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Taxes, the Problem and Solution: A Model for Vanishing Deductions and Exclusions for Residence-Based Tax Preferences

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Taxes, the Problem and Solution: A Model for Vanishing Deductions and Exclusions for Residence-Based Tax Preferences

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I. INTRODUCTION

The Revenue Act of 1913 recently marked its 100-year anniversary.[1] It is difficult to discern why certain policy issues remain unresolved after a century of tax policy. Scholars have called for more progressivity in the tax code, yet there has been little reform.[2] In part, this call seeks to balance the government's demand for revenue and the need to relieve the burden imposed on low- and middle-income taxpayers.[3]

Taxation is an essential component to raising revenue for the government.[4] Despite public resistance to raising taxes during an economic crisis, taxation has historically been successful in addressing revenue shortfalls.[5] While it may be a political risk to increase taxes on ordinary income for the average American, there may not be the same societal resistance to modifying or eliminating tax preferences that primarily benefit the wealthiest taxpayers. By modifying or eliminating certain tax preferences, the government can address some of the revenue shortfalls without raising taxes.

This article contributes to the scholarly discussion on the modification and elimination of tax preferences[6] by demonstrating the connection between the tax

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1. Revenue Act of 1913, Pub. L. No. 63-16, § II(B), 38 Stat. 114.

2. *See, e.g.*, Beverly Moran, *Wealth Redistribution and the Income Tax*, 53 How. L.J. 319 (2010); Adam S. Chodorow, *Biblical Tax Systems and the Case for Progressive Taxation*, 23 J.L. & Religion 51 (2007–2008); John W. Lee, III, *The Capital Gains "Sieve" and the "Farce" of Progressivity 1921–1986*, 1 Hastings Bus. L.J. 1 (2005).

3. Adam Looney & Michael Greenstone, *Just How Progressive is the U.S. Tax Code?*, Hamilton Project (Apr. 2012), http://www.hamiltonproject.org/papers/just_how_progressive_is_the_u.s._tax_code/.

4. *Id.* ("The purpose of any tax system is to raise revenues to fund government programs.").

5. Phyllis C. Smith, *Change We Can't Believe In . . . or Afford: Why the Timing Is Wrong to Reduce the Estate Tax for the Wealthiest Americans*, 42 U. Mem. L. Rev. 493, 506 (2012); *see also* Jeffrey A. Cooper, *Ghosts of 1932: The Lost History of Estate and Gift Taxation*, 9 Fla. Tax Rev. 875, 879 (2010) (explaining that Congress's solution to recover from the Great Depression was grounded in both creating new forms of taxes and increasing existing tax rates). *But cf.* Frank J. Slagle, *A Decade of Tax Policy: A Reflection of the Economic Dilemmas and Budget Deficits During the 1980s*, 25 New Eng. L. Rev. 1, 53 (1990) (explaining how tax savings can result in reduced revenues to the government and cause the federal budget deficit to grow).

6. *See, e.g.*, Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 Harv. L. Rev. 352, 361 (1970).

> The fact that a tax expenditure program can be recast as a direct expenditure program really takes us to the heart of tax reform, for it opens up a new way to consider the entire subject. We can regard a major aspect of income tax reform as involving the re-examination of all of the tax expenditure provisions now contained in the income tax. We should start by examining the list of tax expenditures and seeking to decide which should go and which should remain. In a sense, that of course is what tax reformers have always done, whether they talked in terms of base broadening, elimination of preferences, or needed elimination of loopholes.

Id.; *see also* Joseph A. Pechman, *Tax Reform: Theory and Practice*, 1 J. Econ. Persp. 11, 14, 26 (1987).

> Practically every president since World War II has recommended tax reforms to close loopholes, but only John F. Kennedy, Jimmy Carter, and Ronald Reagan supported reform along the lines of a comprehensive income tax. . . . I have learned the hard way that, if taxed at excessively high rates, the rich will seek out loopholes explicitly or implicitly designed for their benefit. It is a far better strategy to eliminate the loopholes

preferences associated with, and the overinvestment in, homeownership. In addition, this article demonstrates why limitations should be imposed on: (1) the type of taxpayers that qualify for and receive the benefit of these preferences; and (2) how much taxpayers receive. This article proposes limitations based on both household income with phase-outs and on the number of tax benefits a taxpayer may receive based on homeownership. These housing-based tax preferences cost the government billions of dollars in lost revenue, yet benefit only a small percentage of the population without a clear impact on the homeownership rates.[7]

While there are numerous tax preferences associated with homeownership, this article focuses on the two most expensive tax expenditures for housing:[8] (1) the mortgage interest deduction (MID);[9] and (2) the primary principal residence exclusion (PRE).[10] The MID and the PRE work in concert to subsidize wealthier homeowners while providing little-to-no benefit to the vast majority of the population; these tax expenditures represent billions of dollars in lost revenue.[11]

Part II—which is subdivided into three subparts—investigates whether the MID is part of the problem or the solution. Subparts A and B, respectively, introduce the MID and analyze the common historical justifications for promoting homeownership.

> first and expose the real effective tax rates applying to the top incomes. Only then does a battle over the rate of progression become possible.

Id.

7. Cong. Budget Office, The Distribution of Major Tax Expenditures in the Individual Income Tax System 17–18 (2013), *available at* http://www.cbo.gov/sites/default/files/43768_DistributionTaxExpenditures.pdf ("CBO estimates that the top quintile will receive almost three-quarters of the benefit of the deduction in 2013, including 15 percent accruing to the top percentile.").

8. *Id.* at 4 ("Estimates of tax expenditures are traditionally intended to measure the difference between households' tax liabilities under present law and the tax liabilities they would have incurred if the provisions generating those tax expenditures were repealed but households' behavior was unchanged."). *See generally* Joint Comm. on Tax'n, JCX-15-11, Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates 3 (2011), *available at* https://www.jct.gov/publications.html?func=startdown&id=3740 [hereinafter Background Information on Tax Expenditure Analysis] ("The Budget Act uses the term tax expenditure to refer to the special tax provisions that are contained in the Federal income taxes on individuals and corporations.").

9. Treas. Reg. § 1.163-1(b) (Westlaw 1976) ("Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness.").

10. I.R.C. § 121 (Westlaw 2010). "Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more." *Id.* § 121(a). For the purpose of this article, the PRE refers to personal homes for which the principal residence exclusion qualifies under § 121.

11. *See* Joint Comm. on Tax'n, JCS-1-13, Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017, at 33 (2013), *available at* https://www.jct.gov/publications.html?func=startdown&id=4503 [hereinafter Estimates of Federal Tax Expenditures]. The deduction for interest on owner-occupied residences was estimated at $70 billion in 2013, and the expenditures are estimated at $379 billion between 2013 and 2017. *Id.* The exclusion of capital gains on the sale of a principal residence was estimated at $24 billion in 2013. Between 2013 and 2017, expected expenditures are estimated at $130 billion. *Id.*

Subpart B analyzes the purported benefits of homeownership and the effect the MID has on wealth building and housing affordability. Subpart C analyzes the primary beneficiaries of current policies promoting homeownership.

Part III discusses the PRE and analyzes the historical justifications and significant tax policies associated with this exclusion. Because both the MID and the PRE involve tax preferences associated with homeownership, the PRE discussion is limited to the distinctions between the economic impact and exasperation of wealth inequality.

Part IV explores alternative solutions to the MID and the PRE exemption structures. This article offers proposals to modify current policies through the concept of the "vanishing deduction" and the "vanishing exclusion," which shift current policies to provide an increased benefit to low- and middle-income taxpayers with minimal benefit to wealthier taxpayers.[12] By effectively modifying the homeownership incentive programs, the cost of homeownership will be more affordable, taxpayers will be targeted for tax preferences by income group, and the government will recoup "lost" revenue to address the national debt. Part V concludes this article.

II. THE MID: PART OF THE PROBLEM OR THE SOLUTION?

A. Introduction

Initially, the MID[13] was just another personal deduction permissible under the tax code.[14] As originally introduced, the MID was not specifically referenced and was deductible like all other personal-interest debt. Whether a connection between the MID and homeownership is warranted is the substance of the debate surrounding the MID.

Despite debates regarding major tax reforms and different ways to reduce government expenditures, the MID was deemed "untouchable" because it was considered an important part of promoting homeownership.[15] However, there is a

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12. "Vanishing deduction" and "vanishing exclusion" are author-generated terms. The vanishing deduction refers to a method of reducing the amount of the MID available based on household income. The vanishing exclusion applies the same principles by limiting the availability of the PRE based on household income.

13. For the purpose of this article, the MID refers to personal home mortgages for first owner-occupied homes and, when applicable, second homes.

14. Revenue Act of 1913, Pub. L. No. 63-16, § II(B), 38 Stat. 114.

15. David Frederick, *Reconciling Intentions with Outcomes: A Critical Examination of the Mortgage Interest Deduction*, 28 Akron Tax J. 41, 63 (2013).

