The Late Great Mortgage Interest Deduction

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With the possibility of tax reform and tax cuts right around the corner, it is important to understand how the proposed doubling of the standard deduction will impact households and will essentially render the mortgage interest deduction irrelevant for almost all US home owners!

The current Republican plan raises the standard deduction from $6,350 to $12,000 for single filers and from $12,700 to $24,000 for married couples filing jointly. While the much larger standard deduction looks very advantageous, the new tax plan eliminates the personal exemption, which is currently $4,050/person. This means that the increase in tax-free income rises by just $1,600 ($12,000 - $6,350 - $4,050) for single filers and by $3,200 ($24,000 - $12,700 - $8,100) for married couples filing jointly. While these sums are not trivial, they are also not as large as advertised.

The Unified Framework developed by the White House and the Republicans also proposes eliminating all itemized deductions except for mortgage interest and charitable donations, and state and local property taxes up to a cap of $10,000. While this appears to largely maintain the status quo, think again. Traditionally, tax filers added up mortgage interest, charitable donations, state and local taxes, and healthcare expenses. If those deductions (the most commonly used) collectively exceeded the standard deduction, itemizing would make sense and one's tax burden would decline.

Now, not only is the standard deduction almost doubling, but the deductibility of state and local income taxes and healthcare expenses is being eliminated. This means that to itemize, the sum of mortgage interest paid, charitable contributions, and property taxes must exceed $24,000. Few married couples hit that threshold. I estimate that no more than 6 percent of all households will itemize under the proposed plan compared to about 27 percent today.

Moreover, the deductions of those who will still itemize will be worth less than before. This is because the tax advantage of itemizing depends entirely upon how much one's itemized deductions exceed the standard deduction and one's marginal tax rate. Given the increase in the size of the standard deduction, the amount by which one's now smaller itemized deductions exceed the newer, higher standard deduction will necessarily fall. And, as lowering tax rates is a part of this plan, the after-tax tax savings from itemizing will necessarily decline as well.

As for the mortgage interest deduction, I estimate that the percentage of households that currently own their home and will still be able to deduct mortgage interest will fall from the current level of about 33 percent to about 7 percent.

Here is an example to show why. Suppose a husband and wife have $20,000 in itemized deductions including $8,000 for state and local income taxes, $2,000 in charitable donations, $2,000 in property taxes, and $8,000 for mortgage interest. By itemizing now, that couple can reduce their taxable income by an additional $7,300 ($20,000 minus $12,700, the current standard deduction). If in the 25% tax bracket, the tax savings on that additional $7,300 are $1,825. But, as state and local income taxes will no longer be deductible, this couple would then only have $12,000 in deductible expenses. As that is lower than the $24,000 standard deduction, they would not itemize despite paying $8,000 in mortgage interest.

This inability to deduct mortgage interest, despite it being technically deductible, will make home ownership slightly less appealing, and that will reduce the demand for home ownership, thus lowering house prices. To be specific, house prices are likely to fall by between 5 percent and 10 percent, with the decline increasing the more expensive the house and the higher the bite taken by both state and local income taxes.

By nearly doubling the standard deduction and doing away with several key itemized deductions, the proposed Republican tax plan will, if it becomes law - and that is still a big "if" - reduce the value of itemizing and the mortgage interest deduction even though mortgage interest will remain deductible. And that will lower house prices.

**Have a wonderful Thanksgiving, a merry Christmas and a happy 2018 and see you in January! (Remember, I will not be writing an article in December).**

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