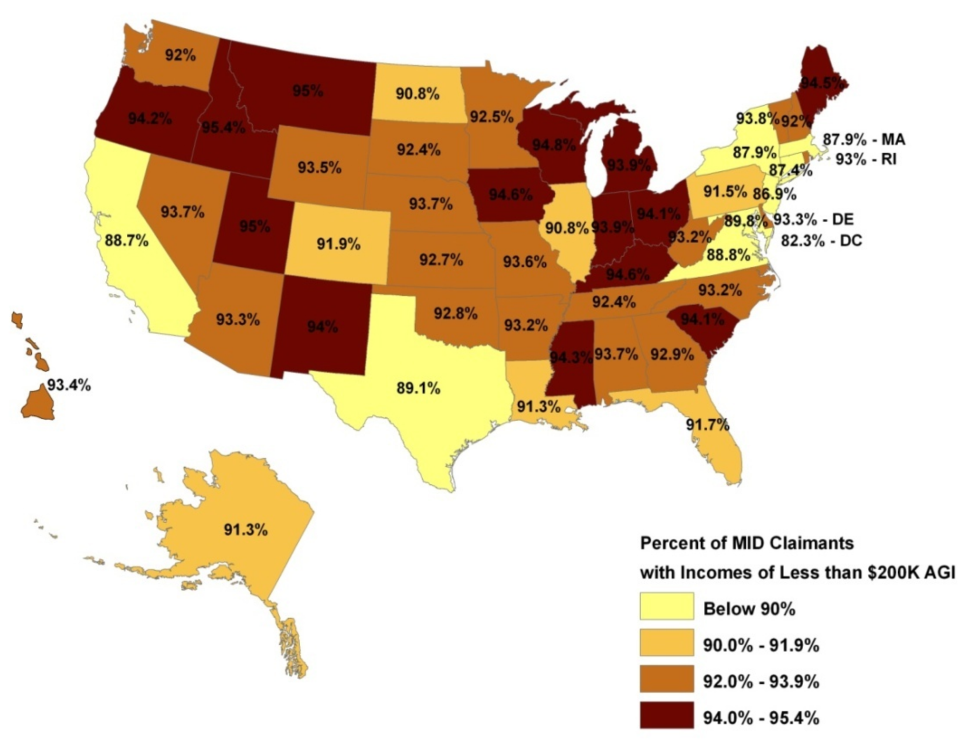
[32] Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018, published by the Joint Committee on Taxation, August 5, 2014, (JCX-97-14) https://www.jct.gov/publications.html?func=startdown&id=4663
[33] Who Benefits from the Housing Tax Deductions?
http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311

Figure 2: Distribution of Taxes Paid and MID Benefit: 2009



Using 2010 tax year data, NAHB has further broken down the distributional data to examine how many taxpayers, with AGI below $200,000, claim the mortgage interest deduction, by state:

Percentage of MID Claimants with Incomes of Less than $200K AGI



These numbers range from a low of 82.3% in Washington, DC, which is a small geographic area with high housing costs and high incomes, to a high of 95.4% in Idaho. In large part, there is little variance from state to state, with nearly all states ranging from 88% to 93%. The data is clear that the mortgage interest deduction is overwhelmingly a middle class deduction, regardless of where a homeowner lives.

It is worth noting a technical point about all of these distribution claims. First, the JCT analysis use economic income, which includes items many people would not consider "income," thus placing them in a higher income class than they would expect. Examples would be employer paid payroll tax and employer paid health insurance.

Second, these are ***household*** income measures. Thus, married couples with dual incomes are going to be concentrated at the top. Given the connection between marriage and homeownership, it is important to keep in mind what household economic income illustrates. For example, the median household cash income for married couple with children in 2012 was $98,104.[34]

<u>The Majority of Homeowners Will Claim the Mortgage Interest Deduction</u>

Another misleading claim is that few homeowners benefit from the MID because itemization is required. Opponents of the mortgage interest deduction note, for example, that only a quarter of tax filers itemize, leading some to conclude that only a small percentage of homeowners claim the MID. This is false.

The most important determinant of taxpayer itemization is homeownership. JCT data reveal that 34.9 million taxpayers claimed the MID for tax year 2014. While this number represents 21% of all tax returns and more than 70% of itemizing returns, the more relevant numbers are the shares of homeowners. There are nearly 75 million homeowners in the U.S., so approximately half *in a given year* claim the MID. However, approximately 25 million of that 75 million own their homes free and clear of a mortgage (but likely benefited from the MID in the past). This means of the <u>homeowners with a mortgage</u>, more than 70% claim the MID.