> The Act refined the deduction by eliminating its application to consumer interest and confirmed it as a tool to encourage homeownership and mortgage consumption. The Act entrenched the deduction as it promised—both implicitly and explicitly—that the new mortgage interest deduction would survive into the future and that homeowners could rely on it when making mortgage consumption decisions. These changes combined to make the Act an important turning point in the life of the interest deduction and one that, if properly observed, can offer insights into the larger role of the mortgage interest deduction in the mortgage market.

Id.

lack of an affirmative correlation between the MID and the housing market.[16] Since the MID preceded the mortgage market boom, it is difficult to determine the effects of the MID on the market.[17] Still, most Americans believe that the MID is the pathway to homeownership.[18]

As with other tax deductions and preferences, limitations should be placed on the types of taxpayers who qualify for, and receive the benefit of, the MID. These limitations should be based on household income to ensure that a taxpayer receives a limited number of tax benefits based on homeownership. Because homeownership has been credited with reducing crime rates and positively impacting communities and society at large, the MID is not a likely candidate for repeal.

B. Historical Justifications for Promoting Homeownership and the MID

1. How Did We Get Here?

MID supporters believe that resources promoting homeownership through the tax code are an appropriate use of this government expenditure.[19] Even people receiving no benefit at all support the MID because they either do not own a home or their mortgage interest does not exceed the standard deduction.[20] Largely, the support stems from one of the following: people mistakenly believing that the MID promotes homeownership; or people wanting to preserve the deduction for the day when they will buy their first home, or if they are already homeowners, a more expensive home.[21]

Scholars and economists consistently provide evidence of the MID's inefficiency in promoting homeownership.[22] To understand how the public became so invested in the mortgage market, it is necessary to briefly review the MID's historical background. When the Revenue Act of 1913 made the income tax permanent, it also

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16. *See infra* notes 63–86 and accompanying text. While some studies correlate housing and the MID, they do so without isolating other factors such as income per capita, unemployment rates, affordability, and other factors that influence the decision to purchase a home. *Infra* notes 63–86 and accompanying text.

17. Frederick, *supra* note 15, at 62. ("Moreover, since the interest deduction preceded the rise of the widespread American mortgage market, scholars have never been able to compare a market without the deduction to one with it, or observe the effects of introducing the deduction as a new variable to the market.").

18. Rebecca N. Morrow, *Billions of Tax Dollars Spent Inflating the Housing Bubble: How and Why the Mortgage Interest Deduction Failed*, 17 Fordham J. Corp. & Fin. L. 751, 760–61 (2012) ("In a recent poll conducted by The New York Times, more than 90 percent of respondents supported the mortgage interest deduction.").

19. *See generally* William T. Mathias, *Curtailing the Economic Distortions of the Mortgage Interest Deduction*, 30 U. Mich. J.L. Reform 43 (1996).

20. Morrow, *supra* note 18, at 759–60; Dean Stansel & Anthony Randazzo, Unmasking the Mortgage Interest Deduction: Who Benefits and By How Much? 4 (2011) ("Yet the mortgage interest deduction remains popular, possibly because of a misunderstanding by the public of its true impact.").

21. *See* Morrow, *supra* note 18, at 761.

22. *See id.* at 761–64; Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 Law & Contemp. Probs. 233, 281 (2010); Stansel & Randazzo, *supra* note 20, at 16.

provided for personal interest deductions—including the MID.[23] Still, the MID was unavailable to most homeowners because the average homeowner had no income tax liability and most Americans did not carry mortgages.[24] In 1910, approximately 33% of Americans carried mortgages, rising to approximately 40% ten years later.[25]

In 1913, only the wealthiest members of society were subject to taxation; homeowners who were not subject to taxation likely had other reasons for buying rather than renting.[26] Because the homeownership rate remained constant between 1900 and 1920, introducing the MID into the tax code did not significantly impact homeownership rates during that era.[27]

After World War II, to generate more revenue, the government expanded the income tax base to include additional taxpayers.[28] Consequently, more taxpayers were introduced into the pool of homeowners eligible to take advantage of the MID.[29] The homeownership rate increased approximately 20% between 1940 and 1960, representing the largest increase since 1913.[30] Since the MID was implemented long before 1940, another explanation likely exists for the increase in homeownership rates.

Professor Dennis Ventry, Jr. asserts that the implementation of three New Deal agencies had a major impact in stabilizing the homeownership market and increasing homeownership: the Home Owners' Loan Corporation (HOLC), the Federal Housing Administration (FHA), and the Federal National Mortgage Association ("Fannie Mae").[31]

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23. Ventry, *supra* note 22, at 236 ("Indeed, the historical record fails to indicate why Congress allowed a deduction for personal interest in 1913. Commentators have surmised that the deductibility of consumer interest 'may have been less a matter of principle than a reflection of the practical difficulty of distinguishing personal from profit-seeking interest.'" (quoting Stanley A. Koppelman, *Personal Deductions Under an Ideal Tax*, 43 Tax L. Rev. 679, 713 (1987))).

24. Frederick, *supra* note 15, at 51.

25. Ventry, *supra* note 22, at 242.

26. Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 Buff. L. Rev. 685, 685 (1989) ("[During] the 1930s, no more than five percent of Americans were income taxpayers."); *see also* Frederick, *supra* note 15, at 46 (citing Revenue Act of 1913, Pub. L. No. 63-16, § II(B), 38 Stat. 114).

27. U.S. Census Bureau, Historical Census of Housing Tables, https://www.census.gov/hhes/www/housing/census/historic/owner.html (last modified Oct. 31, 2011) (stating that homeownership rates were 46.5%, 45.9%, and 45.6% in 1900, 1910, and 1920 respectively); Joint Comm. on Tax'n, JCX-10-13, Present Law, Data, and Analysis Relating to Tax Incentives for Residential Real Estate 25 (2013), *available at* https://www.jct.gov/publications.html?func=startdown&id=4516 [hereinafter Present Law, Data, and Analysis].

28. Frederick, *supra* note 15, at 52 ("First, World War II changed the federal income tax system from a narrow tax on the wealthy to a broad tax that reached every American.").

29. To use the MID, the homeowner must be the taxpayer. When the income tax base expanded to include more taxpaying citizens at lower-income levels, these new taxpayers, who were also homeowners, became eligible to deduct the interest paid on their mortgage debt.

30. Present Law, Data, and Analysis, *supra* note 27, at 25.

31. Ventry, *supra* note 22, at 246–47.

First, he first points out that the HOLC was implemented as an emergency measure to stabilize the housing market.[32] The HOLC sought to make homeownership more affordable by restructuring mortgage loans through the purchase of defaulted mortgages and reissuing mortgages with new terms and conditions.[33] These new terms and conditions included measures that better positioned a borrower to make mortgage payments, such as providing fixed low-interest rates, extending the term of the loan, and providing predictable payment terms.[34]

Second, Ventry explains that while the FHA was established as an emergency stabilization program, it became a major insurer for financial institutions to encourage lending.[35] The FHA contributed significantly to the homeownership rate by making the terms of mortgage repayment more favorable for borrowers, thus encouraging homeownership.[36]

Finally, Ventry discusses how the federal government introduced Fannie Mae to create a secondary mortgage market for FHA-insured loans to provide liquidity to the mortgage market.[37] In the years following, through the joint efforts of these New Deal agencies, the number of foreclosures decreased, mortgage debt stabilized, and homeownership rates increased.[38] Although the income tax pool expanded during

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32. *Id.* at 247.

33. *Id.* ("Congress authorized the HOLC in 1933 as a quintessential emergency measure. It would infuse credit into housing markets, refinance homes to prevent foreclosures, and then liquidate itself (which it eventually did in 1951, though it stopped lending funds in 1935 when its appropriation dried up).").

34. *Id.*

35. *Id.* at 247–48 ("Over time, the FHA became synonymous with homeownership in the United States, becoming 'the largest mortgage insurer in the world,' and insuring over 34 million home mortgages and more than 47,000 multifamily-project mortgages.").

36. *Id.* at 248.

> The agency remade the mortgage industry by insuring long-term (eventually extended to thirty-year terms), fixed-rate, fully amortizing loans. It also insured loans for renovation of existing housing, created and oversaw national mortgage associations, and regulated interest rates and terms for its insured mortgages. Perhaps most importantly, the FHA established loan-to-value ratios (LTV)—historically set below 50%—first to 80% and eventually to as high as 95%. In combination with more favorable mortgage terms for borrowers, the LTV innovations significantly increased the number of people who could afford a down payment on a house and successfully service monthly payments.

Id.

37. *Id.*

> In 1938, Congress added Fannie Mae to the federal housing effort. It authorized the agency to create a secondary mortgage market for FHA-insured loans. By purchasing and securitizing mortgages, Fannie Mae allowed lenders to issue new mortgages to homebuyers without having to wait for borrowers to pay back enough of their original debt before issuing new debt. In this way, Fannie Mae added significant liquidity to the mortgage market.

Id.

38. *Id.*

> Foreclosures slowed and then fell steadily beginning in 1935, dropping from 229,000 to 185,000 in 1936, to 151,000 in 1937, all the way down to 59,000 by 1941. Home

the post–World War II era, the measures implemented under these New Deal agencies likely made the greatest impact on homeownership rates evidenced by homeownership rates that have remained steady since 1960.[39] Thus, the key to increasing and maintaining high homeownership rates is to make housing affordable and repayment terms more favorable for homeowners—not to provide substantial subsidies that primarily benefit wealthier taxpayers.

