PRESENT LAW, DATA, AND ANALYSIS RELATING TO TAX INCENTIVES FOR RESIDENTIAL REAL ESTATE

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on April 25, 2013

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION AND SUMMARY

The House Committee on Ways and Means has scheduled a public hearing on April 25, 2013, entitled "Tax Reform and Residential Real Estate." This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides general background on the tax incentives for residential housing. The first part of this document describes the tax provisions that offer incentives for homeownership. The second part describes the tax provisions that offer incentives for rental housing. The third part provides a discussion of the economic incentives and data related to residential housing. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended ("the Code").

Several provisions of the Code provide favorable tax treatment to homeowners. These include: (1) the home mortgage interest deduction; (2) the deduction for real property taxes; (3) the exclusion of gain from sale of a principal residence; (4) tax-exempt bonds for owner-occupied housing; (5) mortgage credit certificates; (6) qualified first-time homebuyer distributions from an individual retirement plan; (7) exclusion from gross income of the rental value of parsonages and military housing allowances; and (8) exclusion from gross income of discharge of certain qualified principal residence indebtedness.

There are also some tax incentives that provide favorable treatment to rental housing. These include: (1) the low-income housing tax credit; (2) the rehabilitation credit; (3) the exclusion of interest on State and local government qualified private activity bonds for rental housing; (4) accelerated depreciation for rental housing; and (5) exceptions from the passive activity loss rules for rental real estate activities. Many of these incentives increase the rate of return to investment in the residential rental housing sector and may increase the supply of rental housing.

Some of these provisions are broad in their applicability while others are relatively narrow in scope. For example, approximately 37 million returns claimed $394 billion of itemized deductions for home mortgage interest paid for 2010. That same year, only 41,733 returns claimed mortgage interest credits through mortgage credit certificates totaling $51.2 million.[2]

While economists generally reason that subsidies may lead to inefficient outcomes, a rationale to subsidize homeownership may exist if there are spillover benefits ("externalities") that accrue to someone other than the homeowner. For example, if homeowners maintain their homes better than renters, this may benefit others in the form of aesthetics or in fostering other desirable neighborhood characteristics such as lower crime. Part three of this document includes a review of the economic literature related to identifying and measuring the externalities of homeownership.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law, Data, and Analysis Relating to Tax Incentives for Residential Real Estate* (JCX-10-13), April 22, 2013. This document can be found on our website at www.jct.gov.

[2] Internal Revenue Service, *Individual Income Tax Returns 2010*, Publication 1304.

I. TAX INCENTIVES FOR HOMEOWNERSHIP

Several provisions of the Code provide favorable tax treatment to homeowners. Among the most widely utilized provisions are the deductions for home mortgage interest and real property taxes paid, affecting nearly 40 million taxpayers. Taxpayers are also allowed to exclude up to $500,000 of gains from the sale of their principal residences from gross income, an exclusion not available for income from most other types of investments. Tax-exempt bond issuance may also reduce the cost of mortgage financing for certain borrowers. Several other provisions also afford favorable treatment to homeownership. A description of these provisions follows.

A. Home Mortgage Interest Deduction

In lieu of taking the standard deduction, a taxpayer may elect to claim an itemized deduction for qualified residence interest, subject to limitations, notwithstanding the general rule that personal interest is nondeductible.[3] Qualified residence interest means interest on either acquisition indebtedness or home equity indebtedness.

Acquisition indebtedness

Acquisition indebtedness is indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer.

Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. Thus, for example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to $150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to substantially improve the residence). Refinanced acquisition debt continues to be treated as acquisition debt to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the financing.

The indebtedness must be secured by the qualified residence and is limited to $1 million ($500,000 for married persons filing a separate return). A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence.[4] A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

[3] Sec. 163(h)(2)(D) and (h)(3).

[4] Section 163(h)(4) defines qualified residence to include both a principal residence within the meaning of section 121 (relating to an exclusion of capital gain upon sale of a personal residence) and a second residence that satisfies the terms of section 280A(d)(1) (relating to whether a dwelling unit is used as a residence for purposes of the disallowance of certain deductions).

Home equity indebtedness

Certain home equity indebtedness may give rise to deductible qualified residence interest. Home equity indebtedness, for this purpose, means debt secured by the taxpayer's principal or second residence to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

The amount of home equity indebtedness on which interest is treated as deductible qualified residence interest may not exceed $100,000 ($50,000 for married persons filing a separate return).

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used. For example, personal expenditures may include health costs and education expenses for the taxpayer's family members or any other personal expenses such as vacations, furniture, or automobiles. A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer in a lump sum payment (e.g., a traditional mortgage), a series of payments (e.g., a reverse mortgage), or the lender may extend the borrower a line of credit up to a fixed limit over the term of the loan (e.g., a home equity line of credit).

The aggregate limitation on the total amount of a taxpayer's acquisition indebtedness and home equity indebtedness with respect to a taxpayer's principal residence and a second residence that may give rise to deductible interest is $1,100,000 ($550,000, for married persons filing a separate return).

The deduction for interest on home equity indebtedness is not allowed in computing alternative minimum taxable income.

Points

Points (prepaid interest) paid with respect to a home mortgage (including point on a refinancing of a qualified residence of the taxpayer) are generally capitalized and amortized over the period of the indebtedness.[5] An exception to this general rule, however, permits a current deduction for points on debt incurred for the initial purchase or improvement of the taxpayer's principal residence. This exception does not apply to the taxpayer's second residence. The deduction is allowable only to the extent the points would be deductible as qualified residence interest (if they were not prepaid).

Private mortgage insurance

Under a temporary provision, certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and

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[5] Sec. 461(g).

thus deductible. The amount allowable as a deduction is phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000 ($55,000 in the case of married individual filing a separate return). Reporting rules apply under the provision.

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision (December 20, 2006)).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 31, 2013, or properly allocable to any period after that date.

B. Deduction for Real Property Taxes

In lieu of taking the standard deduction, a taxpayer may elect to claim an itemized deduction for State, local, and foreign, real property taxes.[6] A taxpayer may deduct the tax if it is based on the assessed value of the real property and the taxing authority charges a uniform rate on all property in its jurisdiction. The tax must be for the welfare of the general public and not be a payment for a special privilege granted or service rendered to the taxpayer.[7]

Deductible real property taxes do not include itemized charges for services to specific property or people even if paid to the taxing authority. Charges for services include itemized charges such as a fixed charge per gallon of water used, a periodic charge for residential trash collection service, or a flat fee for a single service provided by the taxing jurisdiction (such as for mowing your lawn because its height exceeded that permitted by local ordinance).

Assessments for local benefits that tend to increase the value of the property are not deductible.[8] These include assessments for the construction of new streets and sidewalks, or impact fees to connect to a water or sewer system. Assessments for repair or maintenance or financing costs of existing local benefits are deductible. If only part of the assessment is for repair, maintenance, or financing costs, the taxpayer must be able to show the amount of that part to claim any deduction for that assessment.

Transfer taxes on the sale of a personal residence are not deductible real property taxes. Transfer taxes paid by the buyer are included in the cost basis of the property. Transfer taxes paid by the seller reduce the amount realized on the sale.

Homeowners association assessments are not deductible as real property taxes paid because the homeowners association imposes them rather than a State, local, or foreign government.

The deduction for real property taxes is not allowed in computing alternative minimum taxable income.

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[6] Sec. 164(a)(1).

[7] Treas. Reg. sec. 1.164-3(b).

[8] Sec. 164(c)(1).

C. Exclusion of Gain from Sale of a Principal Residence

An individual taxpayer may 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.[9] To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the years of the five year period ending on the date of the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Present law also contains an election relating to members of the uniformed services, the Foreign Service, certain employees of the intelligence community, and employees or volunteers of the Peace Corps. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty.

Gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income. A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, (1) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), and (2) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, are not taken into account.

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

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[9] Sec. 121.

D. Tax Exempt Bonds for Owner-Occupied Housing

In general

Under present law, gross income generally does not include interest paid on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or that are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds only applies to private activity bonds if the bonds are issued for certain permitted purposes ("qualified private activity bonds"). Subject to certain requirements, qualified private activity bonds, including qualified mortgage bonds and qualified veterans' mortgage bonds ("mortgage revenue bonds"), may be issued to finance owner-occupied housing.[10]

Qualified mortgage bonds

Owner-occupied housing may be financed with the proceeds of qualified mortgage bonds. Qualified mortgage bonds are tax-exempt bonds issued to make mortgage loans to eligible mortgagors for the purchase, improvement, or rehabilitation of owner-occupied housing for single-family principal residences (and certain two to four family residences). The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations for the homes financed with bond proceeds, a first-time homebuyer requirement, and a new mortgage requirement. The income limitations are satisfied if all the financing provided by an issue is provided for mortgagors whose family incomes do not exceed 115 percent (increased up to 140 percent for high housing cost areas) of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The income limitations are modified for mortgagors having a family of fewer than three individuals. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence.

In addition to these limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement). Under a special rule, qualified veterans' mortgage bonds (discussed in more detail below) may be issued to finance mortgages for veterans who served in the active military without regard to the first-time homebuyer requirement.

Qualified mortgage bonds may be used only to finance original "new" mortgages (as contrasted with refinancing of existing mortgages). Limited exceptions allow refinancing of construction loans, bridge loans, and similar temporary initial financing.

[10] Sec. 143.

The income and purchase price limitations are modified for residences in certain economically distressed areas ("targeted area residences"). A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have incomes that are 80 percent or less of the State-wide median income or, (2) an area of chronic economic distress. Generally, at least 20 percent of the proceeds of a qualified mortgage issue must be made available for owner-financing of targeted area residences for at least one year. For targeted area residences, the income limitation is satisfied when no more than one-third of the mortgages are made without regard to any income limits and the remainder of the mortgages is made to mortgagors whose family income is 140 percent or less of the applicable median family income. The purchase price limitation is raised from 90 percent to 110 percent of the average area purchase price for targeted area residences. In addition, the first-time homebuyer requirement does not apply to targeted area residences.

Qualified mortgage bonds may be used to finance qualified home-improvement loans and qualified rehabilitation loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on existing residences, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the properties. Under present law, qualified home-improvement loans generally may not exceed $15,000. Qualified rehabilitation loans are loans for rehabilitations of buildings at least 20 years old in which specified portions of the structure are retained and the rehabilitation expenditures represent at least 25 percent of the mortgagor's adjusted basis in the residence.

All or part of the interest subsidy provided by qualified mortgage bonds is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase.

Another restriction requires spending the bond proceeds on eligible mortgages within 42 months after the issue date and applying mortgage loan repayments to redeem bonds (rather than to finance additional mortgages) starting 10 years after the issue date.

Volume limitations on private activity bonds

As with most qualified private activity bonds, issuance of qualified mortgage bonds is subject to annual State volume limitations (the "State volume cap"). For calendar year 2013, the State volume cap, which is indexed for inflation, equals $95 per resident of the State or $291,875,000, whichever is greater. Exceptions from the State volume cap are provided for bonds issued for certain governmentally owned facilities (airports, ports, high-speed intercity rail, and solid waste disposal) and bonds that are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, qualified green building/sustainable design projects, and qualified highway or surface freight transfer facility bonds).