Of those who do not, most are older homeowners in the later years of the mortgage when they are paying relatively more principal and relatively less interest. For these homeowners, the standard deduction is a better option.

Using Bureau of Economic Analysis data, NAHB estimates that for tax year 2012, 90% of all mortgage interest paid has been claimed as a deduction on Schedule A. Clearly, the mortgage interest deduction is broadly claimed. It is also important to keep in mind that taxpayers benefit from the homeownership tax deductions at specific times during their lives. And cumulatively, these numbers illustrate that <u>over the tenure of homeownership, almost all homeowners will claim the MID for years at time</u>, particularly as first-time homebuyers paying large amounts of interest and relatively little principal.

As an analogy, consider the following non-housing example. The 2005 IRS SOI data reveal that only 8 million taxpayers benefited from the tax code's interest deduction for student loans. This represents approximately 6 percent of all taxpayers. Nonetheless, the student loan interest deduction is, like the mortgage interest deduction, a tax preference claimed at a particular time in an individual's life, and

[34] http://eyeonhousing.org/2014/04/characteristics-of-owners-and-renters/

does not represent a tax preference that benefits only a narrow set of taxpayers, despite its low number of claimants in a single year. Similarly, in recent years, only a quarter of taxpayers in a given year claim the child tax credit. But this is not a complete description of lifetime claims of the credit.

Family Size Matters

The lifecycle aspects of homeownership also produce another interaction with housing tax preferences. It is often claimed that the mortgage interest deduction encourages homeowners to purchase a larger home. This presents a rather narrow view. Homeowners with a larger family need a larger home and will therefore have a large mortgage interest deduction. The need for a larger home created the larger mortgage interest deduction, not the other way around. And NAHB analysis of prior SOI data confirms this.[35] Taxpayers with two exemptions – a proxy for size - who claimed the MID had an average tax benefit of $1,500. Taxpayers with four exemptions had an average benefit of approximately $1,950. In fact, the benefit increased correspondingly from one exemption to five-plus exemptions, which is intuitive with the notion that larger families require larger homes.[36] Moreover, the cost of living, particularly for housing, varies greatly from city to city, so what may appear to be a large deduction for a given home in one area, may in fact reflect a modest home in a high cost area. Indeed, the MID and the real estate tax deductions reflect one of the few elements in the tax code that account for differences in cost-of-living.

And Age Matters

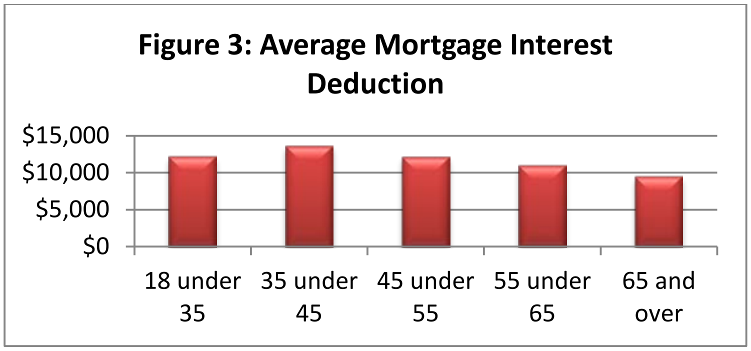
Along with the lifecycle associated with family size, we also see a direct correlation between the age of the homeowner and their resulting benefit from the housing tax incentives. Unlike other itemized deductions, the total benefits of housing-related deductions, such as the mortgage interest deduction, generally *decline* with age. After all, it is younger households who typically have new mortgages, less amount of equity, and growing families.

Using IRS data, NAHB has examined the age characteristics of taxpayers claiming the mortgage interest deduction. Figure 3 plots the average mortgage interest deduction[37] by age cohort.