2. Tax Policy and the MID's Economic Impact

The Tax Reform Act of 1986 ("TRA 1986") gave the MID[40] a seemingly permanent home in the tax code[41] because it eliminated virtually all personal interest deductions, but maintained and specifically codified the MID—the most expensive personal interest deduction.[42]

Under § 163, a taxpayer may deduct the mortgage interest for a qualified residence, subject to certain restrictions.[43] A qualified residence, for the purpose of §

> mortgage debt, which had fallen precipitously from a high of $30.2 billion in 1930 to $23.9 billion just five years later, held firm at about $25 billion for the next ten years. Moreover, new housing starts jumped dramatically from 93,000 in 1933 to over 700,000 by 1941, while the amount spent on new housing construction climbed from $319 million in 1933 to $3.22 billion in 1941.

Id.

39. *Id.* at 249–53.

> The postwar housing boom was fueled in large part by New Deal agencies. The FHA helped millions of Americans keep their homes or become first-time homeowners. In its first two years of operation (1935 and 1936), the FHA insured mortgages for 6% and then 16% of all new homes. Over the next three years, it insured one-third of all new dwelling units. And in each year between 1942 and 1944, FHA-guaranteed loans financed more than 50% of all new construction, including 80% of all privately financed dwelling units in 1943. In total, from its inception in 1934 until 1956, the FHA insured nearly $31 billion in home mortgages on 4.6 million owner-occupied homes, helping transform the United States from a nation of renters to a nation of homeowners.

Id. at 249.

40. Tax Reform Act of 1986, Pub. L. No. 99-514, tit. V(B), § 511, 100 Stat. 2085, 2247.

41. *Id.*; *see also* Frederick, *supra* note 15, at 62–63. ("The Tax Reform Act of 1986 is a turning point because it *refined* and *entrenched* the interest deduction.").

42. *See* Joint Comm. on Tax'n, JCS-10-87, General Explanation of the Tax Reform Act of 1986, at 263–69 (1987), *available at* http://www.jct.gov/jcs-10-87.pdf; I.R.S. Chief Couns. Mem. 2012-01-017 (Jan. 6, 2012), *available at* http://www.irs.gov/pub/irs-wd/1201017.pdf (noting that "[p]ersonal interest became nondeductible under section 163(h) as added by the Tax Reform Act of 1986").

43. Tax Reform Act of 1986, § 511(b) (amending I.R.C. § 163(h)(3)(B) (1984)).

> Under § 163(h)(3)(B), however, interest expense constitute[d] qualified residence interest only to the extent that the underlying debt, when added to the principal balance of all other debt previously secured by the qualified residence, [did] not exceed the lesser of (a) the fair market value of the qualified residence, or (b) the sum of the taxpayer's basis in the qualified residence (adjusted only by the cost of any improvements) plus the amount of qualified indebtedness (secured medical and educational debt).

T.D. 8168, 52 Fed. Reg. 48407-02, 480407 (1987).

163(h)(5), is the principal residence of the taxpayer and one additional residence designated by the taxpayer.[44] Since most low- and middle-income taxpayers struggle to purchase a single home, one could reasonably infer that this definition was designed to provide the greatest tax preferential treatment to wealthier taxpayers.

A lesser-discussed corresponding issue is the home equity interest deduction. The Omnibus Budget Reconciliation Act of 1987 ("OBRA 1987") also affected the mortgage market and the MID by increasing the deductible amount of home equity debt.[45] Although home equity debt had been available and used by homeowners for years before and after the enactment of the OBRA 1987, the deductible amount increased to $100,000 on a qualified residence.[46] Thus, under the OBRA 1987, taxpayer housing subsidies increased, thereby contributing to overall government debt.[47] In the years following the TRA 1986 and OBRA 1987, consumer debt related to homeownership substantially increased.[48] Between 1981 and 1991, home equity debt increased from $60 billion to $357 billion.[49] This rate of increase in debt consumption indicates that the deductibility of home equity interest debt, another component of the MID, likely encouraged homeowners to incur more debt on existing homes, rather than promoted the purchase of a new home. High debt consumption rates negatively impacted homeowners and the economy.[50]

While the MID has affected consumer debt, it has also contributed to the gross federal debt (GFD).[51] Even though the economy is recovering from the Great

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44. I.R.C. § 163(h)(4)(A) (Westlaw 2013).

45. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10102(a), 101 Stat. 1330.

46. *Id.*; Frederick, *supra* note 15, at 76.

47. *See* Omnibus Budget Reconciliation Act of 1987, § 10102(a).

48. *See* Victor Stango, *The Tax Reform Act of 1986 and the Composition of Consumer Debt*, 52 Nat'l Tax J. 717, 721–22 (1999), *available at* http://ntj.tax.org/wwtax%5Cntjrec.nsf/6FBA7C45E24AA4A485256AFC007F1CB4/$FILE/v52n4717.pdf.

> The tax reform of the TRA 86 created a powerful set of incentives to change holdings of debt and to allocate debt differently. The changes in after-tax interest rates had both income effects due to the higher cost of all types of debt and substitution effects due to relative price changes between mortgage debt and personal debt.

Id.

49. Frederick, *supra* note 15, at 72.

> In 1981, there was $60 billion in home equity debt outstanding, making up 2.9% of all consumer credit; in 1986 there was $221 billion outstanding, making up 8.0% of all consumer credit; and in 1991 there was $357 billion outstanding, making up 9.8% of all consumer credit. Of this increase, the highest growth rates—often above 100% increases over prior years—occurred in the early 1980s, before the advent of the Act. These growth rates dropped off substantially in 1987 and slowed further thereafter.

Id.

50. *See* Morrow, *supra* note 18, at 776; *Historical Tables: Table 7.1—Federal Debt at the End of Year 1940–2019*, Office of Mgmt. & Budget, http://www.whitehouse.gov/omb/budget/Historicals (last visited Jan. 25, 2015) [hereinafter *Historical Tables: Table 7.1*]

51. *Historical Tables: Table 7.1*, *supra* note 50.

Recession, the GFD exceeded the national gross domestic product (GDP) in 2013 and is projected to continually increase.[52] The GFD has not been this high since the mid- to late 1940s.[53] In fact, the GFD did not substantially decline until 1961, almost twenty years after the first dramatic increase.[54]

The GFD continued to decrease until 1983, then a steady increase in GFD followed.[55] The GFD, as a percentage of the country's GDP, has made marked increases and has continued to rise since 1983.[56] While there is no way to pinpoint an exact cause for the shift that occurred around 1983, it is not a coincidence that major tax breaks also occurred at around the same time; therefore, tax policy changes after 1983 likely contributed to the United States' rising debt.

The MID costs billions of dollars in tax subsidies;[57] these dollars are greatly needed to address the federal deficit. The Congressional Budget Office, after reviewing select expenditures, reported that the MID is the most expensive deduction of the three selected.[58] According to the U.S. Office of Management and Budget, the MID has cost the government over $646 billion in tax expenditures between fiscal years 2010 and 2014.[59]

Tax policy continues to permit the interest paid from the mortgage of a qualified residence as a deductible expense.[60] Currently, the maximum aggregate amount for deductible interest for acquisition indebtedness on a primary and secondary residence is $1 million.[61] Reform is necessary to reduce the expenditure and shift tax preferences to taxpayers who exhibit a greater need.

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52. *Id.*

53. *See id.* Between 1945 and 1947, the GFD averaged 113.8%. *Id.* In 2012, the GFD was 99.7% with an estimated average of 101.2% for 2013 through 2018. *Id.*

54. The GFD has been measured since 1940. *Id.* Between fiscal years 1942 and 1943, the GFD rose from 53.6% to 77.3%. *Id.* The GFD continued to rise to a historic peak of 118.9% in 1946 before the debt started its slow and steady descent. *Id.* The GFD did not reach 53% again until 1961. *Id.*

55. *Id.*

56. *Id.*

57. John A. Powell, *Reflections on the Past, Looking to the Future: The Fair Housing Act at 40*, 41 Ind. L. Rev. 605, 623 (2008) ("Tax subsidies to homeowners (wherein homeowners write mortgage interest off of their taxable income) amounted to a $119.3 billion subsidy nationwide.").

58. Cong. Budget Office, Tax Expenditures Have a Major Impact on the Federal Budget (Feb. 3, 2012), http://www.cbo.gov/publication/42919 ("Three other major tax expenditures allow taxpayers who itemize deductions to deduct their spending for certain items from their taxable income. The deduction for interest paid on mortgages for owner-occupied residences is the biggest of the three; tax expenditures for that deduction are projected to equal 0.8 percent of GDP between 2013 and 2022.").

59. Office of Mgmt. & Budget, Analytical Perspectives: Budget of the U.S. Government Fiscal Year 2010, at 300 (2009), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2010/assets/spec.pdf.

60. I.R.C. § 163(h)(2)–(3) (Westlaw 2013).

61. *Id.* § 163(h)(3)(B).