Arbitrage limitations

The interest on a tax-exempt bond becomes taxable if the bond is an arbitrage bond. In general, an arbitrage bond is any bond where a portion of the bond proceeds are reasonably expected to be used directly or indirectly to acquire higher yielding investments or to replace funds that were used directly or indirectly to acquire higher yielding investments. A second type of general arbitrage limitation requires payment to the United States of certain excess earnings on nonpurpose investments over the yield on the tax-exempt bonds.

In addition to the generally applicable arbitrage rules, mortgage revenue bonds have additional restrictions. In the case of qualified mortgage bonds the effective rate of interest on mortgage loans provided with an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. This determination is made on a composite basis for the issue rather than on a loan-by-loan basis. Additional rules apply in the case of qualified veterans' mortgage bonds, discussed *infra*.

Mortgage credit certificates

Qualified governmental units can elect to exchange all or a portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs").[11] MCCs entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences. The tax credit provided by the MCC may be carried forward for three years. Once issued, an MCC generally remains in effect as long as the residence being financed is the certificate-recipient's principal residence. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC is required to represent a credit for at least 10 percent (but not more than 50 percent) of interest paid or incurred during the taxable year on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000. The three-year carry-forward is not permitted for amounts in excess of the $2,000. The recapture rules for qualified mortgage bonds also apply to MCCs if the homeowner experiences substantial increases in income and disposes of the subsidized residence within nine years of purchase.

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the qualifying indebtedness is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making $4,000 of qualifying mortgage interest payments in a given year, would receive a $2,000 credit and a deduction for the remaining $2,000 of interest payments.

The aggregate amount of MCCs distributed by an electing issuer cannot exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that was authorized to issue $200 million of qualified mortgage bonds, and that elected to exchange $100 million of that bond authority, could distribute an aggregate amount of MCCs equal to $25 million.

[11] Sec. 25.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are qualified private activity bonds the proceeds of which are used to make mortgage loans to qualified veterans. The Code imposes limitations on qualified veterans' mortgage bonds, including a veterans' residence requirement, a new mortgage requirement, arbitrage restrictions, and a requirement to secure the bonds through a general obligation pledge by the State. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

Mortgage loans can be made to veterans who served on active duty and who applied for the financing before the date 25 years after the last date on which such veteran left active service.

The annual volume of qualified veterans' mortgage bonds that can be issued in California ($340 million) or Texas ($250 million) is based on the average amount of bonds issued in the respective State between 1979 and 1984. In Alaska, Oregon, and Wisconsin, the annual limit on qualified veterans' mortgage bonds that can be issued is $100 million each. Unused allocation cannot be carried forward to subsequent years.

E. Other Incentives

1. Qualified first-time homebuyer distributions from an individual retirement plan

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies.[12] Among other exceptions, the 10-percent early withdrawal tax does not apply to qualified first-time homebuyer distributions from an individual retirement arrangement ("IRA") (including a Roth IRA).

Qualified first-time homebuyer distributions are withdrawals of up to $10,000 during the individual's lifetime that are used within 120 days to pay costs (including reasonable settlement, financing, or other closing costs) of acquiring, constructing, or reconstructing the principal residence of a first-time homebuyer who is the individual, the individual's spouse, or a child, grandchild, or ancestor of the individual or individual's spouse. A first-time homebuyer is an individual who has not had an ownership interest in a principal residence during the two-year period ending on the date of acquisition of the principal residence to which the withdrawal relates. The spouse of the individual must also meet this requirement as of the date the contract is entered into or construction commences. The date of acquisition is the date the individual enters in to a binding contract to purchase a principal residence or begins construction or reconstruction of such a residence. For this purpose, principal residence is defined as under section 121 relating to the exclusion of gain from the sale of a principal residence.[13]

The 10-percent additional tax on early withdrawals is imposed with respect to any amount not used within 120 days of the date of withdrawal. If the 120-day rule cannot be satisfied due to a delay in the acquisition of the residence, the taxpayer may recontribute all or part of the amount withdrawn to a Roth IRA prior to the end of the 120-day period without adverse tax consequences.

2. Exclusion from income of certain housing allowances and related deductions

<u>Rental value of parsonages</u>

A minister of the gospel's gross income does not include: (1) the rental value of a home furnished as part of his compensation; or (2) the rental allowance paid as part of his compensation, to the extent used to rent or provide a home, and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.[14]

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[12] Sec. 72(t).

[13] See discussion in part I.C. above relating to the exclusion of gain from the sale of a principal residence.

[14] Sec. 107.

Military housing allowances

Qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) that: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income. Qualified military benefits include the basic allowance for housing authorized under Title 37 U.S.C. section 403.

Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel

Section 265 disallows deductions for expenses allocable to tax-exempt income, such as expenses incurred in earning income on tax-exempt investments. In addition, that provision has been applied in certain cases where the use of tax-exempt income is sufficiently related to the generation of a deduction to warrant disallowance of that deduction. However, section 265 does not apply with respect to parsonage and military housing allowances. That is, no otherwise allowable deduction is denied for interest paid on a mortgage on, or real property taxes paid on, the home of the taxpayer in the case of (1) a minister of the gospel, on account of a parsonage allowance that is excluded from gross income under section 107, or (2) a member of a military service on account of a military housing allowance. Thus, a minister of the gospel or a member of the military may claim an otherwise allowable deduction for mortgage interest or real property taxes notwithstanding the receipt of a tax-free allowance to purchase the property.

3. Exclusion from income of discharge of certain qualified principal residence indebtedness

In general

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness.[15] In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after

[15] Secs. 61(a)(12) and 108. A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (sec. 102).

the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.[16]

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Qualified principal residence indebtedness

Under a temporary provision, an exclusion from gross income is provided for any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of section 163(h)(3)(B) (relating to the home mortgage interest deduction), except that the dollar limitation is $2 million) with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness. For these purposes, the term "principal residence" has the same meaning as under section 121 of the Code.[17]

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 debt is discharged, then only $100,000 of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion.

The basis of the individual's principal residence is reduced by the amount excluded from income under the provision.

The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead the general exclusion rules apply. In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

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[16] Sec. 1017(b)(2).

[17] See discussion in part I.C. above relating to the exclusion of gain from the sale of a principal residence.

The exclusion for qualified principal residence indebtedness is effective for discharges of indebtedness before January 1, 2014.

4. Treatment of tenant-stockholder of a cooperative housing corporation

A tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued to the cooperative to the extent those amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative which are paid or incurred by the cooperative on the cooperative's land or buildings and (2) interest allowable as a deduction to the cooperative that is paid or incurred by the cooperative on its indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, alteration, rehabilitation, or maintenance of the cooperative's buildings.[18]

A cooperative housing corporation generally is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock in the corporation, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, except on complete or partial liquidation of the cooperative, and (4) the corporation meets one of the following three requirements: (a) 80 percent or more of the corporation's gross income for that taxable year is derived from tenant-stockholders; (b) at all times during that table year 80 percent or more of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to such residential use; or (c) 90 percent or more of the expenditures of the corporation paid or incurred during that taxable year are paid or incurred for the acquisition, construction, management, maintenance, or care of the corporation's property for the benefit of tenant-stockholders.

[18] Sec. 216.

II. TAX INCENTIVES FOR RESIDENTIAL RENTAL HOUSING

There are also some tax incentives that may reduce the cost of renting relative to owning. These include the low-income housing tax credit, the rehabilitation credit, the exclusion of interest on State and local government qualified private activity bonds for rental housing, accelerated depreciation for rental housing, and exceptions from the passive activity loss rules for rental real estate activities. A description of these provisions follows.

A. Low-Income Housing Tax Credit

In general

The low-income housing tax credit may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels.[19] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building. Eligible basis is generally adjusted basis at the close of the first taxable year of the credit period.

Qualified low-income housing project

To qualify for the low-income housing tax credit, the incomes of the tenants must satisfy certain targeting rules similar to the rules for tax-exempt bond financed qualified residential rental projects. Under the tax credit rules, a project is a qualified low-income housing project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified low-income housing project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The owner must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified low-income housing projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test. In practice many projects have every unit satisfy the income targeting rules so that the entire project qualifies for the credit.

Present value credit

In general

The calculation of the applicable percentage is designed to produce a credit equal to: (1) 70 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not Federally subsidized (the "70-percent credit"); or (2) 30 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is Federally subsidized and existing

[19] Sec. 42.

housing that is substantially rehabilitated (the “30-percent credit”). For example, in a zero interest rate environment, a building eligible for a 70-percent credit would have an annual applicable percentage of 7 percent for each of the ten years of the credit period. As interest rates rise, the 7-percent applicable percentage also rises to preserve the present value of the credit.

Where existing housing is substantially rehabilitated, the existing housing is eligible for the 30-percent credit and the qualified rehabilitation expenses (if not Federally subsidized) are eligible for the 70-percent credit.

Special rule

Under a special rule the applicable percentage is set at a minimum of 9 percent for newly constructed non-Federally subsidized buildings placed in service after July 30, 2008 with respect to credit allocations made before January 1, 2014.

Substantial rehabilitation requirement

Rehabilitation expenditures paid or incurred by a taxpayer with respect to a low-income building are treated as a separate building and may be eligible for the 70-percent credit if they satisfy the otherwise applicable credit rules. To qualify for the credit, the rehabilitation expenditures must equal the greater of an amount that is (1) at least 20 percent of the adjusted basis of the building being rehabilitated; or (2) at least $6,000 per low-income unit in the building being rehabilitated. The $6,000 amount is indexed for inflation so it is $6,400 in 2013.

At the election of the taxpayer, a special rule applies allowing the 30-percent credit to both existing buildings and rehabilitation expenditures if the second prong (*i.e.*, at least $6,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied. This special rule applies only in the case where the taxpayer acquired the building and immediately prior to that acquisition the building was owned by or on behalf of a government unit.

Calculation of the applicable percentage

The credit percentage for a low-income building is set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued.

These credit percentages (used for the 70-percent credit and 30-percent credit) are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the Applicable Federal Rates for mid-term and long-term obligations for the month the building is placed in service. The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

Enhanced credit for buildings in high-cost areas

Generally, buildings located in three types of high-cost areas (*i.e.*, qualified census tracts, difficult development areas and buildings designated by the State housing credit agency as requiring the enhanced credit in order for such buildings to be financially feasible) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. A further requirement for the enhanced credit in qualified census tracts and difficult development areas is that the portions of each metropolitan statistical area or nonmetropolitan statistical area designated as difficult to develop areas cannot exceed an aggregate area having 20 percent of the population of such statistical area. Buildings designated by the State housing credit agency as requiring the enhanced credit in order for such buildings to be financially feasible are not subject to the limitation limiting high cost areas to 20 percent of the population of each metropolitan statistical area or nonmetropolitan statistical area.

Recapture

The compliance period for any building is the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date.

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set aside requirement, or the gross rent requirement, or other requirements with respect to the units comprising the set aside) is recapture of the accelerated portion of the credit, with interest, for all prior years.