[35] Who Benefits from the Housing Tax Deductions?
http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311

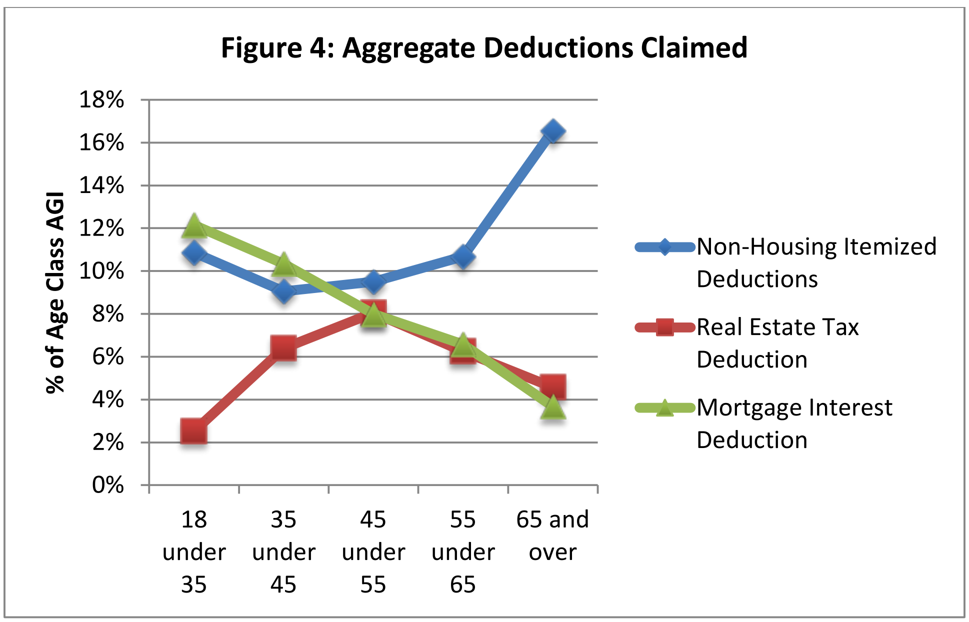
[36] The data also show that income rises with the number exemptions for those claiming the MID. For taxpayers with AGI less than $50,000 who claim the MID, the mean number of exemptions was 2.01 in 2004. It was 2.57 for those with AGI $50,000 to $75,000, 2.89 for those with $75,000 to $100,000 in AGI, and 2.98 for those between AGI $100,000 and $200,000 and 3.03 for those above these AGI levels.

[37] This includes the deduction for home equity loans and real estate tax deductions. See Housing Tax Incentives: Age Distribution Analysis, by Robert Dietz, May, 2, 2010.
http://www.nahb.org/fileUpload_details.aspx?contentID=149284&fromGSA=1



This is consistent with the deduction for mortgage interest peaking soon after the taxpayer moves from renting to homeowning and then declines as homeowners pay down their existing mortgage debt.

Figure 4 shows this data as shares of AGI. The data reveal that the mortgage interest and the real estate tax deductions fall as a share of taxpayer income for older taxpayers.



As a share of household income, the largest benefit goes to those aged 18 to 35. Together, this data highlights the fact that the mortgage interest deduction strongly benefits younger households who tend to be recent homebuyers with less home equity.

The importance of this deduction to younger buyers can be seen by looking at the United Kingdom.[38] In the 1980s and 1990s, the U.K. phased out its mortgage interest deduction. Some opponents of the

[38] Analysts often make cross country comparisons when discussing the MID, noting differences or similarities in homeownership rates. We note that there are multiple factors that determine the homeownership rate, which is the number of homeowning households divided by the number of households. Thus policies that discourage household formations can have complicated impacts. Additionally, factors like average population age (older populations will have more homeownership) and urbanization rates (more urbanized nations will have lower homeownership) matter as well. For example, the U.S. is a "younger" nation (36.9) compared to the U.K. (40.5) and Canada (40.7). The U.S. is also more urbanized (82.4%) than the U.K. (79.6%) and Canada (80.7%).

mortgage interest deduction cite the U.K. when calling for eliminating the deduction in the U.S. However, the changes in the U.K. have had a dramatic impact on younger homebuyers. In the UK, among households aged 25 to 34, the homeownership rate fell from 59% in 2003 to 36% in 2014 according to the data reported in the Economist magazine.[39]

NAHB believes that any policy change that makes it harder to buy a home, or delays the purchase of the home until an older age, will have significant long-term impacts on household wealth accumulation and the makeup of the middle class as a whole. Delayed investment in homeownership may translate into lower assets at retirement or a later retirement. It is also worth noting in this vein that the largest homeownership declines as a result of the Great Recession have occurred among younger homeowners. This has two causes. One, fewer households are being formed as younger individuals double up or, as a second reason, such individuals choose to live with their parents or other family. NAHB estimates that in recent years 2.1 million households have not formed for these reasons, and thereby constitute "pent-up housing demand." The Census Bureau has found similar estimates.[40]

Given that the MID offers large benefits, as a share of household income, for younger homeowners, the loss of this benefit will only make homeownership less-accessible to those younger households who have been devastated by the ongoing housing crisis. Weakening the mortgage interest deduction, particularly in high cost areas (which are high cost because housing demand is high, typically because jobs are in supply), means shutting out younger, aspiring middle class Americans from homeownership, which could have far reaching social and economic outcomes.