3. *Benefits of Homeownership*

Proponents of the MID have a variety of claims regarding the benefits of both homeownership and the role of the MID.[62] This discussion briefly analyzes four common assertions made to promote the ideology of homeownership and, by proxy, the MID.

a. *Homeownership and Crime Rates*

Proponents assert that homeownership gives people a stake in their communities, thereby stabilizing neighborhoods and reducing crime rates.[63] I discuss the following three studies in my analysis of the actual value of homeownership through the lens of crime rates: (1) the Ingrid Gould Ellen and Margery Austin Turner study; (2) the Jinlan Ni and Christopher Decker study; and (3) the Donald Haurin, Robert Dietz, and Bruce Weinberg study. Based on these studies, the research regarding the effect of homeownership on crime rates and neighborhood stabilization has revealed mixed results.

An article by Ellen and Turner states that "few studies explore how neighborhood environment might affect criminal behavior."[64] Ellen and Turner discovered that quantitative empirical research conducted on neighborhoods and criminal behavior, which relied solely on the analysis of aggregate neighborhood data,[65] consistently found a connection between neighborhood environments and crime rates.[66]

Ellen and Turner challenged this causal connection by identifying the challenge in determining whether the community, or some independent factor, affects people's behavior.[67] Specifically, they demonstrated that the quantitative research for most of the studies did not have controls and did not account for other variables, such as the behavioral aspects of a criminal mind.[68]

In another empirical study, Ni and Decker evaluated crime in different counties across the United States to determine whether homeownership has affected crime rates in select years.[69] By using estimating strategies, they modeled homeownership as a function of the lagged crime rate.[70] Their findings revealed that insufficient

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62. *See* Present Law, Data, and Analysis, *supra* note 27, at 28–33.

63. *See generally* Denise DiPasquale & Edward L. Glaeser, *Incentives and Social Capital: Are Homeowners Better Citizens?*, 45 J. Urb. Econ. 354 (1999).

64. Ingrid Gould Ellen & Margery Austin Turner, *Does Neighborhood Matter? Assessing Recent Evidence*, 8 Housing Pol'y Debate 833, 852 (1997).

65. *Id.*

66. *Id.*

67. *See id.* at 852–53.

68. *Id.*

69. Jinlan Ni & Christopher Decker, *The Impact of Homeownership on Criminal Activity: Empirical Evidence from United States' County Level Data*, 2 Econ. & Bus. J.: Inquiries & Persp. 17 (2009). This study was conducted between 1990 and 2000. *Id.* at 20.

70. *Id.* at 21.

evidence exists to demonstrate a relationship between crime and homeownership using simple correlations.[71]

Instead—by controlling for other variables,[72] such as population density and income per capita through a linear regression model[73]—Ni and Decker claim to have more accurate results by comparing the crime rate to the homeownership rates over a one- or two-year time period.[74] Their research suggests that homeownership unequivocally reduces future crime rates, both property and violent crimes.[75]

Notwithstanding their conclusions, Ni and Decker acknowledge that income also impacts the correlation between homeownership and crime rates.[76] The income level of a person seeking to purchase a home determines what type of home and neighborhood he can afford to live in. Neighborhoods with higher property taxes inevitably have greater resources devoted to the police department, which influences crime-deterrent factors such as response time to reports of criminal activity.[77] Therefore, someone who can afford to purchase a more expensive home may gravitate toward neighborhoods with existing low crime rates.[78]

Ni and Decker also acknowledge that unemployment rates, poverty rates, and population density affect criminality, as well as the types of crimes committed.[79] Given all of the concessions on these additional variables, Ni and Decker's argument that homeownership has a definitive positive impact on crime rates is unpersuasive. At best, Ni and Decker's research reveals mixed results.

In another study, Haurin, Dietz, and Weinberg reviewed literature theorizing the connection between homeownership, crime rates, and other effects. Their study sought to determine how neighborhoods and homeownership rates affected residents

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71. *Id.* at 19.

72. *Id.* at 21. The researchers reviewed existing empirical research and collected a number of "'control' variables generally accepted to be determinants of crime rates . . . includ[ing] income per capita, unemployment rates, poverty rates, population density and percentage of black population, all of which are delineated at the county level." *Id.*

73. *Linear Regression*, Yale, http://www.stat.yale.edu/Courses/1997-98/101/linreg.htm (last visited Jan. 25, 2015) ("Linear regression attempts to model the relationship between two variables by fitting a linear equation to observed data. One variable is considered to be an explanatory variable, and the other is considered to be a dependent variable.").

74. Ni & Decker, *supra* note 69, at 21.

75. *Id.* at 26.

76. *See id.* at 21.

77. Nina L. Pickering, *Local Control vs. Poor Patrol: Can Discriminatory Police Protection be Remedied Through the Education Finance Litigation Model?*, 86 B.U. L. Rev. 741, 744 (2006) (noting that wealthier neighborhoods have an advantage over poor neighborhoods because they have more money for public services, including police protections); *see also* Alexandra Natapoff, *Underenforcement*, 75 Fordham L. Rev. 1715, 1723 (2006) (noting that in minority neighborhoods with higher crime rates, police offer less service).

78. Ni & Decker, *supra* note 69, at 21.

79. *Id.* at 22.

and surrounding areas.[80] Their study reveals that prior empirical work tended to focus on the size of the neighborhood effect rather than testing how or even whether such effect existed.[81] After reviewing the different theoretical and empirical literature, Haurin, Dietz, and Weinberg concluded that insufficient empirical research existed to determine what, if any, relationship exists between homeownership and the social benefits it purports to provide.[82]

A comparison of these three studies shows that while homeownership may be admirable and preferred, the government is not justified in keeping this substantial tax expenditure in its current form based on the assertion that homeownership reduces crime rates.

b. *Homeownership and the Impact on Children*

MID proponents also assert that homeownership has a positive impact on children. Ellen and Turner conducted various research projects on the impact neighborhood environments have on families and children.[83] Their findings indicate that some empirical studies conducted by other researchers likely over- or understate the neighborhood's effect due to "methodological pitfalls."[84] When measuring neighborhood conditions, many studies use various proxies that do not accurately reflect the purported outcomes.[85]

While some research supported the premise that neighborhoods are important, Ellen and Turner found that other factors, such as family dynamics and parents'

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80. Donald R. Haurin et al., *The Impact of Neighborhood Homeownership Rates: A Review of the Theoretical and Empirical Literature*, 13 J. Housing Res. 119, 119 (2003).

81. *Id.* at 125. Haurin, Dietz, and Weinberg also identified variables that make it difficult to predict or estimate the neighborhood effect with certainty, such as price of homeownership and interactions with family, as well as neighborhood characteristics and gentrification. *See id.* at 133.

82. *Id.* at 143.

83. Ellen & Turner, *supra* note 64, at 834.

84. *Id.* at 843.

> Three significant methodological pitfalls challenge empirical research on neighborhood effects. First, it may be difficult to identify and measure the neighborhood conditions that actually play the most important role in shaping outcomes for families and children. Second, neighborhood effects may be nonlinear, and therefore may not be easily discernible. And third, as many have pointed out, it is difficult to separate the effects of neighborhood environment from individual or family characteristics, especially characteristics that are difficult to measure and observe.

Id.

85. *Id.*

> For example, it might be crime rates, school quality, social capital, or some interaction of several factors that makes a neighborhood a more or less healthy place for families to live. Unfortunately, because many symptoms of neighborhood distress are highly correlated, it may be extremely difficult . . . to differentiate their effects.

Id.

education and income levels, significantly impact a child's educational attainment.[86] For example, neighborhoods with wealthy homeowners generate higher property taxes, which are used to fund local schools. In areas with higher property taxes, more resources are allocated to those schools. Conversely, the same tax dollars are not available—resulting in fewer resources for schools in low-income areas.[87] Therefore, it is hard to determine a government benefit for subsidizing homeownership using the MID in this regard.

c. Homeownership and Wealth Building

MID proponents also assert that homeownership contributes to a person's ability to build wealth. Traditionally, Americans have believed that homeownership is an essential component of the "American Dream."[88] To that end, in many households, homeownership represents the most valuable asset in a family's wealth holdings.[89] The appreciation of a home's value is a major factor in determining whether homeownership contributes to a homeowner's wealth. If a home maintains value, then a homeowner benefits even though he receives no additional income on the investment.

For example, in some states, such as Florida, a homeowner values the home as asset protection and wealth building for the next generation.[90] If the home loses value, a homeowner may be saddled with a home that is worth substantially less than owed on the mortgage, which could lead to foreclosure, threaten wealth building, and affect the nation's overall economic stability.[91]

Generally, the presumption is that if homeowners have negative equity, they will simply choose to abandon their homes, but research shows that the majority of

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86. *Id.* at 846.

87. *See* Pickering, *supra* note 77, at 744.

88. *See* Powell, *supra* note 57, at 623 ("Public opinion polls indicate that most renters aspire to be homeowners and that homeownership is a high priority, regardless of one's demographic status (married, single, with children, etc.).").

89. *See id.*

90. Florida has very generous homestead protections for homeowners. Homes are not subject to most creditor claims, and these protections can be transferred to the heirs of the homeowner. *See* FLA. CONST. art. X, § 4(a)–(b) (Westlaw 1998).