Volume limits

A low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Generally, the aggregate credit authority provided annually to each State for calendar year 2013 is $2.25 per resident, with a minimum annual cap of $2,590,000 for certain small population States (Rev. Proc. 2012-41). These amounts are indexed for inflation. Projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit do not require an allocation of the low-income housing credit, but the related use of tax-exempt bonds is subject to limitation as described below.

B. Rehabilitation Tax Credit

Present law provides a two-tier tax credit for rehabilitation expenditures.[20]

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

[20] Sec. 47.

C. Tax-Exempt Bond Financing for Residential Rental Housing

In general

Private activity bonds are bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for interest paid on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes, but is not limited to, qualified mortgage bonds, qualified veterans' mortgage bonds, and bonds for qualified residential rental projects.

Qualified residential rental projects

Residential rental property may be financed with qualified private activity bonds if the financed project is a "qualified residential rental project."[21] A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The issuer must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified residential rental projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test.

As with most qualified private activity bonds, bonds for qualified residential rental projects are subject to annual State volume limitations (the "State volume cap"). For calendar year 2013, the State volume cap, which is indexed for inflation, equals $95 per resident of the State, or $291,875,000, if greater.

Bonds issued to finance qualified residential rental projects are subject to a term to maturity rule which limits the period of time such bonds may remain outstanding. Generally, this rule provides that the average maturity of a qualified private activity bond cannot exceed 120 percent of the economic life of the property being financed.

[21] Sec. 142(d).

D. Accelerated Depreciation for Residential Rental Housing

Depreciation in general

For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under MACRS whereby different types of property generally are assigned applicable recovery periods and depreciation methods.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years.[22] The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[23] switching to the straight-line method for the first taxable year where using the straight-line method with respect to the adjusted basis as of the beginning of that year will yield a larger depreciation allowance. The recovery periods for most real property are 27.5 years (for residential rental property) and 39 years (for nonresidential real property). The depreciation method applicable to such real property is straight-line.

Real property

In general

The cost of residential rental property is recovered using the straight-line method of depreciation, and a recovery period of 27.5 years. The cost of nonresidential real property is recovered using the straight-line method, and a recovery period of 39 years. In addition, building improvements and structural components, based on their use, are recovered over either 27.5 years for residential rental property or 39 years for nonresidential real property.

Real property also includes leasehold improvements; however, the assigned recovery period may be longer than the lease term. In general, leasehold improvements are recovered over the same period of time as the property to which the improvement relates (*i.e.*, 27.5 years for residential rental property and 39 years for nonresidential real property).[24] For certain qualified improvements placed in service before 2014 (*i.e.*, qualified leasehold improvement

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[22] For certain tangible assets, the recovery period is controlled by statute (see, *e.g.*, section I.B.6 of Joint Committee on Taxation, , *Background and Present Law Relating to Manufacturing Activities Within the United States* (JCX-61-12), July 17, 2012, which includes a table of statutorily defined recovery periods for specific types of property). For all other tangible assets, the recovery period is generally determined by administrative guidance (see, *e.g.*, Rev. Proc. 87-56, 1987-2 CB 674, and Appendix B of IRS Publication 946).

[23] Declining balance methods accelerate a portion of the total allowable deductions into the earlier years of the recovery period. For example, under the 200-percent declining balance method, the deduction in the first year is twice what it would be under the straight-line method, but the annual allowance amount declines over the recovery period. The allowable amount is thus smaller in the later years than the allowable amounts for those years would have been under the straight-line method.

[24] Special rules (*e.g.*, section 165) may permit a deduction of the cost at the end of the lease term.

property,[25] qualified restaurant property,[26] and qualified retail improvement property[27]), the cost of the property is recovered over 15 years, using the straight-line method.[28] Special rules provide a 15-year recovery period for qualified construction allowances for short-term leases as well.[29]

Placed in service convention

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention. In the case of both residential rental property and nonresidential real property, a mid-month convention applies. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Nondepreciable assets

Certain assets, including land, are not depreciable. The cost of land is recovered only upon sale. Certain improvements to land (*e.g.*, sidewalks, roads, fences, shrubbery) can be depreciated if closely associated with other depreciable property (*e.g.*, residential rental property).[30]

Depreciation recapture

Depreciable real property, other than that included within the definition of section 1245 property,[31] disposed at a gain is known as section 1250 property.[32] Gain on the disposition of section 1250 property is treated as ordinary income, rather than capital gain, only to the extent of the excess of post-1969 depreciation allowances over the depreciation that would have been available under the straight-line method.[33] However, if section 1250 property is held for one

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[25] Sec. 168(e)(6).

[26] Sec. 168(e)(7).

[27] Sec. 168(e)(8).

[28] Secs. 168(e)(3)(E)(iv), (v), and (ix).

[29] Sec. 110.

[30] See, *e.g.*, asset class 00.3 of Revenue Procedure 87-56, 1987-2 C.B. 674, that defines land improvements eligible for depreciation.

[31] Depreciable personal property, whether tangible or intangible, and certain depreciable real property (typically real property that performs specific functions in a business, but not buildings or structural components of buildings) disposed at a gain are known as section 1245 property. Sec. 1245(a)(3).

[32] Sec. 1250(c).

[33] Sec. 1250(a)(1).

year or less, all depreciation is recaptured, regardless of whether it exceeds the depreciation that would have been available under the straight-line method. Special rules phase out the recapture for certain types of property held over a specified period of time.[34]

For corporations, the amount treated as ordinary income on the disposition of section 1250 property is increased by 20 percent of the additional amount that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property.[35] For individuals, any capital gain that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property is taxed at a maximum rate of 25 percent.[36]

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[34] Sec. 1250(a)(1)(B). The special phaseout rule applies to residential rental property, certain types of subsidized housing, and property for which rapid depreciation of rehabilitation expenditures was claimed under section 167(k).

[35] Sec. 291(a)(1).

[36] Sec. 1(h)(1)(E).

E. Passive Activity Loss Rules and Special Rental Real Estate Rules

In general

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity in a fully taxable transaction to an unrelated person.

The passive loss rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Except as provided in regulations, no interest as a limited partner is treated as an interest with respect to which the taxpayer materially participates.

A passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. This rule applies without regard to whether the taxpayer materially participates in the activity.

Special rules for rental real estate activities

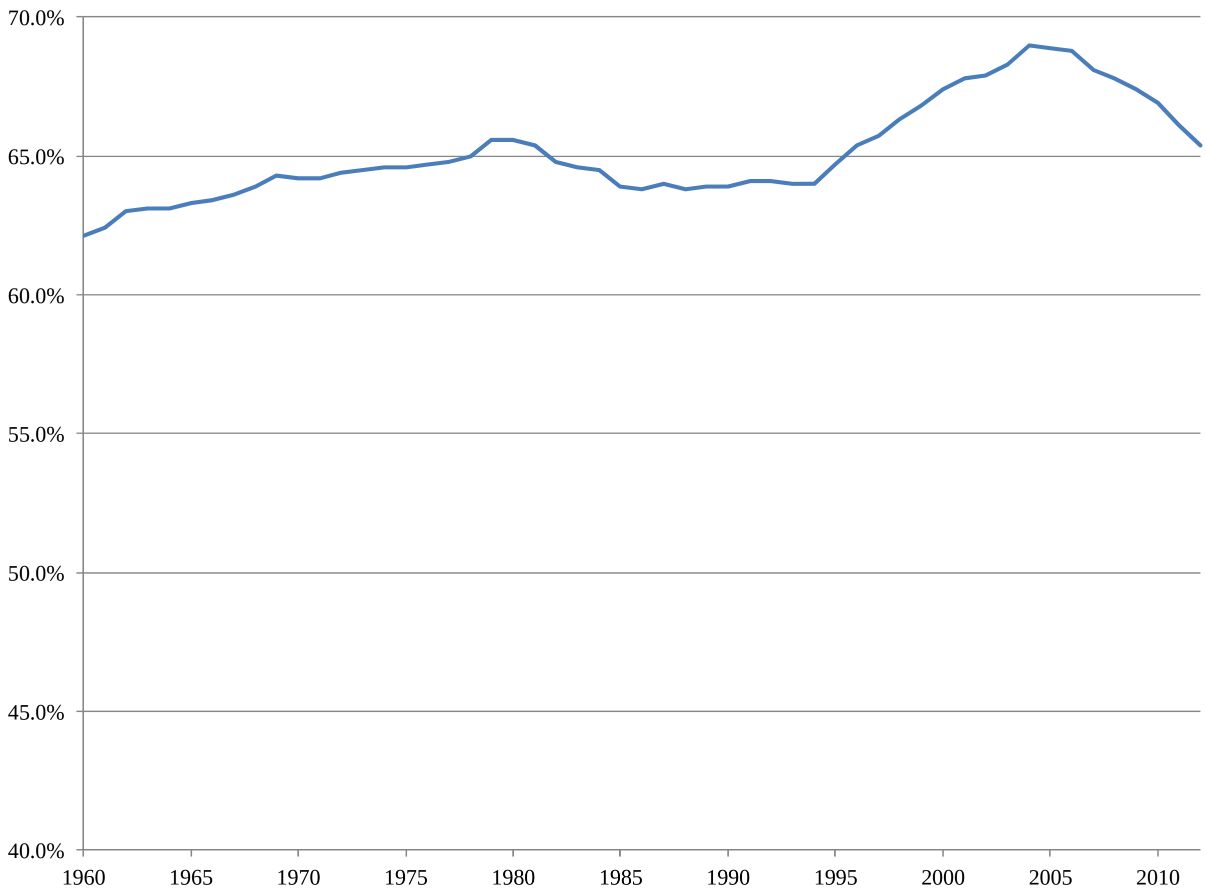
Rental activities (generally including rental real estate activities) are treated as passive activities, regardless of the level of the taxpayer's participation. However, a special rule treats a taxpayer's rental real estate activities in which he materially participates as not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements. To be eligible, (1) more than half of the personal services the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. Another special rule permits the deduction of up to $25,000 of losses from rental real estate activities in which the taxpayer actively participates. The $25,000 amount is allowed for taxpayers with adjusted gross incomes of $100,000 or less and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000.

III. DATA AND ANALYSIS RELATED TO TAX INCENTIVES FOR RESIDENTIAL HOUSING

A. Homeownership Rates

Figure 1 shows homeownership rates for the United States from 1960 through 2012. The homeownership rates presented here are based on data from the Current Population Survey/Housing Vacancy Survey[37] conducted by the U.S. Bureau of the Census. For 2012, the U.S. homeownership rate is 65.4 percent. Homeownership rates vary from a low of 62.1 percent in 1960 to a peak of 69.0 percent in 2004, a fairly narrow range around the average rate of 65.1 percent during this period. However, looking at only the last fifty years obscures the increase in homeownership rates since the beginning of the last century.