When evaluating options for tax reform, NAHB would urge the Committee look beyond the typical income distribution analysis. The conclusions presented here suggest that proposals to change these deductions should also examine the generational or age-cohort consequences. Generational impacts are not typically discussed by tax policy analysts in lieu of traditional income distributional analysis, but the long-term effects are potentially significant. This is why NAHB believes that part of designing a fair tax system involves looking at the effects on both income distribution and across age groups.

Home Prices, Affordability, and Household Net Worth

Most studies find that elimination or significant weakening of the mortgage interest deduction would reduce prices for owner-occupied homes, perhaps by as much as 15% depending on local market conditions (average income, housing supply response, and other economic factors).[41] The exact amount depends to a great degree on how much of the tax benefit is capitalized into prices, which in turn depends on the ease of home builders to provide additional housing units. In markets where new

[39] http://www.economist.com/news/britain/21645735-david-camerons-housing-policies-are-all-posturing-weak-foundations?frsc=dg|d

[40] http://blogs.census.gov/censusblog/2011/09/households-doubling-up.html

[41] Some recent analysis suggests that recent data yield uncertain price effects. This has been interpreted incorrectly by some as suggestive of no price impact. This is incorrect. The inconclusive results are just that – inconclusive – given the historic movements in price and interest rates in recent years. NAHB looks to studies of older periods with less statistical noise as better guides of policy impact.

supply is difficult to add, the capitalized value may be large. In markets where new supply is easier to add, the capitalized value may be small.

This is important because one claim made by opponents is that eliminating the deduction would cause prices to fall and affordability to increase. But this claim ignores the role that debt plays in buying a home. If the after-tax cost of servicing the mortgage increases due to the removal of the interest deduction, the cost of homeownership can actually rise even as the price of the home falls. For example, assume a married couple earning $90,000 and in the 25% tax bracket. Suppose the household buys a $200,000 home and puts down 20% ($40,000). They obtain a $160,000 mortgage at a 5% interest rate. In the first year of their mortgage, they will pay approximately $2,159 in principal and $7,289 in interest.

Now the value of their mortgage interest deduction is based on the amount of the interest payment that exceeds the difference between the standard deduction and the sum of their other Schedule A items. If the sum of their Schedule A possible deductions is less than the standard deduction, they of course do not itemize. If only $1,000 of mortgage interest exceeds the standard deduction, when stacked on top of all other itemized deductions, then only that $1,000 yields a tax benefit from the MID.

Using 2009 Statistics of Income data from the IRS, we can estimate reasonable values of these itemized deductions for a taxpayer in this income class. Assume the couple pays $4,500 in state/local income taxes, $2,200 in property taxes (Census data indicate an average 1.1% effective tax rate on homes), $2,500 for charitable deductions, and a little more than $1,500 for all other Schedule A items. This yields a total of $10,700 for non-mortgage interest deduction Schedule A items, and total deductions of $17,989.

To properly account for the tax benefit from the mortgage interest deduction, we subtract the 2009 values of the standard deduction for a married couple ($11,600) from the total of non-mortgage interest deductions ($10,700), for a difference of $900. The mortgage interest deduction benefit should then be reduced by $900 to a total of $6,389 in order to estimate the realized benefit: $6,389 times 25% or $1,597.

Suppose, as a counterfactual, the mortgage interest deduction has been eliminated and home prices fall by 10%. The couple now purchases a revised priced $180,000 home. They use a 20% downpayment and obtain a mortgage of $144,000 at a 5% interest rate. They now pay $6,560 in interest and $1,943 in principal in the first year.