91. Brent T. White, *Underwater and Not Walking Away: Shame, Fear, and the Social Management of the Housing Crisis*, 45 WAKE FOREST L. REV. 971, 973–74 (2010).

> The collapse of the U.S. housing market has left millions of homeowners owing more on their mortgages than their homes are worth. As a historical snapshot, more than 34% of all mortgaged properties in the United States were "underwater" as of the third quarter of 2009. The national numbers hide the full extent of the problem, however, as the percentage of underwater mortgages has been much higher in the regions suffering the worst price declines. Again, as a snapshot, by the end of 2009, 65% of mortgage borrowers in Nevada were already underwater, 48% of homeowners were underwater in Arizona, 45% were underwater in Florida, 37% were underwater in Michigan, and 35% were underwater in California.

Id.

homeowners remain in their homes against their economic interests.[92] Some of these homeowners can take advantage of additional government financial assistance available through the Troubled Asset Relief Program (TARP).[93] However, by providing direct financial assistance to troubled homeowners, TARP also contributes to the federal deficit.[94]

Despite the best efforts of a homeowner, he may ultimately lose a home to foreclosure. The financial setbacks associated with a foreclosure eliminate most, if not all, of the wealth built by the household. In addition, the tax benefits received by the homeowner—such as the MID, real estate tax deduction, and TARP relief—are eliminated through the foreclosure process. In these situations, not only does the taxpayer lose his home, but the government forfeits revenue. Therefore, building a program focused on affordable homeownership is the best method to promote homeownership.

Another aspect of wealth building provided by homeownership is equity financing. Generally, homes build equity over time, providing homeowners with the option to borrow funds and use their home equity as collateral. Tax policy favors home equity financing. Section 163(h)(3)(C) provides a deduction for home equity debt totaling $100,000 or less.[95] Therefore, in addition to accessing built-in equity for whatever purpose a homeowner desires, that homeowner also has the benefit of deducting the interest associated with home equity financing.[96]

In theory, home equity loans sound like a great opportunity to build wealth. However, in reality, the encouragement of home equity financing may pose a problem for the homeowner because of the consequences of large debt.[97] By making home equity debt tax deductible, homeowners are encouraged to incur more debt, which in the end, places homeownership at risk.[98]

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92. *Id.* at 971–72.

93. Cong. Budget Office, The Budget and Economic Outlook: Fiscal Years 2013 to 2033, at 15 (2013), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/43907-BudgetOutlook.pdf ("In addition, the TARP recorded $3 billion in new spending, primarily for mortgage assistance, thus pushing outlays for the program to about $25 billion in 2012.").

94. *See id.*

95. I.R.C. § 163(h)(3)(C) (Westlaw 2013).

> The term "home equity indebtedness" means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed (I) the fair market value of such qualified residence, reduced by (II) the amount of acquisition indebtedness with respect to such residence. The aggregate amount treated as home equity indebtedness for any period shall not exceed $100,000 ($50,000 in the case of a separate return by a married individual).

Id.

96. *See generally id.* § 163.

97. Morrow, *supra* note 18, at 776.

98. For instance, when a homeowner has equity in a home, that homeowner has "phantom" wealth because equity exists as a result of the home's market value at that point in time. *See id.* at 775. If the market value changes, that positive equity could just as easily change to negative equity. *Id.* ("Americans often have

When a homeowner "cashes out" the equity, that homeowner converts low loan-to-value (LTV) ratio property to high LTV ratio property. Not only do high LTV ratios threaten the potential homeowner's household, they also threaten the community at large. Professor Rebecca N. Morrow observed that high LTV ratios contributed to the recent housing crisis.[99] In her research, she found that, "[h]omeowners with high LTV ratios lose their homes to foreclosure more frequently than homeowners with low LTV ratios."[100] This housing crisis contributed to what has become known as the Great Recession.[101]

In another example, if a homeowner owns the home debt free, he should not be encouraged to obtain debt using home equity to reduce unsecured debt or make consumer-based purchases. If a homeowner overestimates the future appreciation in the home, he could obtain debt with little or no ability to pay, thereby placing the home in jeopardy.[102] By encouraging homeowners to incur substantial debt via home equity loans, tax policy has created more problems than solutions for homeowners and the government.

By incentivizing home equity debt, tax policy undermines the very action it purports to encourage.[103] With the trend in homeownership debt outpacing consumer

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mortgage balances that approach, equal or exceed the fair market value of their homes. Unfortunately, the mortgage interest deduction encourages taxpayers to have high loan-to-value (LTV) ratios.").

99. *Id.* at 776.

100. *Id.* ("When a homeowner with a low LTV ratio becomes unable to pay his mortgage, he may sell his home and cash out his equity interest. In contrast, homeowners with high LTV ratios often cannot satisfy their mortgages through potential sale proceeds and are forced to default."); *see also* Larry Cordell et al., *Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program* 10 (Fin. & Econ. Discussion Series Div. of Res. & Stat. & Monetary Aff., Working Paper No. 2009-43), *available at* http://www.federalreserve.gov/pubs/feds/2009/200943/200943pap.pdf.

> Another factor contributing to the rise in defaults and foreclosures has been a dramatic increase in the number of households with negative equity; that is, the combined balance of all their mortgages exceeds the value of the underlying property. As of summer 2009, some estimates put the number of U.S. households that are "underwater" with their mortgages as high as 14 million, or 27 percent of U.S. homeowners with mortgages in 2009:Q1.

Id.

101. A recession is defined as a sharp decline in unemployment coupled with a low GDP (actual production and demand for goods services). *See Testimony of Chad Stone Chief Economist: Hearing on "Could Tax Reform Boost Business Investment and Job Creation"*, Ctr. on Budget & Pol'y Priorities 1 (2011), *available at* http://www.cbpp.org/files/11-17-11bud-test.pdf. The Great Recession time period is designated as between December 2007 and June 2009. *Id.* The National Bureau of Economic Research defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial promotion, and wholesale-retail sales." *US Business Cycle Expansions and Contradictions*, Nat'l Bureau Econ. Res. (Apr. 23, 2012), http://www.nber.org/cycles/US_Business_Cycle_Expansions_and_Contractions_20120423.pdf; *see also* Richard A. Posner, *When Does a Depression or a Recession End?*, Atlantic (Aug. 1, 2009, 4:47 PM), http://www.theatlantic.com/business/archive/2009/08/when-does-a-depression-or-a-recession-end/22544/.

102. *See* Morrow, *supra* note 18, at 774–76.

103. *See* Frederick, *supra* note 15, at 80.

debt, the wealth building justification of homeownership and the MID has lost merit over the years.[104]

d. Homeownership and Affordability

Finally, proponents assert that the MID makes homeownership more affordable because the deductible mortgage interest makes the net cost comparable to renting.[105] Research reveals the opposite. Morrow demonstrates that the MID actually inflates housing prices through price capitalization.[106] As a result, the MID contributes to making homeownership less affordable, while purporting to make it affordable due to price capitalization.[107] In fact, price capitalization is believed to have contributed to the "housing bubble" that ultimately burst in 2009.[108]

Instead of contributing to wealth building, the current policies associated with the MID contribute to wealth inequality because higher-income taxpayers receive the lion's share of the benefits.[109] The benefits of current policies flow to those with greater wealth because they purchase more expensive homes and are able to claim the tax deduction.[110] This reduces their tax liability and contributes to the regressive nature of our taxing system.[111]

Consequently, greater deductions flow to wealthier taxpayers and their overall tax liability decreases. This means that the government will receive substantially less

104. *See id.* 78–79.

> The trend of home equity debt growth relative to consumer debt is again broadly consistent with the general trend of mortgage debt patterns observed throughout this analysis: growth in the late 1980s, stability in the 1990s, and fast growth in the early 2000s. In this case, mortgage debt growth was consistently higher than consumer debt growth from 1986 to 1993, mortgage growth flattened off and consumer debt growth resurged in the mid-1990s, and mortgage debt once again grew quickly, noticeably faster than consumer debt growth, starting in 2001.

Id.

105. *See* White, *supra* note 91, at 979–80 ("As a rule of thumb, a potential homebuyer is generally better off renting when the home price exceeds fifteen or sixteen times the annual rent for comparable homes.").

106. Morrow, *supra* note 18, at 771–72, 776. ("Price capitalization is the increase in the price of an asset due to the increase in the value of an asset caused by a subsidy or incentive.").

107. *Id.* at 771–72.

108. *See id.* at 776.

109. Ventry, *supra* note 22, at 279–80.

110. *Id.* at 279–81.

111. Morrow, *supra* note 18, at 795.

> Moreover, the MID has gotten increasingly regressive over the last twenty years. In 1986, tax returns reporting income below $50,000 (indexed to 2009 dollars) received 13.7% of the tax savings associated with the MID, while returns reporting income over $100,000 (also indexed) received roughly 22% of the benefits. By 2007, returns reporting income below $50,000 received just 4.1% of the MID's largesse, while returns reporting income above $100,000 received an astounding 73% of the subsidy's value.