Figure 1.−U.S. Homeownership Rate, Annually 1960-2010

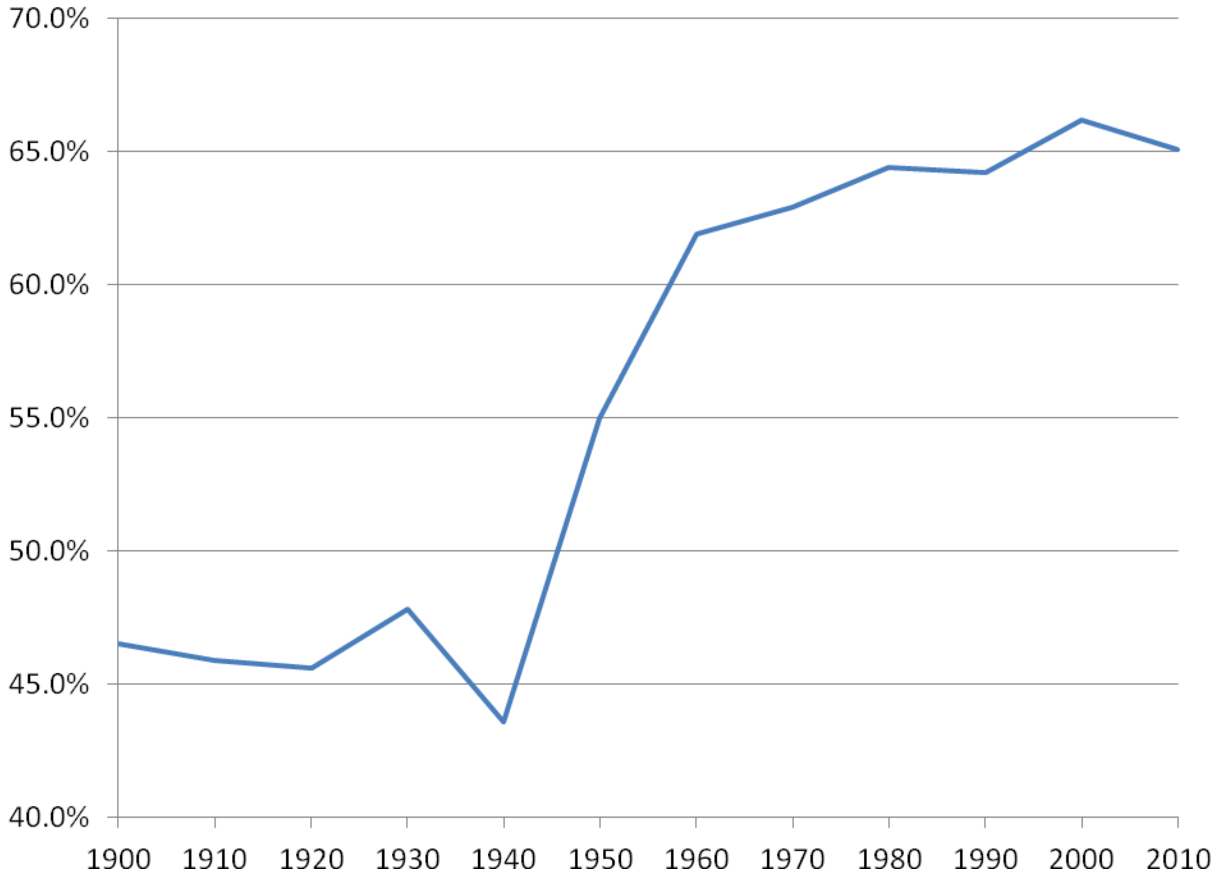


Source: U.S. Bureau of the Census, CPS-HVS.

[37] The homeownership rate is the percentage of occupied housing units that are owner-occupied. Rates for the same time period may differ from those presented elsewhere in this document because they are based on data from different surveys. The U.S. Bureau of the Census conducts at least three surveys that ask questions related to housing tenure (rent vs. own): the Current Population Survey/Housing Vacancy Survey, the American Housing Survey, and the Decennial Census of Housing.

Using data from the Decennial Census of Housing, Figure 2 shows decennial homeownership rates from 1900 to 2010 on the same scale as Figure 1. At the beginning of the century, fewer than half of households owned their home. While the homeownership rate declined from 1900 to 1920, economic growth in the 1920s raised the homeownership rate in the subsequent decade. The Great Depression drove the rate to its lowest level of the century in 1940, at 43.6 percent, about three percentage points below where it had been in 1900. However, the homeownership rate increased nearly 20 percentage points from 1940 to 1960.

Figure 2.−U.S. Homeownership Rates, Decennial Census, 1900-2010



Source: U.S. Bureau of the Census, Decennial Census of Housing.

Table 1 shows homeownership rates by household income in 2011 as reported by the American Housing Survey conducted by the U.S. Bureau of the Census. Unsurprisingly, homeownership rates rise with household income, ranging from less than 40 percent ownership rates for households with $5,000 to $9,999 annual income to nearly 90 percent ownership rates for households with greater than $120,000 annual income. Median household income for all households is $46,000 versus $28,000 for renters and $59,000 for owner-occupiers. Because higher income households are more likely to itemize deductions, these data are consistent with the claim that the home mortgage interest and real property tax deductions disproportionately benefit higher income households.

Table 1.−Homeownership Rates by Household Income, 2011

Household Income	Total Occupied Units	Owner Occupied Units	Renter Occupied Units	Homeownership Rate
Less than $5,000	6,299	2,609	3,689	41.4%
$5,000 to $9,999	5,244	1,969	3,275	37.5%
$10,000 to $14,999	6,390	2,859	3,531	44.7%
$15,000 to $19,999	6,317	3,062	3,255	48.5%
$20,000 to $24,999	6,248	3,216	3,033	51.5%
$25,000 to $29,999	8,092	4,817	3,275	59.5%
$30,000 to $34,999	6,311	3,687	2,624	58.4%
$35,000 to $39,999	5,594	3,508	2,086	62.7%
$40,000 to $40,999	10,107	6,652	3,456	65.8%
$50,000 to $59,999	8,647	6,064	2,582	70.1%
$60,000 to $79,999	14,058	10,532	3,525	74.9%
$80,000 to $99,999	9,830	7,922	1,908	80.6%
$100,000 to $119,000	6,842	5,845	997	85.4%
$120,000 or more	14,929	13,349	1,580	89.4%
Total	114,907	76,091	38,816	66.2%

Number of units in thousands.
Source: American Housing Survey: 2011, U.S. Bureau of the Census.

Homeownership rates vary greatly by country. Table 2 reports the most recent data available on the percentage of housing units that are owner-occupied by country. These range from a low of 43.8 percent in Switzerland to rates above 90 percent for several former socialist republics that privatized State-owned housing after the fall of communism. The average homeownership rate for the 27 member countries of the European Union listed in the first part of the table is 70.7 percent.

Table 2.−International Homeownership Rates, Latest Data

Country	Latest Data	Ownership Rate		Country	Latest Data	Ownership Rate
Austria	2011	57.5%		Slovenia	2011	77.5%
Belgium	2011	71.8%		Spain	2011	82.7%
Bulgaria	2011	87.2%		Sweden	2011	69.7%
Cyprus	2011	73.8%		UK	2011	67.9%
Czech Republic	2011	80.1%		EU27	2011	70.7%
Denmark	2011	67.1%				
Estonia	2011	83.5%		Australia	2010	68.8%
Finland	2011	74.1%		Belarus	2004	82.0%
France	2011	63.1%		Canada	2011	66.8%
Germany	2011	53.4%		Croatia	2011	92.1%
Greece	2011	75.9%		Georgia	2003	94.8%
Hungary	2011	89.8%		Iceland	2011	77.9%
Ireland	2010	73.4%		Israel	2004	70.6%
Italy	2011	72.9%		Japan	2008	61.1%
Latvia	2011	82.5%		Kyrgyzstan	2008	96.0%
Lithuania	2011	92.3%		New Zealand	2012	66.9%
Luxembourg	2011	68.2%		Norway	2011	84.0%
Malta	2011	80.8%		Russia	2003	63.8%
Netherlands	2011	67.1%		Singapore	2012	90.1%
Poland	2011	82.1%		Switzerland	2011	43.8%
Portugal	2011	75.0%		Turkey	2006	60.7%
Romania	2011	96.6%		Ukraine	2004	87.8%
Slovakia	2011	90.2%		USA	2012	65.4%

Source: Australian Bureau of Statistics, Eurostat, Statistics New Zealand, Statistics Singapore, Swiss Finance Institute, U.N. Economic Commission for Europe, U.S. Bureau of the Census.

B. Rationale for Providing Incentives for Homeownership

Overview

The tax treatment of home ownership has a number of potential consequences for both the efficiency of housing markets and the equity of treatment across participants in these markets. When participants face changes in the cost of acquiring and holding housing as a result of new tax policies, they respond to these new costs by changing their demand for, or supply of, housing. If underlying housing markets are efficient, these changes distort economic activity that would otherwise enhance the well-being of both buyers and sellers (economists refer to this distortion as "efficiency loss"). On the other hand, if there are existing inefficiencies in the market (for example, due to spillover effects), subsidies or taxes may reduce efficiency losses, depending on whether those existing inefficiencies lead to too little or too much consumption. Furthermore, if tax policies redistribute resources in a way that lawmakers believe to be more equitable, lawmakers may be willing to trade losses in efficiency due to the tax for gains in equity. Also, the policies could trade off a loss of efficiency or equity for a gain in simplicity of administration and compliance.

Economists generally favor the outcomes of the free market, reasoning that taxes or subsidies in the market generally lead to inefficient outcomes. That is, in an otherwise efficient market, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. An example of such a good is a vaccination. The individual who is vaccinated benefits by not contracting an infectious disease, but the rest of society benefits as well. By not contracting the disease, the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a "positive externality." Externalities are factors (positive or negative) that are not traded in any market and that influence any party not directly involved in a particular economic transaction. On his or her own, the individual would weigh only his or her own reduced probability of contracting the disease against the cost of the vaccination. The individual would not account for the additional benefit the vaccination produces for society. As a result, the individual might choose not to be vaccinated, even though from society's perspective the total reduction in the rate of infection throughout the population would be worth more than the cost of the vaccination. The private market might yield too few of the vaccinations. That is, the private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of a good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

Rationale for subsidizing homeownership

Homeownership may offer a wide variety of benefits to owners beyond providing a place to live. These may include something as simple as the property right to paint the walls whatever color one desires to insurance against future increases in rents.[38] These are examples of purely private benefits accruing to the individual homeowner. However, a rationale for government subsidy may arise if there are spillover benefits that accrue to someone other than the homeowner.[39] Economists have studied at least three channels through which homeownership may generate externalities. First, homeowners maintain their homes better than renters (or landlords). This may yield benefits to others in the form of aesthetics or in fostering other desirable neighborhood characteristics such as lower crime.[40] Second, the value of a home is tied to the strength of the community. This may encourage homeowners to support investments in the long-term prospects of the community more than renters, who may actually lose if rents rise disproportionately to the direct benefits they receive. However, the incentive to raise house prices might also lead homeowners to restrict supply of new homes artificially to prop up prices through inefficient land use regulation. Third, homeownership reduces residential mobility. Reduced mobility may provide owners with a longer time horizon over which to evaluate community investments (whether through involvement in local civic organizations or investments in local government goods and services). Neighborhood stability may also be associated with lower crime. Reduced mobility, however, may have negative consequences for the labor market if it prevents people from moving to jobs or encourages them to accept jobs to which they may be poorly matched. Identifying and measuring the externalities from homeownership has been the subject of much economic research, which is surveyed below.