Despite the 10% decline in price, the total cost of servicing the debt for the home increased. The after-tax interest payment in the MID regime is $5,692 ($7,289 minus the $1,597 MID benefit) compared to $6,560 with no MID and a 10% price reduction. In other words, despite the price decline, the after-tax user cost of the home actually increased $868.[42] And all existing homeowners suffered a 10% windfall loss to housing wealth due to the price decline. The winners from this policy change are cash and investor buyers, who are not the typical owner-occupants that generate and collect the private and social benefits of homeownership.

[42] If principal payments, which represent savings, are included, housing costs increase by $652.

Besides affordability, price declines would affect net worth of homeowning households. Even small price shocks can have huge impacts on housing wealth. According to the fourth quarter 2014 Federal Reserve Flow of Funds, household owned housing real estate totaled $20.6 trillion.[43] At these levels, a one percentage point decline would wipe out $206 billion in wealth. A 5% decline would eliminate more than a trillion dollars of homeowner wealth. And a 15% decline would destroy more than $3 trillion of housing asset value. These are not trivial numbers, even at the low end. Even opponents of the MID acknowledge these points. The message is clear. Raising revenue through weakening of the MID is an expensive way to raise tax revenue, in terms of effects on homeowner wealth, and the resulting spillover effects in terms of reduced consumption by these households and reduced property taxes for state and local governments.

Second Homes and the Mortgage Interest Deduction

Tax Rules for the Second Home

Homeowners may deduct interest payments on up to two homes in a given tax year: a primary residence and one other residence. The amount that may be deducted is still limited to the combined cap of $1 million in acquisition debt. A second home is one that is not rented[44] and is not the homeowner's primary residence. In addition, a second home can also be a home under construction for which the homeowner has an outstanding construction loan.

When is a Second Home not a Second Home?

In practice, the second home deduction is important for many households who in fact do not think of themselves as owning two homes. For example, the second home deduction facilitates claiming the mortgage interest deduction during a period of homeownership transition, such as when a family relocates and will own two separate principal residences in a given tax year—even if both homes are not owned concurrently. Without the second home MID, this family would only be able to claim an interest deduction on a portion of their total mortgage interest payment. This would not only act as a tax on moving, but it could distort consumer behavior by discouraging relocation or leading to homeowners moving only at the start or end of a tax year in order to minimize the tax implications.

Further, the second home rules allow up to 24 months of construction loan interest on a newly-constructed home to be claimed while the family resides in their existing principal residence.[45] This rule provides parity for custom home building where the eventual homeowner finances the cost of construction. This form of construction is a larger share of home building today due to the recent decline in the housing market. While both of these issues are technical and easily fixed as part of transition, NAHB raises them for consideration because no reform proposal that eliminates the second

[43] http://eyeonhousing.org/2015/03/u-s-household-balance-sheet-improves-again/

[44] Interest on debt used to acquire rental units may also in general be deducted under the tax code, but not under the mortgage interest deduction; it is a general business expense.

[45] Treasury Regulations 1.163.

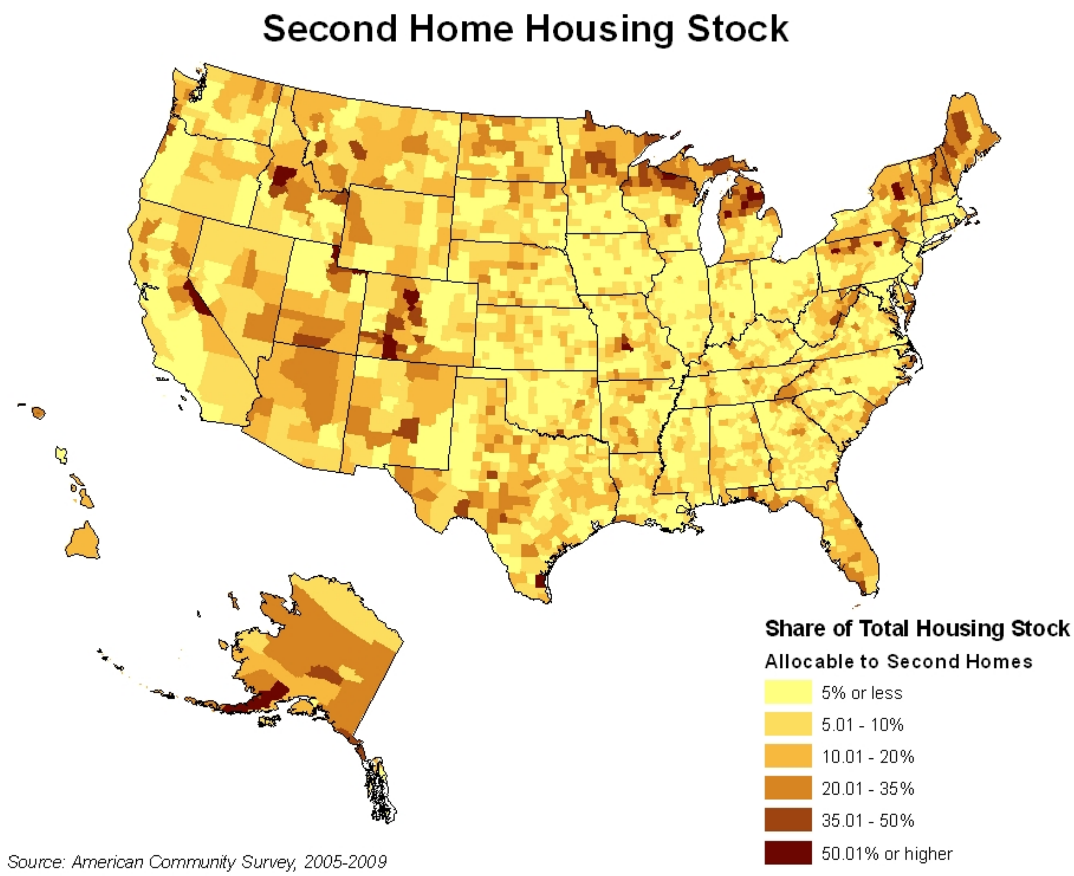
home deduction has ever considered the implications on homeowners who move or take on a construction loan.