Ventry, *supra* note 22, at 280.

revenue, thereby requiring other areas to compensate for the revenue shortfall, such as cuts in government spending, raising revenue through other means, or increasing government debt. None of these options are justified when considering that wealthier taxpayers are the primary beneficiaries of the MID as it is currently implemented.[112]

Currently, the MID and home equity deduction contradict the goal of wealth building because these deductions encourage homeowners to acquire more debt than they can afford. Additionally, price capitalization caused by the MID drives up the cost of buying a home and, thus, makes homeownership less affordable.[113]

C. Who Are the "Biggest Winners" of the MID?

To determine whether the tax subsidy actually incentivizes taxpayers to purchase homes, it is necessary to determine who primarily benefits from the subsidy. One challenge in determining whether a link exists between variables in any given situation is measuring or attributing specific behavior when multiple factors are in play. Does the price, low interest rate, location, a potential homeowner's income, school ratings, low crime levels, or the MID drive a person to purchase a home? If all these factors existed except the MID, would the taxpayer still purchase the home? This is the million, or more appropriately, billion dollar question.

While it may be challenging to understand what motivates someone to purchase a home, it is not as difficult to assess the kind of person who does so. To make this assessment, it is necessary to compare the typical homeowner based on income level and homeowners who claim the MID on their tax returns.

Taxpayers in the top 10% of the income quintile generally become homeowners without an incentive because affordability and creditworthiness are not major factors in their decision to purchase. On the other end of the income quintile are people who earn the least amount of money and are most likely to be renters due to the debt associated with homeownership.[114] Even if people in the lowest-income quintile decided to purchase a home, such a decision would likely be based on tax-neutral reasons, such as affordability and creditworthiness.[115] As a result, whether they become renters or homeowners, the MID is likely unavailable to people in the lowest-income quintile because the MID is not likely to exceed the standard deduction.[116]

Between the two extremes are middle-income taxpayers. Because factors other than income level may influence their choice, these taxpayers do not have a predictable

112. *See infra* notes 119–34 and accompanying text.

113. *See* Morrow, *supra* note 18, at 772.

114. *See id.* at 795. Those on the lowest end of the income quintile tend to be a higher credit risk, and thus their interest amounts will be higher. With a higher interest rate, a house would have to be priced lower to be affordable.

115. *See* Powell, *supra* note 57, at 622–23.

116. *Id.* at 624 ("Only 3% of home owners with incomes of under $20,000 itemized their deductions in 1998; in contrast, 86% of homeowners with incomes above $75,000 itemized. 'And even among low-income homeowners that do itemize,' the value of the mortgage interest deduction is lower because their marginal tax rates are lower.").

pattern for whether they will become homeowners or renters. For instance, they are more likely to have some higher education and better paying jobs, as opposed to many low-income taxpayers.

However, these same middle-income taxpayers may also have debt associated with achieving higher education, which will likely affect their credit risk and influence their decision to purchase a home. Middle-income homeownership research shows only a slight benefit to middle-income taxpayers when compared to the high-income quintile.[117]

Middle-income homeowners have a homeownership rate of 67.95%.[118] More specifically, the Joint Committee on Taxation reported homeownership rates of 65.8% and below for households with an income of $40,999 or less,[119] and 70.1% and above for households with an income of $50,000 or more.[120] The homeownership rate for households with an income exceeding $120,000 is 89.4%.[121]

But, despite a high homeownership rate, middle-income taxpayers will not benefit from the MID if the mortgage interest does not exceed the standard deduction.[122] The rate at which taxpayers claim the MID has remained steady, but the beneficiaries of this tax benefit reveal the inequities associated with the MID.[123]

In 1991, IRS data showed that taxpayers with income less than $50,000 claimed the MID at a rate of 36% or less, even though this group comprised a majority of the taxpayers who filed that year.[124] On the other hand, in the same fiscal year, taxpayers with income of at least $100,000 claimed the MID at a rate of 76%.[125] By 2009, taxpayers with income of less than $50,000 claimed the MID at a rate of 22.9% while taxpayers with income of at least $100,000 claimed the MID at a rate of 64% or more.[126]

As taxpayer income increases, so does the percentage of taxpayers benefitting from the MID. In 2012, the MID tax expenditure averaged $642 or less for taxpayers with income less than $50,000.[127] This translated to over $2.02 billion in tax

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117. Ventry, *supra* note 22, at 280.

118. *See* Present Law, Data, and Analysis, *supra* note 27, at 26. Approximately 67.95% of median income households ($40,000–$59,999) own homes. *See id.* Homeownership rates range from 41.4% among those who earn less than $5,000 to 89.4% for those who earn more than $120,000. *Id.*

119. While the Joint Committee on Taxation reported that households with income between $40,000 and $40,999 have a homeownership rate of 65.8%, it can be strongly inferred from the other ranges of reported income levels that 65.8% accounts for household income between $40,000 and $49,999. *See id.*

120. *Id.*

121. *Id.*

122. Ventry, *supra* note 22, at 280.

123. *Id.*

124. Stansel & Randazzo, *supra* note 20, at 31.

125. *Id.*

126. *Id.*

127. Present, Law, Data, and Analysis, *supra* note 27, at 37.

expenditures.[128] In the same year, the MID tax expenditure averaged $1,018 or more for taxpayers with income between $50,000 and $75,000.[129] Thus, taxpayers with income of $50,000 or more primarily benefitted from the MID.[130] This translates to over $5.9 billion in tax expenditures.[131]

In the end, taxpayers who own homes and have income in the lower- to middle end of the income spectrum tend to receive little-to-no benefit from the MID.[132] The "biggest winners" of the MID are taxpayers with a household income exceeding $50,000.[133] When providing incentives, the government should make sure these incentives are extended to people who might not otherwise purchase a home but for the incentives.[134]

When incentives are provided to people who would otherwise purchase homes without them, it is a handout. In fact, the statistics discussed above reveal the true perversity of this tax preference—the primary beneficiaries do not financially need the subsidy. As such, this tax expenditure is somewhat unjustified as it applies to taxpayers with a household income of $50,000 or more, and is wholly unjustified as it applies to taxpayers with a household income of $100,000 or more—both scenarios contribute to the regressive nature of the tax code.

III. THE PRE

A. Introduction

Buying a home is one of the most important decisions a person will ever make,[135] and the decision to sell a home is an important decision as well. The next part of this article focuses on the tax implications and benefits when a home is sold.

A home is a capital gains property, meaning that any gains are taxable when the home is sold.[136] Instead of taxing built-in gains, the PRE allows homeowners to exclude a certain amount of capital gains when a home is sold at a gain.[137] Specifically, the PRE allows single taxpayers to exclude up to $250,000 ($500,000 for taxpayers

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128. *Id.*

129. *See id.*

130. Stansel & Randazzo, *supra* note 20, at 6 ("[T]wo thirds of those taxpayers with incomes above $100,000 [claim the mortgage interest deduction].").

131. Estimates of Federal Tax Expenditures, *supra* note 11, at 48.

132. Stansel & Randazzo, *supra* note 20, at 6.

133. *See* Estimates of Federal Tax Expenditures, *supra* note 11, at 48. Other "big winners" are the realtors, homebuilders, and financial institutions. *See* Lily Kahng, *Path Dependence in Tax Subsidies for Home Sales*, 65 Ala. L. Rev. 187, 210 (2013).

134. *See* Background Information on Tax Expenditure Analysis, *supra* note 8, at 13.

135. See *supra* Part I–II for a discussion on the benefits of homeownership.

136. *See* I.R.C. § 1221 (Westlaw 2010) (defining capital asset); *id.* § 121 (Westlaw 2010) (providing the exclusion rule for gain from the sale of a principal residence); Eisner v. Macomber, 252 U.S. 189 (1920) (explaining that a realization event is required before capital property is subject to taxation).

137. I.R.C. § 121.

filing jointly) if certain requirements are met.[138] This is a poor tax policy when combined with the MID provisions because both tax preferences benefit wealthier taxpayers at the expense of a majority of taxpayers.

B. Historical Justifications and Tax Policy

The preferred tax treatment for the sale of a principal residence made its initial debut into the tax code as a one-time tax deferral.[139] Section 1034, repealed in 1997, provided for non-recognition of gains for individuals who sold their personal residences to purchase a more expensive residence.[140] Section 1034 was not an exclusionary provision, but a tax deferral. Therefore, the tax on any gains from the property was due when the home was subsequently sold or otherwise disposed.[141]

Under § 1034, a taxpayer qualified for the tax deferral if he reinvested funds from the sale of his first home into the purchase of a new one.[142] Consequently, he would have had to purchase a more expensive home to qualify for the tax deferral.[143] Requiring the taxpayer to purchase a more expensive home to qualify for a deferral meant that the taxpayer had a choice of either: (1) paying the tax immediately; or (2) buying a more expensive home to defer paying the tax.[144] The tax deferral system caused a bunching effect when the borrower continued to "rollover" the gains into the purchase of a more expensive home.[145]

The tax bill would become due when the homeowner disposed of the home.[146] Whether the taxpayer decided to sell the home to downsize or to abandon the burden of homeownership altogether, a potentially large tax bill could be due based on years of untaxed gains carried over from one sale to the next.[147]

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138. *Id.* § 121(b).