The presence of net positive externalities alone is not sufficient justification for tax incentives for homeownership. Any gains to efficiency due to intervention in the housing market may be offset by losses in efficiency in other markets, for example by higher distortionary taxes to finance the subsidy. Even recognizing that a subsidy might be justified does not identify the magnitude of the subsidy necessary to promote efficiency nor the best method for delivery of the subsidy. For example, the Federal government has historically subsidized homeownership, in its earliest forms through land grants such as the Homestead Act of 1862[41] and campaigns to

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[38] Todd Sinai and Nicholas S. Souleles, "Owner-occupied Housing as a Hedge against Rent Risk," *Quarterly Journal of Economics*, vol. 120, no. 2, May 2005, pp. 763-789.

[39] See Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy 17*, Cambridge, Mass.: The MIT Press, 2003, pp. 37-82 for a review of the literature on externalities. See also N. Edward Coulson and Herman Li, "Measuring the External Benefits of Homeownership," 46th Annual AREUEA Conference Paper, 2010, available at SSRN: http://ssrn.com/abstract=1717014.

[40] When there are well-defined property rights and costless bargaining, private negotiations among the affected parties may bring about the socially optimal solution without government intervention. For the articulation of what has become known as the Coase Theorem, see Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics*, vol. 3, October 1960, pp. 1-44. Some have suggested that Coasian solutions are likely to be more effective in the case of highly localized externalities, as may be the case with aesthetic externalities here. See Jonathan Gruber, *Public Finance and Public Policy*, Third Edition, New York: Worth Publishers, 2010.

[41] Pub. L. No. 37-64.

promote ownership in the 1910s and 1920s. Subsequent government involvement to support housing finance began in the 1930s and has continued to the present day through the creation and insurance of specialized financial institutions such as Federal Home Loan banks, regulation of financial institutions,[42] Federal Housing Administration and Veterans Administration mortgage guarantees, secondary mortgage market support by National Mortgage Associations (e.g., Fannie Mae, Ginnie Mae, and Freddie Mac), and even direct provision of mortgages through the Department of Housing and Urban Development and the Department of Agriculture.[43] There are also various State-level subsidies for homeowners that may reduce financing costs (e.g., low- or zero-interest loans) or closing costs (e.g., waiver of transfer taxes on real estate or other grants that reduce closing costs). It is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities.

Empirical evidence on externalities

Home maintenance

Benefits of home maintenance accrue to the owner of the property as well as the occupant, suggesting that owner-occupiers have the strongest incentive to perform maintenance. If the level of home maintenance raises the value of other homes in the neighborhood, then it is likely that there are externalities to homeownership through this channel. Studies have shown that homeowners indeed are more likely to invest in home maintenance and gardening than renters.[44] Rental property also depreciates more quickly than owner-occupied property because of lack of tenant care for the property.[45] However, the differences may not be large.[46] Lower crime may also be associated with a higher level of home maintenance.[47]

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[42] Examples of such regulation include the Home Mortgage Disclosure Act (Pub. L. No. 94-200) and the Community Reinvestment Act (Pub. L. No. 95-128).

[43] For a survey of Federal government policy that promotes homeownership as of 1998, see Michael S. Carliner, "Development of Federal Homeownership 'Policy," *Housing Policy Debate*, vol. 9:2, 1998, pp. 299-321. The author notes, however, that "most programs that support ownership have been developed for other purposes."

[44] George Galster, "Empirical Evidence on Cross-Tenure Differences in House Maintenance and Conditions," *Land Economics*, 59, February 1983, pp. 107-113. John Harding, Thomas J. Miceli, and C. F. Sirmans, "Do Owners Take Better Care of Their Housing Than Renters?," *Real Estate Economics*, 28, 2000, pp. 663-681. Denise DiPasquale and Edward L. Glaseser, "Incentives and Social Capital: Are Homeowners Better Citizens?," *Journal of Urban Economics*, 45, 1999, pp. 354-384.

[45] James Shilling, C. F. Sirmans, and Jonathan Dombrow, "Measuring Depreciation in Single-Family Rental and Owner-Occupied Housing," *Journal of Housing Economics*, 1, 1991, pp. 368-383.

[46] Dean H. Galtzlaff, Richard K. Green, and David C. Ling, "Cross-Tenure Differences in Home Maintenance and Appreciation," *Land Economics*, 74, August 1998, pp. 328-342.

[47] John Q. Wilson and George Kelling, "The Police and Neighborhood Safety: Broken Windows," *Atlantic Monthly*, 127, 1982, pp. 29-38. Steve Gibbons, "The Costs of Urban Property Crime," *The Economic Journal*, 114, November 2004, pp. F441-F463. However, some have found that lower crime may be associated with stronger social cohesion and not less physical disorder alone. Robert J. Sampson and Stephen W. Raudenbush, "Systematic Social Observation of Public Spaces: A New Look at Disorder in Urban Neighborhoods," *American Journal of*

Social capital and community activism

If homeowners are more likely to care about their neighborhoods than those who rent, and if this care increases civic involvement and local decision-making that prioritizes long-run investments leading to long-term gains in property values, then homeownership may create externalities that warrant subsidization. Homeownership is generally correlated with higher levels of social interaction, though whether it causes such increased interaction is unclear.[48] Based on data from the General Social Survey,[49] homeowners are more likely than renters to be members of every type of organization surveyed. Even adjusting for various individual characteristics, owners are more likely to join service organizations, school service organizations, hobby groups and church-affiliated organizations. However, some research fails to find evidence for correlations between homeownership and social benefits such as increased civic involvement and local decision-making that prioritizes long-run investments.[50]

Homeowners are also more politically aware about who their local elected leaders are and more likely to vote than renters. Owners have incentives to favor policies that raise property values, whether they receive a direct benefit or not, while renters have incentives to favor policies that support more immediate benefits. For example, an owner without children may favor spending on schools if that spending results in higher property values. A childless renter faces higher rents as a result of that additional spending, while receiving no immediate benefit. Research shows that homeownership is associated with lower per capita local government spending overall and less spending on transfer payments, suggesting owners may seek to keep taxes and transfer payments low because they reduce long-run property values.[51] Homeowners may also seek to raise prices by inefficiently restricting supply of new homes or other development (e.g., a noisy airport) via zoning or other land use regulation. This restriction is inefficient if such development raises overall well-being but is opposed because it also lowers local property values.[52] This suggests that there are both benefits and costs to the effects of homeownership on local public policy.

Sociology, 105(3), 1999, pp. 603-651. Both stronger social cohesion and less physical disorder may be externalities associated with increased homeownership rates.

[48] Denise DiPasquale and Edward L. Glaseser, "Incentives and Social Capital: Are Homeowners Better Citizens?," *Journal of Urban Economics*, 45, 1999, pp. 354-384.

[49] The General Social Survey, conducted by the National Opinion Research Center at the University of Chicago since 1972, is the largest project funded by the Sociology Program of the National Science Foundation and is designed to monitor changes in social characteristics and attitudes in the United States.

[50] Gary Engelhardt, Michael Eriksen, William Gale, and Gregory Mills, "What Are the Social Benefits of Homeownership?" Experimental Evidence for Low-Income Households," *Journal of Urban Economics*, September 2009.

[51] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy 17*, Cambridge, Mass.: The MIT Press, 2003, p. 69.

[52] William Fischel, *The Homevoter Hypothesis: How Home Values Influence Local Government Taxation, School Finance, and Land-Use Policies,* Cambridge: Harvard University Press, 2001.

Residential mobility/stability

Many of the externalities (both positive and negative) associated with homeownership relate to the way in which it reduces mobility and increases stability in a particular neighborhood. Higher residential mobility may be associated with a higher homicide rate.[53] Homeownership may be associated with higher high school graduation rates[54] and higher math and reading test scores for some younger children.[55] Research suggests this association may be indirect, driven by the effect of homeownership on increasing residential stability.[56] Living in a neighborhood for a long time may be more likely if one owns a home rather than rents. In neighborhoods with other homeowners, peers may also be likely to be around longer. However, it is also possible that any observed effect of homeownership is attributable to other unobserved characteristics.

Residential stability also has negative aspects. Evidence suggests that homeownership can limit labor market mobility.[57] This may increase unemployment if homeowners are more reluctant to relocate to more attractive job markets than renters due to high transaction costs in selling a home or the risk of selling at a time when the housing market and the labor market may be depressed simultaneously. Even at full-employment, this lock-in effect of homeownership may lead workers to hold jobs to which they are less than perfectly matched, as owners may be less likely to move to access better jobs in other labor markets. Reduced residential mobility also increases the likelihood that households are poorly matched to the house size that they desire if family size changes. Households may also be poorly matched to the local services available if they cannot move with ease. For example, a household may desire different amenities during a period in which they have school-aged children than when they no longer do.

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[53] Charis E. Kubrin, "Structural Covariates of Homicide Rates: Does Type of Homicide Matter?," *Journal of Research in Crime and Delinquency*, 2003, pp. 139-170. Lauren J. Krivo and Ruth D. Peterson, "The Structural Context of Homicide: Accounting for Racial Differences in Process," *American Sociological Review*, vol. 65, no. 4, August 2000, pp.547-559. For contrary findings, see Corina Graif and Robert J. Sampson, "Spatial Heterogeneity in the Effects of Immigration and Diversity on Neighborhood Homicide Rates," *Homicide Studies*, vol. 13, no. 3, August 2009, pp. 242-260 and Robert J. Sampson, Stephen W. Raudenbush, and Felton Earls, "Neighborhoods and Violent Crime: A Multilevel Study of Collective Efficacy," *Science*, vol. 277, pp. 918-924.

[54] Richard Green and Michelle White, "Measuring the Benefits of Homeowning: Effects on Children," *Journal of Urban Economics*, 41(3), 1997, pp. 441-461.

[55] Lisa L. Mohanty and Lakshmi K. Raut, "Home Ownership and School Outcomes of Children: Evidence from the PSID Child Development Supplement," *American Journal of Economics and Sociology*, 68(2), April 2009. Donald R. Haurin, Toby L. Parcell, and R. Jean Haurin, "Does Homeownership Affect Child Outcomes?," *Real Estate Economics*, 30, 2002, pp. 635-666.

[56] Daniel Aaronson, "A Note on the Benefits of Homeownership," *Journal of Urban Economics*, 47(3), 2000, pp. 356-369.

[57] Fernando Ferreira, Joseph Gyourko, and Joseph Tracy, "Housing Busts and Household Mobility," *Journal of Urban Economics*, 68(1), July 2010, pp. 34-45. Andrew Henley, "Residential Mobility, Housing Equity, and the Labour Market," *Economic Journal*, 108, March 1998, pp. 414-427.

General evidence

If homeownership is valuable beyond the owner directly, then one should be willing to pay a premium to live near other homeowners. Researchers have attempted to determine whether house prices are related to the rate of homeownership in a neighborhood, after controlling for the many other structural, location, and neighborhood quality attributes that may influence housing values. Many researchers have found a positive association between the ownership rate within a census tract (or other neighborhood definition) and housing values.[58] However, without controlling for unobserved neighborhood characteristics that may themselves be correlated with homeownership, any connection between ownership rates and housing values may be spurious.