The Geographic Distribution of Second Homes

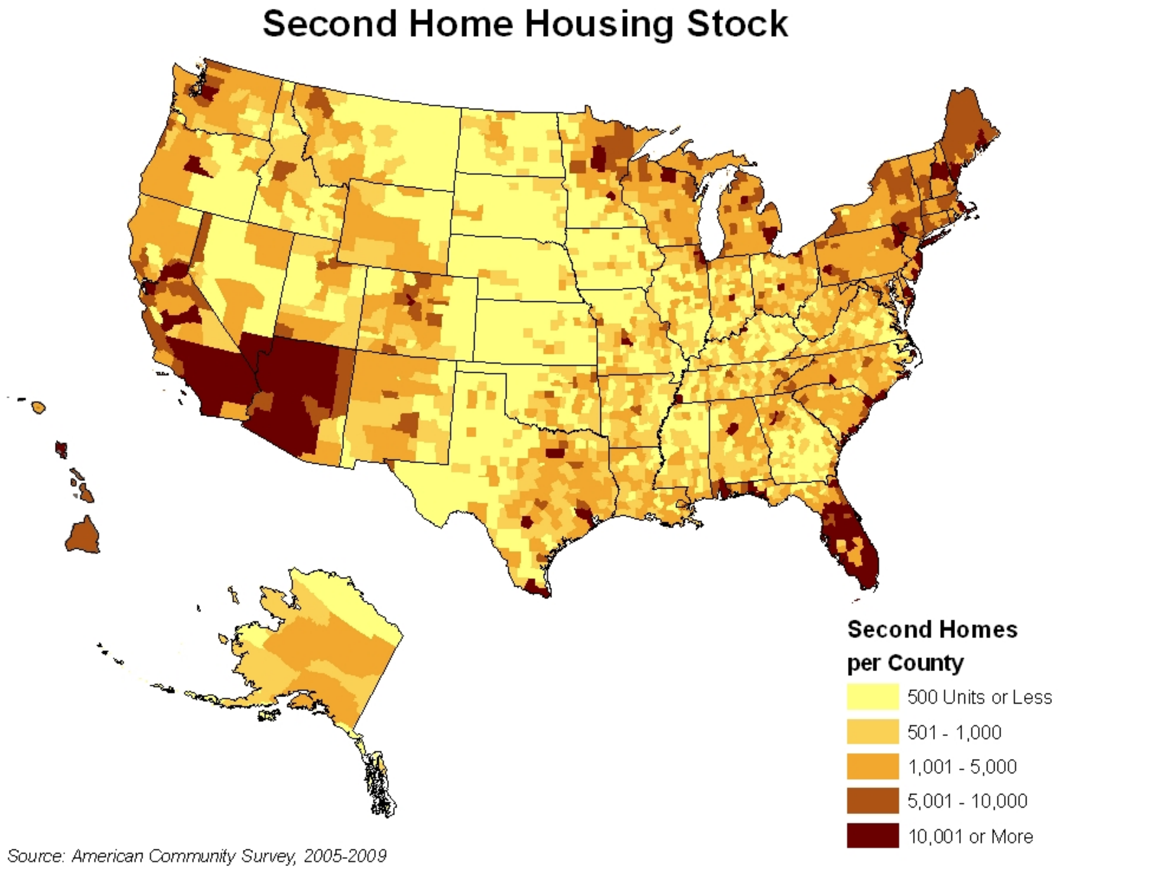
NAHB estimates using 2009 Census ACS data that there are 6.9 million non-rental second homes, which totals more than 5% of all housing units in the United States. When most Americans think of second homes, thoughts typically go to expensive beach homes. However, such homes are more likely to be owned by higher-income families who own the home free and clear of a mortgage—or rent out the home, in which case the owner does not claim the mortgage interest deduction. The face of the typical second home owner is more varied than most realize.