139. *Id.* § 1034, *repealed by* Pub. L. No. 105-34, tit. III, § 312(b), 111 Stat. 839 (1997).

140. *Id.*

141. Christopher H. Hanna, *The Real Value of Tax Deferral*, 61 Fla. L. Rev. 203, 223 (2009).

> Generally, a deferral provision falls into one of two categories: (1) an item of income or gain that is not currently taxed, but rather is taxed in a later year, or (2) a deduction or loss that is accelerated from a future year to the current year. In both cases, a tax savings is achieved for the current year with an offsetting increase in taxes in a later year.

Id.

142. I.R.C. § 1034(a) (repealed 1997).

143. *Id.*

144. *See* Hanna, *supra* note 141, at 223.

145. David L. Cameron & Elliot Manning, Federal Taxation of Property Transactions 70 (2012) (explaining that bunching occurs when "the accumulated gain from the appreciation in the value of property is all realized in the year of disposition" and as a result are taxed at a higher marginal rate).

146. Hanna, *supra* note 141, at 222 ("Academics and practitioners commonly analogize tax deferral to an interest-free loan from the government to the taxpayer.").

147. While homes have historically appreciated in value, the potential for loss is always present in capital gains property.

For example, if a homeowner sold his home during retirement to purchase a smaller home, any tax deferred in prior years would become due. Owing a substantial tax bill on capital gains during retirement, or any other period when income is substantially reduced, places a homeowner at financial risk. These foreseeable, yet unintended consequences forced Congress to reevaluate the tax deferral system.

A repeal of the tax deferral system in favor of a "pay-as-you-go" system would have been the most obvious solution and would have eliminated the incentive to purchase a more expensive home in order to receive the tax benefit. Additionally, it would have solved the problem with any lurking gains associated with the deferral. Instead, Congress replaced a bad tax policy system with an even more regressive one.

Following the repeal of the § 1034 tax deferral, Congress amended the § 121 tax exclusion, which was originally enacted as part of the Revenue Act of 1964 ("Tax Reduction Act").[148] Section 121 provided a $20,000 tax exclusion for taxpayers over the age of sixty-five who had owned their home at least five of the eight years prior to the date of the sale.[149] The new provisions of § 121 provided some tax relief for taxpayers who had taken advantage of the tax deferrals in prior years. Some taxpayers also received the $20,000 tax exclusion as an additional tax preference[150] in order to provide relief from the bunching effect of the deferrals.[151]

The combination of the tax deferral, tax exclusion, and the MID has made homeownership a very expensive endeavor for the government to subsidize.[152] In addition, these preferences provide a perverse incentive for taxpayers to purchase more expensive homes to receive these tax benefits.

For years, tax policy following the Tax Reduction Act continued to increase the amount of the exclusion available to taxpayers, which made it easier for more taxpayers to qualify for the tax relief.[153] The Taxpayer Relief Act of 1997 ("TRA 1997") provided the next major tax breaks that affected the § 121 exclusion. When Congress repealed § 1034, the TRA 1997 provided an exclusion for capital gains from gross income up to $125,000 ($250,000 for taxpayers filing jointly) on the sale of a principal residence.[154]

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148. Revenue Act of 1964, Pub. L. No. 88-272, § 206(a), 78 Stat. 19.

149. I.R.C. § 121 (Westlaw 1964).

150. *Id*.

151. *See* Cameron & Manning, *supra* note 145, at 70.

152. *See* Present Law, Data, and Analysis, *supra* note 27, at 36.

153. *See, e.g.*, Tax Reform Act of 1976, Pub. L. No. 94-455, tit. XIV, § 1404(a), 90 Stat. 1520; Revenue Act of 1978, Pub. L. No. 95-600, tit. IV, § 404(a)–(c)(2), 92 Stat. 2763; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, tit. III, § 312(a), 111 Stat. 788 (various implemented Revenue Acts affected many aspects of the principal residence exclusion).

154. Taxpayer Relief Act of 1997, § 312(a). In order to qualify, taxpayers must meet certain requirements: (1) taxpayers must be fifty-five years or older; and (2) the property must have been the primary principal residence at least two of the last five years. The exclusion is available to the taxpayer for one-time use every two years. *Id*.; *see also* I.R.C. § 121 (Westlaw 1997).

For the PRE, the current form of the § 121 exclusion is the most regressive.[155] First, this new exclusion eliminated the age requirement.[156] Second, taxpayers may utilize the exclusion as often as every two years, provided the taxpayer has used the home as a principal residence for two of the last five years.[157] As such, this tax provision has created a windfall for the wealthiest homeowners and contributed to the regressive nature of tax policy.

Since no reporting requirements exist for taxpayers whose capital gains on the sale of a principal residence are less than the exclusion amount, tracing the actual PRE benefits is largely based on speculation.[158] Therefore, only homeowners whose property substantially appreciates in value will have any traceable benefits. The tax expenditures reported by the U.S. Office of Management and Budget for the exclusion of capital gains were approximately $31 billion in 2012, and are expected to exceed $263 billion between fiscal years 2014 and 2018.[159] This is an expensive tradeoff for the government.

C. Economic Impact and Wealth Building

Support for the PRE, as with the MID, is primarily based on the notion that it promotes homeownership.[160] As previously discussed, there is little support for this claim. However, tax policy continues to reward a population who would likely invest in homeownership despite the exclusion.

Like the MID, the PRE affects the country's economic health on a national scale, accounting for over $30 billion in tax expenditures in 2012.[161] The estimated expenditures for fiscal year 2014 was over $45 billion and is estimated to "cost" over $263 billion between fiscal years 2014 and 2018.[162] To place these numbers in perspective, the projected expenditure for 2014 is almost 30 times more than the estimate for the deductibility of student loans in 2012, and almost 200 times the estimate for student loans for fiscal years 2014 through 2018.[163]

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155. The current form of § 121 is the most regressive because the greatest benefit will be received by homeowners with the most capital appreciation. *See* Ventry, *supra* note 22, at 280. These homeowners will likely be in the higher-income households. *Id.*

156. I.R.C. § 121 (Westlaw 2010).

157. *Id.* § 121(a), (b)(3).

158. *See id.* § 6045(e)(5) (Westlaw 2011).

159. Office of Mgmt. & Budget, Analytical Perspectives: Budget of the U.S. Government Fiscal Year 2014, at 249 (2014), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/spec.pdf [hereinafter Analytical Perspectives 2014].

160. Mark Andrew Snider, *The Suburban Advantage: Are the Tax Benefits of Homeownership Defensible?*, 32 N. Ky. L. Rev. 157, 186 (2005).

161. Analytical Perspectives 2014, *supra* note 159, at 244.

162. *Id.* at 254.

163. *Id.* at 245. The estimate for tax expenditures for deductible interest for student loans is approximately $1.4 billion in fiscal year 2012 and $4.5 billion for fiscal years 2014 through 2018. *Id.*

Proponents of the PRE assert that it is justified because it contributes to wealth building.[164] Homeownership is a wealth building instrument for wealthier taxpayers because they tend to purchase homes in desirable neighborhoods that appreciate in value.[165] On the other hand, homes located in less desirable neighborhoods tend to have less appreciation, if any.[166] While a home may be the most valuable asset in a household, this is not enough to justify the PRE in its current form.

IV. WHERE DO WE GO FROM HERE?: A PROPOSED MODEL OF VANISHING DEDUCTIONS AND EXCLUSIONS

A. The Need for Change and Why the Time Is Now

Historically, society has encouraged homeownership based on the perception that homeownership creates more stable neighborhoods, provides children with better education options, reduces crime, and other intangibles beneficial to society at large.[167] The MID was codified based on the assertion that it increases homeownership rates.[168] During the earliest stages of the tax code, the wealthiest taxpayers shouldered the burden of raising revenue through taxation.[169] As time passed, the burden surreptitiously

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164. Snider, *supra* note 160, at 186.

165. *See* Jared Ruiz Bybee, *In Defense of Low-Income Homeownership*, 5 ALA. C.R. & C.L. L. REV. 107, 129–30 (2013).

> While the homes purchased by upper-income households may appreciate faster and cost less to maintain, the appreciation of homes purchased by low-income households still represents a greater boon to that family's wealth as compared to the increase in wealth from home appreciation experienced by upper-income households. In other words, while some benefits of homeownership may be muted in real terms, those same benefits can be more significant for low-income households in marginal terms.

Id. at 130.

166. *See id.* at 128–30.

167. Morrow, *supra* note 18, at 757 ("The mortgage interest deduction has received significant public and political support because of the strong belief that high rates of homeownership are critical to a strong economy and society, as well as the assumption that the mortgage interest deduction increases the rate of homeownership."); *see supra* Part II.B.3.

168. Morrow, *supra* note 18, at 756–57.

> The reason cited by Congress in 1986 for preserving the mortgage interest deduction was the promotion of homeownership. Congress believed that encouraging homeownership was an important policy goal and retained the mortgage interest deduction in an effort to advance that goal. In a government publication explaining the Tax Reform Act of 1986, for example, the Joint Committee on Taxation, a committee including Senators and Members of the House of Representatives, described the reason for preserving the mortgage interest deduction as furthering the policy goal of promoting homeownership. It stated: "Congress . . . determined that encouraging homeownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest." In an effort to advance the policy goal of homeownership, mortgage interest was saved from the phase out of the deduction for other forms of personal interest.