More recent research has attempted to control for these unobservable characteristics in various ways and has continued to find that an increase in neighborhood homeownership rates is associated with higher housing prices.[59] A 10-percentage point increase in the homeownership rate is associated with increases in house prices of between 4.5 percent and 15.7 percent. This finding is consistent with the hypothesis that homeownership creates positive externalities.

[58] For an early example, see Jon Nelson, "Airport Noise, Location Rent, and the Market for Residential Amenities," *Journal of Environmental Economics and Management*, 6, 1979, pp. 320-331. See also, Janet Kohlhase, "The Impact of Toxic Waste Sites on Housing Values," *Journal of Urban Economics*, 30, 1991, pp. 1-26.

[59] N. Edward Coulson and Herman Li, "Measuring the External Benefits of Homeownership," 46th Annual AREUEA Conference Paper, 2010, available at SSRN: http://ssrn.com/abstract=1717014.

C. Data on Tax Incentives for Residential Housing

Mortgage interest and real property tax deductions

Utilization

The Code contains a number of provisions that provide incentives for owning a home relative to renting.[60] The deductions for home mortgage interest and for real property taxes paid[61] reduce the after-tax cost of financing and maintaining a home. However, there are limits to these incentives.

For example, the deductions for mortgage interest and property taxes are only available if a taxpayer itemizes deductions. For 2010, a total of 142.9 million returns were filed. Of these, only 46.6 million claimed itemized deductions totaling $1.2 trillion in aggregate. Of returns claiming itemized deductions, nearly 41 million returns claimed a deduction for $172.2 billion of real property taxes paid. However, data suggest that perhaps as many as one-third[62] of returns filed by homeowners do not claim the itemized deduction for real property taxes paid. Approximately 37.5 million returns claimed $414.8 billion of itemized deductions for interest paid, of which 37 million claimed $394 billion of home mortgage interest, 2.9 million claimed $1.5 billion of deductible mortgage points, and 4.2 million claimed $5.6 billion of qualified mortgage insurance premiums.[63]

International comparison

The United States and many other countries have favorable tax treatment for homeownership, though the extent of tax preference varies across countries. Among the 33 countries that are members of the Organization for Economic Cooperation and Development ("OECD"), 18 provide a deduction for mortgage interest. Only nine impose some form of taxation on imputed rental income on owner-occupied housing. Every country except Switzerland provides some special treatment under the income tax for capital gain on the sale of a principal residence.

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[60] There are also some tax incentives that may reduce the cost of renting relative to owning. These are discussed in part II of this document.

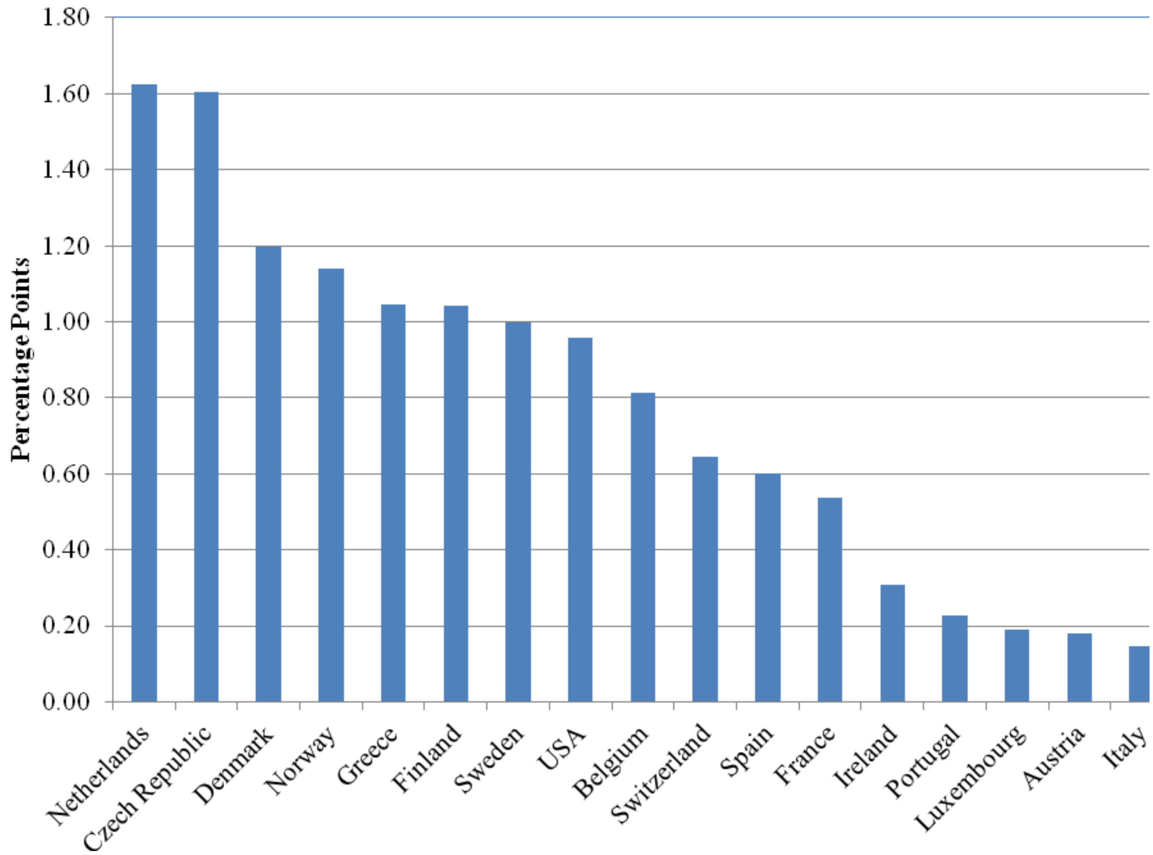
[61] Landlords may also deduct mortgage interest and real property taxes paid in determining taxable income. The preference for owning relative to renting comes from the fact that the deductions are permitted even though the imputed income that is generated is exempt from tax. See discussion below.

[62] In 2009, a temporary provision permitted nonitemizers to increase their standard deduction by a portion of real property taxes paid. An additional 19.5 million returns took advantage of this provision. Of the 45.7 million returns claiming itemized deductions that year, nearly 40 million returns claimed a deduction for $167.8 billion of real property taxes paid. The fraction of returns with some form of a deduction for real property taxes paid that claimed the above-the-line deduction is 19.5 million/59.5 million (19.5 million plus 40 million), or 32.7 percent. Internal Revenue Service, *2009 Estimated Data Line Counts, Individual Income Tax Returns*, Rev. 08-2011.

[63] Internal Revenue Service, *Individual Income Tax Returns 2010*, Publication 1304, Rev. 08-2012, Tables 1.1 and 2.1.

Figure 3 reports one measure of the extent of the tax preference for homeownership. It compares how different OECD countries[64] apply tax relief to the debt financing of homeownership by calculating the difference between the market interest rate and the after-tax interest rate on mortgages. For countries without a preference for home mortgage interest, this indicator takes the value of zero. The Netherlands, the Czech Republic, and the Scandinavian countries have a relatively greater wedge between the market interest rate and after-tax interest rate on mortgages than other OECD countries, including the United States.

Figure 3.–Tax Relief on Debt Financing Cost of Homeownership, 2009



This indicator takes into account if interest payments on mortgage debt are deductible from taxable income and if there are any limits on the allowed period of deduction or the deductible amount, and if tax credits for loans are available. For countries that have no tax relief on debt financing costs, this indicator takes the value of zero. Source: OECD.

[64] Sixteen of the 18 countries referred to above are shown. Data are not available for Estonia or Iceland. In addition, France is depicted, though it repealed its mortgage interest deduction effective from 2011.

Empirical evidence relating to the mortgage interest deduction

One study estimates that the mortgage interest deduction lowers the cost of capital for owner-occupied housing by seven percent.[65] Some researchers argue that this creates economic distortions; the subsidized mortgage debt may lead households to demand houses that are larger and more expensive than would be demanded in the absence of the mortgage interest deduction. In markets where the marginal buyer itemizes, this increased demand for larger and more expensive homes leads to a rise in price for these homes above what the market dictates in the absence of the deduction. The mortgage interest deduction may also lower the cost of home mortgage loans relative to other types of debt. Households may increase their demand for owner-occupied housing instead of choosing from potentially higher pre-tax return investments in other sectors. Finally, if the mortgage interest deduction results in relatively lower cost of home mortgage debt, households may increase their holdings of home mortgage debt.

Supporters of the home mortgage interest deduction believe that this policy has a positive effect on the U.S. economy, encouraging homeownership and accompanying positive spillover benefits. The empirical literature related to the externalities of homeownership is reviewed above. Other research questions whether the home mortgage interest deduction serves the purpose of encouraging homeownership, noting that the deduction disproportionately benefits high-income taxpayers, many of whom would be homeowners in the absence of any deduction.[66] Because money is fungible, it is also possible that these taxpayers use mortgage loans to increase other consumption rather than home purchases.

In addition to effects on efficiency, the home mortgage interest deduction carries distributional consequences. Because marginal tax rates increase with income, the average tax savings from the mortgage interest deduction increases as annual household income increases.[67] Furthermore, the average tax savings from the mortgage interest deduction varies within income groups. Consistent with the "life cycle" theory of savings in which younger households borrow more than older households to smooth consumption over the life cycle,[68] research suggests that for households with greater than $75,000 of annual income, average tax savings from the mortgage interest deduction are largest for younger homeowners (ages 25 to 35). For households with less than $75,000 of annual income, average savings are largest for middle-aged

[65] James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings*, vol. 96, May 2008.

[66] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy 17*, Cambridge, Mass.: The MIT Press, 2003, pp. 37-82.

[67] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017* (JCS-3-10), February 1, 2013, p. 48.

[68] Milton Friedman. *A Theory of the Consumption Function*, Princeton University Press, 1957. Alberto Ando and Franco Modigliani, "The 'Life Cycle' Hypothesis of Saving: Aggregate Implications and Tests," *American Economic Review*, 53:1, March 1963, pp. 55-84. Rather than subject consumption to fluctuations in current income, consumers may smooth their consumption over time. For example, consumers may accomplish this smoothing by saving to fund consumption during retirement and by borrowing to finance consumption early in life.

homeowners (ages 35 to 50).[69] Within income groups, the largest benefits generally accrue to taxpayers who have higher loan-to-value ratios, and to those taxpayers purchasing more expensive homes.

Table 3 shows the distribution of tax expenditures for the mortgage interest deduction by income class in 2012. The largest tax expenditures accrue to those households with the highest incomes as they are more likely to own homes, are more likely to itemize deductions, face higher tax rates, and have larger mortgages.