Using Census data, NAHB estimated the stock and share of such tax definition-based second homes and the results contrast with the stereotyped view of the second home mortgage interest deduction favoring beach homes. Nearly every state has areas with significant numbers of second homes; 49 states have a county where at least 10 percent of the housing stock consists of second homes.[46] The data showed 26 counties where 50 percent or more of the housing stock is second homes. Six of those counties are in Michigan; five in Colorado, two each in Pennsylvania, Utah, Massachusetts, and California, and one each in New York, Alaska, Idaho, Missouri, Wisconsin, Texas, and New Jersey. As the next map shows, second homes are found throughout the country.

[46] Connecticut is the only state that did not have at least one county where 10 percent of the housing stock was a second home.



It is also important to look at geographical breakout based on aggregate numbers of second homes. Dense urban areas may have a significant number of second homes but they may represent only a small number of the total housing stock. In fact, there are 12 states with at least one county with 25,000 or more second homes: Florida, California, New Jersey, New York, Texas, Delaware, Michigan, South Carolina, Nevada, Massachusetts, Illinois, and Arizona. The next map illustrates the count of second homes throughout the country.



An examination of the geographic location of second homes also shows that most second homes are located in areas of the country that are generally affordable. Based on this observation, NAHB believes that homeowners using the second home deduction for a vacation home may have lower incomes than commonly recognized. Because the IRS does not require homeowners to differentiate between principal and second home mortgage interest on their tax forms, there is no IRS data available. However, NAHB has used the Consumer Expenditure Survey released by the Bureau of Labor Statistics to match the average household income to homeowners who have a mortgage on a second home. According to NAHB's analysis, the average household income is only $71,344. This is, frankly, significantly lower than many would expect. And for homeowners living in high cost areas, such as Washington, DC, or New York, having two homes at this income level may appear unfeasible, but for many areas of the country, it is possible. And the maps above correspond with many of those affordable markets. In fact, according to a 2014 survey published by the National Association of Realtors in 2015, the median sales price of a second home was just $150,000.

Clearly, the issue concerning second homes and the mortgage interest deduction is more complicated than many expect. Repeal of the second home mortgage interest deduction rules would impact large sections of the country and nearly every state. There would be negative economic consequences throughout the nation in terms of lost home sales, home construction, as well as price impacts. And those price declines would of course be more significantly realized in those areas of the country for which second home ownership is more common. As home values directly correlate with property taxes, repealing the second home mortgage interest deduction would not just touch the homeowner, but the broader community, as local governments would face additional revenue shortfalls. This is particularly important as many impacted communities lack a diverse tax base, and second homeowners are the ideal taxpayers, often paying a higher property tax rate while not placing heavy demands on local government services.

Home Equity Deduction

Present tax law also permits homeowners to deduct interest allocable to up to $100,000 of home equity loan debt. Such loans are defined as mortgages that are either used for purchase, construction or improvement purposes or as a means to access equity. The type of use of the home equity loan is important in the rules for the Alternative Minimum Tax. In general, deductions for mortgage interest may be claimed against AMT taxable income. However, interest on home equity loans **not** used for home improvement purposes may not be claimed against AMT tax liability.

According to the 2009 American Housing Survey, half of all home equity loans are used for remodeling purposes. Remodeling is, of course, another form of housing investment which creates jobs and improves the nation's housing stock, particularly with respect to energy efficiency. Disallowing a deduction for interest for home remodeling provides a disincentive for homeowners to improve the nation's existing housing stock and hurts job creation in the remodeling industry.

