# The Tax Reform Act: Mortgage Interest and Housing Capital Gains

## Changes in the Mortgage Interest Deduction

In assessing this feature of the new Tax Act, it’s important to remember the status quo – or current policy. At present, individuals are allowed to deduct the interest on mortgage debt that does not exceed 1 million. That can be any combination of mortgage debt (of any kind) on one’s primary home as well as on a 2nd home. Given current average leverage ratios, that means that homes worth more than about 1.5m are already under a cap: buy a bigger home than that and the interest deduction will not increase. Hence the cost of buying a larger home currently takes a noticeable increase around this value.

At the other extreme, as many as half of new homebuyers often decide not to even itemize their deductions – and hence take advantage of mortgage interest deductibility. In many parts of the country, a “starter” home with 80% LTV will involve a mortgage of only 200k. At today’s rates the annual interest on such a loan is around $6000. Without significant other deductions, itemization may simply not be worth it. Still not convinced? Several recent studies have shown econometrically, that states with income taxes which mimic the Federal tax (and hence have an extra combined interest deduction) do not have more 1st time buyers than those in states that do not allow the extra deduction. This has cast much doubt on claims that the interest deduction helps to promote homeownership. And if that’s its rationale, why extend the deduction to 2nd homes? How does that help homeownership?

More and more economists now realize that the current policy mainly assists upper middle income households in buying larger and better homes up to the 1.5m range.

## The extended holding period for the capital gains exclusion.

Currently, the treatment of housing capital gains in the tax code is also extremely generous: a couple can exclude up to 500k in capital gains when they sell their home. More importantly they can take this exclusion *repeatedly every two years*. Hence with proper planning long term home appreciation totally escapes capital gains taxation. Live in a home until it appreciates to the $500k cap, then sell and move to a similar home down the street… repeat. A nice incentive to move a little more often! And once again this advantage mainly accrues to households buying and selling more expensive housing.

In the current bill, the exclusion period is lengthened to 5 years, which clearly is less of an incentive to move for the sake of avoiding taxes. Perhaps in the end that’s a good thing.

So keeping score: extending the capital gains holding period is probably good, while reducing the cap on the mortgage interest deduction does little for homeownership and mainly reduces a long standing entitlement for upper middle income households to own larger homes.