Table 3.−Distribution by Income Class of the Tax Expenditure for the Home Mortgage Interest Deduction at 2012 Rates and 2012 Income Levels[1]

Income Class[2]	All Returns[3]	Tax Expenditure for Home Mortgage Interest Deduction		
	Returns (thousands)	Returns (thousands)	Amount ($ millions)	Average Per Return in Dollars
Below $10,000	17,878	1	$1	-----
$10,000 to $20,000	17,418	177	48	271
$20,000 to $30,000	18,526	489	235	481
$30,000 to $40,000	15,862	997	585	587
$40,000 to $50,000	14,182	1,792	1,151	642
$50,000 to $75,000	26,339	5,799	5,906	1,018
$75,000 to $100,000	16,618	6,081	7,567	1,244
$100,000 to $200,000	22,735	14,065	29,068	2,067
$200,000 and over	6,321	4,701	23,606	5,021
Total	155,879	34,102	68,166	$1,999

[1] Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.
[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.
[3] Includes filing and nonfiling units. Filing units include all taxable and nontaxable returns. Nonfiling units include individuals with income that is exempt from Federal income taxation (*e.g.*, transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.
Note: Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

[69] James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings*, vol. 96, May 2008.

Table 4 reports the distribution of tax expenditures for the real property tax deduction by income class in 2012. As is the case for the mortgage interest deduction, the largest tax expenditures for the real property tax deduction accrue to those households with the highest incomes as they are more likely to own homes, are more likely to itemize deductions, and face higher tax rates.

Table 4.−Distribution by Income Class of the Tax Expenditure for the Real Property Tax Deduction at 2012 Rates and 2012 Income Levels[1]

Income Class[2]	All Returns[3]	Tax Expenditure for Real Property Tax Deduction		
	Returns (thousands)	Returns (thousands)	Amount ($ millions)	Average Per Return in Dollars
Below $10,000	17,878	[4]	[5]	-----
$10,000 to $20,000	17,418	120	$19	$158
$20,000 to $30,000	18,526	363	72	198
$30,000 to $40,000	15,862	860	196	228
$40,000 to $50,000	14,182	1,729	428	248
$50,000 to $75,000	26,339	5,903	2,232	378
$75,000 to $100,000	16,618	6,389	3,094	484
$100,000 to $200,000	22,735	15,185	12,199	803
$200,000 and over	6,321	3,749	6,071	1,619
Total	155,879	34,298	$24,310	$708

[1] Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.
[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.
[3] Includes filing and nonfiling units. Filing units include all taxable and nontaxable returns. Nonfiling units include individuals with income that is exempt from Federal income taxation (*e.g.*, transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.
[4] Fewer than 500 returns.
[5] Positive tax expenditure of less than $500,000.
Note: Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

<u>Deduction for interest on home equity loans</u>

Deductions for interest on home equity loans contribute to lower after-tax costs to the borrower for home equity loans relative to other sources of loans. Because the use of proceeds is not restricted, this may create an incentive for households to borrow for any purpose, including for consumption or investment. For example, a home equity loan can be used to pay off other debt, purchase a car, or for medical or educational expenses. Some researchers believe restrictions on the tax-deductibility of nonmortgage interest payments have spurred home equity borrowing in the past.[70]

The increased ability to borrow attributable to home equity loans may allow households to smooth lifetime consumption more optimally. Also, households may be able to improve lifetime earnings if they reinvest the loans in ways that increase future earnings and wealth. Supporters of the deduction on interest for home equity loans point to these possibilities as ways to improve equity in the tax treatment of households. On the other hand, some researchers find a significant negative correlation between a household's stock of second mortgage debt and its net worth, consistent with the view that households primarily use home equity loans to increase consumption.[71]

Exclusion of imputed rental income

Homeowners also receive preferential treatment under U.S. tax law because the imputed rental income on owner-occupied housing (that is, the cost of rent which the taxpayer avoids by owning and occupying a home) is not taxed. Consider two taxpayers: one rents a home at a $1,000 monthly rate, and the other owns a home which carries a $1,000 monthly mortgage. All else equal, a renter pays taxes on a measure of income that includes the $1,000 used to pay rent and the homeowner pays taxes on a measure of income that does not include that same $1,000. Similarly, compare the homeowner to a landlord. A landlord is taxed on net rental income (gross rent less deductions for mortgage interest, property taxes, depreciation, and insurance). A homeowner could rent the house to another tenant and receive an economic benefit equal to this net rental income. The economic benefit received by a homeowner who decides to live in his own house must be no less than the net rental income he could have received by renting to another tenant (otherwise the homeowner would be better off renting out his house). However, this economic benefit is not subject to tax. If imputed rental income were included in income, it would be consistent with income tax principles to allow a deduction for mortgage interest, property taxes, and depreciation as costs of earning that income. Because tax law allows taxpayers to deduct mortgage interest and property taxes to determine their taxable income but does not tax imputed rental income or allow them to deduct rental payments, it creates an incentive to buy rather than rent a home, and to finance the acquisition with debt.

Most other countries do not tax imputed rental income under the income tax. Among OECD countries, only Belgium, Greece, Iceland, Luxembourg, the Netherlands, Poland, Slovenia, Switzerland, and Turkey tax imputed rents.[72] Many countries do not tax imputed rental income because of difficulty in measuring it accurately. Some of the countries that do tax it often underestimate the rental value or only tax it partially. An efficient income tax system

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[70] Joyce Manchester and James Poterba, "Second Mortgages and Household Saving," *Regional Science and Urban Economics*, 19, 1989.

[71] *Ibid*.

[72] Calista Cheung, "Policies to Rebalance Housing Markets in New Zealand," OECD Economics Department Working Paper No. 878, July 1, 2011, pp. 38-39.

would tax all income in the same way, implying a tax on imputed rental income, net of interest, taxes, depreciation, and insurance. An alternative would be to exclude imputed rental income, but deny deductions for mortgage interest, property taxes, depreciation, and insurance.[73]

Qualified private activity bonds

Gross income generally does not include interest paid on State or local qualified private activity bonds, including qualified private activity bonds issued to finance residential housing. Figure 4 shows the volume of new money issuances of long-term private activity bonds in total, the volume of mortgage revenue bonds,[74] and the volume of residential rental bonds since 1988 as reported to the IRS on Form 8038.[75] For 2010, $4.3 billion of qualified mortgage bonds were issued to finance owner-occupied residences and $3.5 billion of qualified residential rental bonds for residential rental housing. Mortgage revenue bonds range between 2.1 percent and 30.7 percent of all new money issuances of qualified private activity bonds over this period with an average of 12.8 percent. They also represent on average less than one-third of one percent of all single-family mortgage originations.[76] Qualified residential rental bonds represent between 1.5 percent and 13.6 percent of all new money issuances of qualified private activity bonds between 1988 and 2010, with an average of 7.6 percent.

The mortgage revenue and the qualified residential rental bond programs allow States to issue tax-exempt bonds to finance residential housing. Because the interest on these bonds is excluded from gross income for Federal income tax purposes, and in some cases for State income tax purposes, investors are generally willing to accept a lower interest rate on these bonds than they might otherwise accept on a taxable investment, all else being equal (such as credit worthiness). This, in turn, lowers the borrowing cost for the beneficiaries of such financing. Some of the benefits, however, accrue to bond investors in higher marginal tax brackets in the form of higher after-tax returns rather than to borrowers in the form of reduced interest costs or renters in the form of lower rents.[77]

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[73] OECD, *Tax Policy Reform and Economic Growth*, OECD Publishing, 2010, p. 93, available at http://dx.doi.org/10.1787/9789264091085-en.

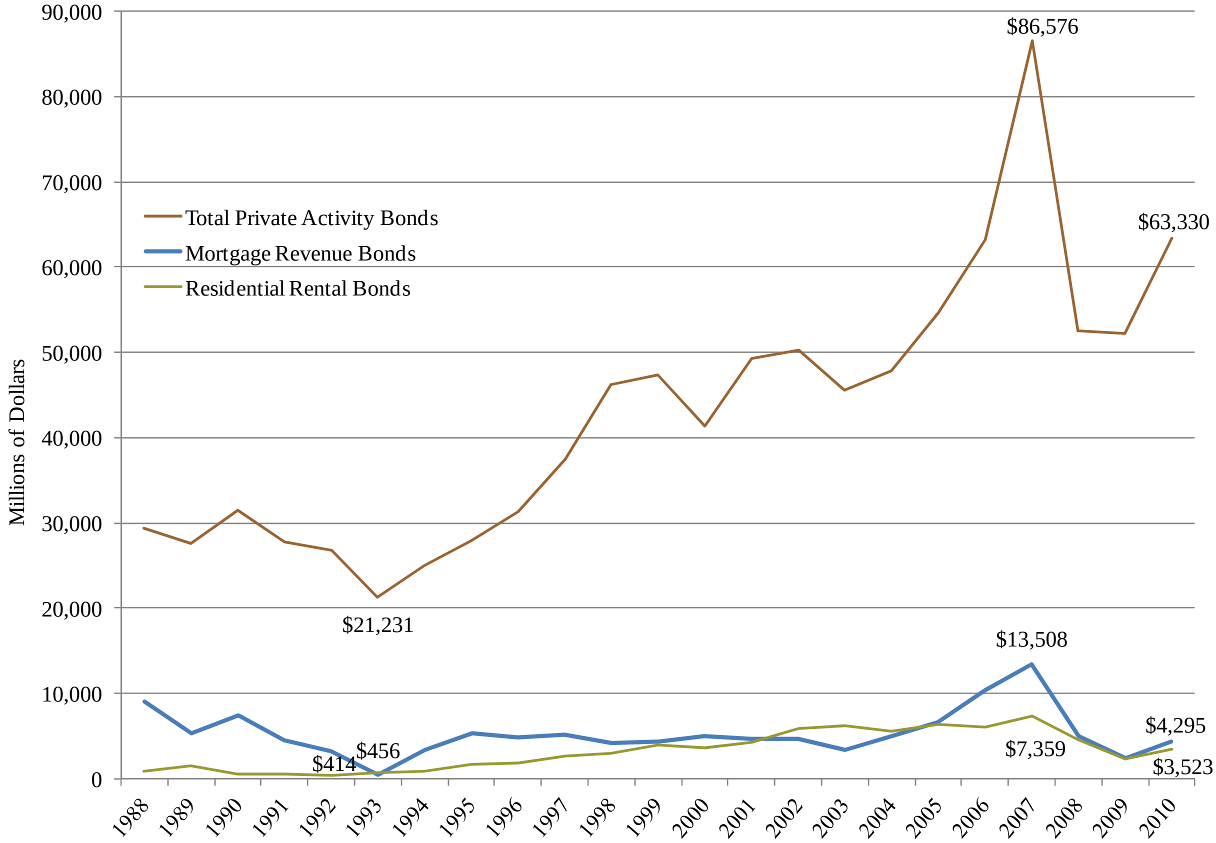
[74] Data are reported for qualified mortgage bonds only and not separately for qualified veterans' mortgage bonds because the detailed data for several years have been deleted to avoid disclosure of information about specific bonds. However, the data for all issuances are included in the appropriate totals.

[75] The highest and lowest volumes of issuance during the period are indicated on the chart for each bond purpose, as well as the volume for the most recent year for which data are available.

[76] Joint Committee staff calculations based on data from the Federal Housing Finance Agency on estimates of single-family mortgage originations, 1990-2010.