There is no data that indicates what the remaining half of home equity loans are used for, but anecdotal evidence suggests that those purposes include college expenses, health emergencies and some consumption purposes.

Remodeling and home improvement are important economic activities for a nation with an aging housing stock. Remodeling expenditures totaled $147 billion for professional remodeling jobs, according to 2009 American Housing Survey data. Every $100,000 in remodeling expenditures creates 0.89 full-time equivalent jobs according to NAHB estimates.[47] So this economic activity supported 1.31 million jobs in the construction and related sectors (such as manufacturing and retail).

<u>How Voters View the Housing Tax Incentives</u>

On behalf of the National Association of Home Builders, Public Opinion Strategies and Lake Research Partner conducted a national survey of 2,000 likely 2012 voters. The survey was conducted May 3-9, 2011, and has a margin of error of +2.19%. Due to the large sample size of our survey (2,000 respondents compared to the typical political survey ranging from 900 to 1,200), we are able to show key data among both homeowners and renters.

[47] http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=227858&channelID=311

Despite the housing crisis, the survey results showed that owning a home is still very much a part of the American dream. Americans believe that owning their own home is as important as being successful at their job or being able to pay for a family member's education. Seventy-five percent of Americans said that owning a home is worth the ups and downs of the housing market, and 67 percent of renters say that owning a home is the best long-term investment they can make. In fact, 73 percent of voters who do not currently own a home say that it is a goal of theirs to eventually buy one. This is even higher when looking at the 18 to 54 age bracket, where 83 percent aim to eventually buy a home.

When looking at the housing tax incentives, Americans across party lines believe it is appropriate and reasonable for the federal government to provide tax incentives to encourage homeownership; 73 percent agree this is a good idea. And a strong majority of voters oppose eliminating the home mortgage interest deduction, with 71 percent opposed.

Although the housing market continues to struggle in this economy, for many Americans, owning a home is part of their American dream, and the housing tax incentives play an important role in making that dream come true.

Conclusion

NAHB is an organization that represents all facets of the residential construction industry, including for-sale builders of housing, multifamily developers, remodelers, manufacturers, and other associate members. As such, NAHB defends housing choice. While homeownership offers communities and households numerous benefits, it is important to recognize that for every family there is a time to rent and a time to own a home.

For these reasons, NAHB also supports policies that promote a healthy rental housing sector, including support for the Low-Income Housing Tax Credit, which was created as part of the *Tax Reform Act of 1986* and has become a successful public-private partnership that assists in the development of affordable housing.

Since most homeowners benefit from the mortgage interest deduction, and most of that benefit flows to younger, middle class families, making homeownership less accessible is likely to diminish the financial success of future generations. And as owning a home is a significant means for savings for most homeowners, the capital gains exclusion protects that investment. Without the mortgage interest deduction, NAHB believes that disparity in economic income would increase, and the middle class would continue to shrink.

Homeownership is the major path to wealth for the middle class. We believe that any policy change that makes it harder to buy a home, or delays the purchase of the home until an older age, will have significant long-term impacts on household wealth accumulation and the makeup of the middle class as a whole.

Unfortunately, none of us have to guess what will happen if we have a prolonged decline in home prices. We have lived it. The housing market is still recovering from a depression, and further weakening demand, or increasing user costs, will further restrict economic growth or risk sliding back into another recession.

Many in Congress have looked back to the tax reform efforts in 1986 as a guide forward for today. And there are some important lessons to remember from that experience. First, it is possible to achieve those low rates and maintain strong incentives for housing. But we also saw for commercial and multifamily real estate the perils of significant tax policy changes. Most economists agree that the changes in the 1986 Act led to a crisis in commercial and multifamily real estate. How housing is dealt with in tax reform will shape the economy moving forward. Housing can be a key engine of job growth that this country needs.

NAHB supports the goal of many in Congress to reform the tax code. NAHB believes that lower rates, simplification, and a fair system will spur economic growth and increase competitiveness. And that's good for housing, because housing not only equals jobs, but jobs means more demand for housing. To foster that virtuous cycle for economic growth, we believe strongly that you must look upon changing the homeownership tax incentives with caution. As the Committee moves forward on tax reform, NAHB wants to be a constructive partner and help the committee with this important issue.