[77] For a discussion of the economic issues of tax-exempt bond financing and a table showing historical implied marginal tax rates for the marginal investor see Joint Committee on Taxation, *Present Law and Background Information Related to Federal Taxation and State and Local Government Finance* (JCX-7-13), March 15, 2013, pp. 50-56. See Joint Committee on Taxation, *The Federal Revenue Effects of Tax-Exempt and Direct-Pay Tax Credit Bond Provisions* (JCX-60-12), July 16, 2012, for a discussion of the economic modeling that the staff of the Joint Committee on Taxation undertakes to assess the Federal revenue effects of tax-exempt bond provisions.

Figure 4.-Long-term Tax-Exempt Private Activity Bonds, New Money Issuances, 1988-2010
(millions of dollars)



Source: Statistics of Income.

Because there are multiple tax brackets and the market-clearing purchaser of municipal bonds is likely to be in a lower bracket than most other bondholders, the loss of Federal tax receipts is greater than the reduction in the interest costs of tax-exempt issuers. Consider a taxpayer with a 25-percent marginal tax rate who purchases a $1,000 taxable bond that pays 6 percent. That investor receives $60 in interest income and pays $15 in income tax, for an after-tax return of $45 and an after-tax yield of 4.5 percent. That return is the same as the return the taxpayer receives on a $1,000 tax-exempt that pays 4.5 percent interest.

However, some taxpayers who purchase these bonds may be in a higher tax bracket and save more in taxes than the issuer saves in interest costs. For example, a taxpayer with a 33-percent marginal tax rate who purchases a $1,000 taxable bond that pays 6 percent receives $60 in interest income and pays $20 in income tax for an after-tax return of $40 and an after-tax yield of 4 percent. However, this bond investor receives 4.5 percent net return on the tax-exempt bond. Thus, unlike the investor in the 25-percent tax bracket who is indifferent to investment in taxable or tax-exempt bonds, the bond investor in the 33-percent marginal tax bracket receives a greater benefit by purchasing the tax-exempt bond. In contrast, a bond investor with a 15-percent marginal tax rate receives no benefit from purchasing the tax-exempt bond.

Some of the benefits may accrue to the issuers of the bonds rather than to the borrower or renter. Since investors are generally willing to accept a lower rate of return on tax-exempt bonds than other similar investments, an issuer could borrow at the reduced rate and invest the proceeds in higher yielding investments. However, the Code provides detailed rules with which issuers must comply to ensure that the tax-exempt bonds do not become arbitrage bonds.[78]

The mortgage revenue bond program limits eligibility based on house prices and incomes. In markets with expensive housing, the income limits may preclude borrowers from participating, while in less expensive markets, many may participate who would be homeowners in the absence of the program. House price limits could push borrowers to markets where expectations of future price appreciation may be low, and therefore, where renting may be more attractive financially.[79]

Mortgage credit certificates

Holders of qualified mortgage credit certificates issued by State or local governmental units or agencies claim a credit for mortgage interest on Form 8396 of their individual income tax return. This reduces the after-tax cost of purchasing a home; however, the mortgage interest credit is limited to before-credit tax liability. For 2010, 41,733 returns claimed mortgage interest credits totaling $51.2 million. Table 5 reports the number of returns claiming the credit, the amount of credit claimed in current dollars and in constant 1990 dollars since 1990. It also reports the average mortgage rate for conventional single-family nonfarm mortgage loans.[80]

The number of returns claiming mortgage interest credits has declined by more than 50 percent since the peak in 1997, while the amount of credits claimed has fallen by nearly 60 percent. Since the credit is equal to a percentage of mortgage interest paid, the drop in interest rates in this period (about 30 percent) may be responsible for about half of that decline.

[78] Section 143(g) provides that the effective interest rate on mortgages financed by a qualified mortgage bond issue cannot exceed the yield on the bond issue by more than 1.125 percentage points. Qualified mortgage loans that satisfy this requirement are treated as meeting the general arbitrage requirement under section148.

[79] Richard K. Green, “Homeowning Social Outcomes, Tenure Choice, and U.S. Housing Policy,” *Cityscape: A Journal of Policy Development and Research*, 5(2), 2001, pp. 21-29.

[80] Data on mortgage rates are from the Federal Housing Finance Agency Finance Board's Monthly Survey of Rates and Terms on Conventional Single-Family Nonfarm Mortgage Loans. The reported information is based on fully amortized conventional mortgage loans used to purchase single-family nonfarm homes. The survey excludes mortgage loans insured by the Federal Housing Administration or guaranteed by the Veterans Administration, as well as loans used to refinance houses, nonamortized loans, and balloon loans.

Table 5.−Mortgage Interest Credit

Year	Number of Returns	Current Dollars (000)	Constant 1990 Dollars (000)	Average Mortgage Interest Rate
1990	51,659	54,769	54,769	9.74
1991	46,138	59,013	56,634	9.07
1992	63,587	76,648	71,433	7.83
1993	71,309	85,079	76,925	6.93
1994	75,273	80,857	71,302	7.31
1995	67,645	80,502	69,041	7.69
1996	79,173	94,796	78,997	7.58
1997	94,943	106,169	86,457	7.52
1998	98,432	103,744	82,730	6.97
1999	75,524	104,740	82,149	7.14
2000	72,316	85,325	64,738	7.86
2001	53,864	82,092	60,585	6.94
2002	66,789	69,016	50,157	6.44
2003	53,922	69,115	49,087	5.67
2004	51,477	52,646	36,433	5.68
2005	48,221	55,771	37,330	5.85
2006	48,897	48,366	31,366	6.54
2007	33,185	37,432	23,602	6.42
2008	39,094	43,319	26,302	6.06
2009	44,686	44,182	26,924	5.05
2010	41,733	51,199	30,695	4.81

Source: Statistics of Income, Federal Housing Finance Agency.

Exclusion from income of certain housing allowances and related deductions

The exclusion from income for the rental value of parsonages and the military basic allowance for housing may also provide an incentive to own a home. The exclusion is available whether the individual owns or rents a home. However, in the case of a homeowner, no otherwise allowable deduction for mortgage interest or real property taxes is denied, notwithstanding the general rule that deductions related to tax-exempt income are not permitted. Thus, the taxpayer is permitted these deductions even though the income used to acquire the home and the imputed rental income from the owner-occupied housing are both excluded from income. This makes it more attractive to use these benefits to own rather than rent a home.

Taxation of income from the discharge of indebtedness

Taxation of income from the discharge of indebtedness may affect the incentives of households to borrow. In principle, taxation of this income reduces the net benefit of filing for bankruptcy and reduces incentives to borrow.

Researchers are divided on the main causes of bankruptcy filings. Some studies claim that bankruptcy filings are primarily the result of adverse events (such as sickness, accidents, unemployment, divorce). Others claim that consumption patterns play a larger role.[81] If consumption patterns play an important role in households' decisions to file for bankruptcy, these filings may be strategic. That is, households may weigh costs and benefits in their decision to file. Furthermore, the availability of the option to file for bankruptcy can change households' consumption patterns if households are more likely to consume knowing they bear less than the full cost of consumption in the event of bankruptcy. Some research shows households do indeed behave strategically, filing for bankruptcy when the benefits of filing (for example, discharge of indebtedness) exceed the costs of filing (for example, forfeiture of assets).[82] Taxation of indebtedness income reduces incentives to borrow by reducing the net benefit of filing for bankruptcy. If adverse events are primarily responsible for bankruptcy filings, these incentives will have a smaller effect on actual borrowing. On the other hand, if consumption patterns are primarily responsible for bankruptcy filings, these incentives will have a larger effect on actual borrowing.

Some types of debt discharges are excluded from Federal income taxation. They include, for example: farm indebtedness, certain qualified real property business indebtedness, qualified principal residence indebtedness that is discharged before January 1, 2014, and certain student loan indebtedness. The exclusion of qualified principal residence indebtedness that is discharged before January 1, 2014, from Federal income taxation reduces the cost of borrowing and therefore increases the incentives to borrow to purchase a home.

For 2010, 229,959 returns excluded an amount from gross income due to the discharge of qualified principal residence indebtedness, of which 72,520 reduced the basis of their home because they continued to own it. Table 6 reports the number of returns claiming this benefit since 2008.

Table 6.–Discharge of Principal Residence Indebtedness

Year	Number of Returns	Returns with Basis Reduction
2008	82,075	36,747
2009	168,691	62,494
2010	229,959	72,520

Source: Statistics of Income.

[81] Ning Zhu, "Household Consumption and Personal Bankruptcy," *Journal of Legal Studies*, 40, 2011.

[82] Scott Fay, Eric Hurst, and Michelle White, "The Household Bankruptcy Decision," *American Economics Review*, 92, 2002.

Low-income housing tax credit

A low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Table 7 reports the allocations of 70-percent credits and 30-percent credits from 2001 through 2011. The effect of the special rule establishing a temporary minimum present-value credit rate for the 70-percent credits is evident in 2009. Having represented about three-quarters of all credit allocations on average in prior years, the 70-percent credits represent over 90 percent of all allocations in 2009.

Table 7.–Low-Income Housing Credit Allocations (millions of dollars)

Year	70% Credits	30% Credits
2001	462.3	137.2
2002	517.2	201.7
2003	573.6	215.2
2004	606.0	216.4
2005	586.5	246.1
2006	730.8	256.0
2007	790.6	315.2
2008	939.9	335.0
2009	1,136.2	93.6
2010	917.4	186.9
2011	749.7	228.3

Source: State Housing Finance Agencies Factbook: NCHSA Annual Survey Results, Years 2001-2011.

Table 8 reports low-income housing tax credits claimed by corporations[83] on Form 3800 (relating to general business credits) since 2001.[84] Credits claimed increased steadily through the decade and reached a peak of nearly $6.4 billion in 2008 before declining.

[83] In addition to the credits claimed by corporations, a small amount of low-income housing tax credits is claimed by individuals. These amounts are not included in the table.

[84] The amounts reported do not reflect the actual tax reduction achieved by taxpayers claiming low-income housing tax credits, as the actual tax reduction depends upon whether the taxpayer had operating losses, is subject to the alternative minimum tax, and other aspects specific to each taxpayer's situation.

Table 8.–Low-Income Housing Tax Credits Claimed by Corporations (millions of dollars)

Year	Credits Claimed
2001	2,823.5
2002	3,490.8
2003	3,976.3
2004	4,366.4
2005	4,755.7
2006	5,336.6
2007	5,519.8
2008	6,370.4
2009	6,097.8
2010	5,479.5

Source: Various Statistics of Income Corporate Files.

Rehabilitation tax credit

Table 9 reports the total amount of rehabilitation tax credits claimed since 2003.[85] The data represent claims by both individuals and corporations for both the 20-percent credit for historic structures and the 10-percent credit for buildings other than historic structures.

Table 9.–Rehabilitation Tax Credits Claimed (millions of dollars)

Year	Credits Claimed
2003	608
2004	556
2005	606
2006	730
2007	739
2008	805
2009	681
2010	651

Source: Statistics of Income.

[85] The amounts reported do not reflect the actual tax reduction achieved by taxpayers claiming rehabilitation tax credits, as the actual tax reduction depends upon whether the taxpayer had operating losses, is subject to the alternative minimum tax, and other aspects specific to each taxpayer's situation.