Id.

169. *See* Cooper, *supra* note 5, at 885–86.

shifted to low- and middle-income taxpayers via tax preferences for wealthier taxpayers. The time has come to start investing in the right taxpayers.

The pathway to homeownership should be structured to make it more affordable for low- and middle-income taxpayers. Since these taxpayers have traditionally received minimal benefit from the current versions of the MID and the PRE, it is appropriate to shift certain preferences in their direction. With billions of dollars in tax expenditures dedicated to homeownership, the price of homeownership (as currently implemented) is too high for the government to continue subsidizing.

There is a way to bridge the gap between the low-, middle-, and high-income taxpayers, but it will require major changes to the MID and the PRE. By redirecting government resources away from high-income taxpayers, the government will have more resources to provide assistance to low- and middle-income taxpayers. This will provide a true pathway to homeownership.

B. Make Home Buying More Affordable for Low- and Middle-Income Households

One of the primary barriers to homeownership is its price,[170] which impedes the ability of low- and middle-income taxpayers to purchase a home.[171] As such, providing assistance in the form of a tax deduction is inefficient and ineffective for low- and middle-income taxpayers. If a major barrier includes the upfront costs of purchasing a home, then receiving a deduction in the following calendar year does not provide meaningful assistance. Even if a taxpayer could afford the upfront costs, the deduction is a below-the-line deduction, meaning that the taxpayer must pay enough interest to exceed the standard deduction in order to receive a tax benefit.[172]

Because the standard deduction tends to provide a greater tax benefit to low- and middle-income taxpayers, the interest payment for a home in an affordable price range may not exceed the standard deduction to allow the homeowner to qualify for the benefit.[173] The older generation of these taxpayers tend to own their homes outright; as such, they receive no benefit from the MID.[174]

It bears repeating that the MID does little to assist low- and middle-income taxpayers with homeownership costs. For taxpayers on the margins, the current MID provisions may, instead, provide a perverse incentive to purchase a more expensive home than they can afford based on the belief they will qualify for the tax

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170. Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 Ariz. St. L.J. 1347, 1367 (2000).

171. Gerald Prante, *Who Benefits from the Home Mortgage Interest Deduction?*, Tax Found. (Feb. 6, 2006), http://taxfoundation.org/article/who-benefits-home-mortgage-interest-deduction; *see also* Present Law, Data, and Analysis, *supra* note 27, at 26 ("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.").

172. Prante, *supra* note 171.

173. Stansel & Randazzo, *supra* note 20, at 5–6.

174. Prante, *supra* note 171.

benefit.[175] Even if they qualify, the financial benefit[176] may not be worth the debt incurred if the homeowner is "house poor."[177] When taxpayers purchase homes they cannot afford, greater instability may be released on the market. With the housing market crash during the Great Recession, home values diminished in ways that devastated a homeowner's overall net worth for many households and led to unstable neighborhoods.[178]Any adjustments in policies to promote homeownership should include methods to make the cost of housing affordable for low- and middle-income taxpayers.

Professor Stanley S. Surrey proposes trading certain tax expenditures for direct financial assistance grants to certain taxpayers to address the tax policy inequities favoring the wealthy.[179] Surrey suggests that providing direct subsidies to taxpayers in the form of a loan or grant would give the government a more targeted and effective approach to incentivizing certain social behavior.[180]

This proposal would work well to promote homeownership, but I propose a solution to work in concert with a modified MID structure. One-time assistance may be a more effective, efficient, and fiscally sound option for the government since the government's financial assistance would be limited to the amount of the subsidies.

For taxpayers, a one-time grant or loan assistance would help with upfront costs—a common barrier to homeownership.[181] Since taxpayers are aware that government assistance is provided only once, a one-time grant removes the incentive to buy a more expensive home to receive a tax benefit. By limiting the amount of government assistance based on income, the expense to the government would be substantially less than the current government expenditures via the MID and the PRE.[182]

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175. *See* Morrow, *supra* note 18, at 774–75.

176. In 2008, the annual tax savings for households with income between $40,000 and $50,000 was $114. Stansel & Randazzo, *supra* note 20, at 9. There was no benefit for households with an income of $30,000 or less. *Id.*

177. "House poor" refers to a person who spends a large amount of his income on purchasing a home, but is unable to technically afford the house. Lynn Spruill, *House Poor*, Comm. Dispatch (Oct. 17, 2014, 10:18 AM), http://www.cdispatch.com/opinions/article.asp?aid=37291. As a consequence of paying the costs for the house and upkeep, he does not have funds for anything else. *Id.*

178. *See* Morrow, *supra* note 18, at 775–77.

179. *See generally* Surrey, *supra* note 6.

180. *See id.* at 366.

181. *See* Fannie Mae, Future Homeownership: Own-Rent Analysis 21 (2012), *available at* http://www.fanniemae.com/resources/file/research/ownrent/pdf/own-rent-data-analysis-presentation-2012.pdf (illustrating that 56% of renters will continue to rent because they cannot afford to purchase a home).

182. Between 2014 and 2018, the MID and the PRE are estimated to cost over $640 billion and $263 billion in government expenditures, respectively. Analytical Perspectives 2014, *supra* note 159, at 245. Compare those estimates with the First Time Homebuyer Credit program, in which the GAO reports an estimated $22 billion in government expenditures through 2019. U.S. Gov't Accountability Office, GAO-10-1025R, Tax Administration: Usage and Selected Analyses of the First-Time Homebuyer Credit 1 (2010), *available at* http://www.gao.gov/assets/100/97031.pdf.

My proposal adopts Surrey's proposal for a one-time grant, but limits the grant assistance to households earning $50,000 or less. This grant amount would be limited to 10% of the purchase price (up to $8,000), and the taxpayer would have the option to apply and receive approval for the grant prior to purchasing the home. The grant would be verified and signed by both the purchaser and the seller. Basing the grant amount on a percentage of the home price necessarily limits the grant amount.

This proposal is regressive in nature because the grant amount would increase as the home price increased. In this instance, however, the regressive approach is justified. This percentage-based model is designed to assist with the upfront costs to a potential homeowner. Therefore, as taxpayers commit to a more expensive home, they would receive more in upfront costs. By using a percentage-based model instead of a fixed amount, the assistance is equitable without encouraging the taxpayer to overspend and every income-qualified taxpayer would be eligible to receive immediate assistance.

By providing specific one-time assistance, the government provides a more direct way to promote homeownership without encouraging homeowners to overspend. This method also removes tax policy from the equation. By placing the homeownership responsibility in the hands of the taxpayer, he will most likely purchase a home within his price range. Finally, providing assistance with upfront costs removes one of the first barriers to homeownership for low- and middle-income taxpayers.

In my proposal, the loan program would be available to taxpayers who did not qualify for the grant-based program subject to additional income restrictions. The loan-based program would be available for households with incomes between $50,000 and $100,000 ($100,000 and $200,000 for taxpayers filing jointly). The loan amount would be limited to 10% of the purchase price (up to $10,000). This program would provide limited assistance to potential homebuyers whose income levels already have an impressive homeownership rate, but does so in a manner more affordable for both the government and the homebuyer.

If the loan is paid in full within ten years, it would be interest free. After ten years, a low, nondeductible interest rate (the applicable federal rate for other tax loans and extensions) would automatically attach. If the home is sold within five years of purchase, the interest rate would accelerate and automatically accrue from the date of initial purchase; after five years, the interest-free status would vest and the ten-year repayment terms and conditions would remain. This loan-based proposal, like the grant-based proposal, would be independent of the tax code.

C. *Vanishing Deduction*

The second phase of this proposal requires adjustments to the current MID provisions. Scholars have called for the repeal of the MID because they recognize that any benefits received by low- and middle-income taxpayers are minor compared

to the financial benefits received by high-income taxpayers.[183] They also recognize that more efficient and effective ways to promote homeownership exist.[184]

Instead of a full repeal, Professor Dorothy A. Brown proposes converting the MID to a refundable credit.[185] She also acknowledges the political infeasibility of converting the MID to a refundable credit based on race and class matters.[186] Due to overwhelming public support, a full repeal is also likely infeasible despite the inefficiencies and inequities associated with the MID.[187]

Still, eliminating the MID entirely would eradicate one of the largest tax expenditures on the books.[188] A middle ground between full repeal and refundable credits is a partial repeal with phase-outs, such as the vanishing deduction. The vanishing deduction model proposes the following: (1) the MID would be limited to one home per household; (2) a complete phase-out for taxpayers with household income more than $100,000 ($200,000 for taxpayers filing jointly); and (3) the MID would be limited to homes with a purchase price under $500,000.

For taxpayers with an existing home that does not meet these vanishing deduction qualifications, this proposal recommends that the ability to deduct would vanish three years after its implementation. The three-year time period worked successfully in 1986 when all other personal interest deductions were eliminated.[189] Therefore, there is no reason it cannot work successfully now.

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183. *See* Mann, *supra* note 170, at 1384.

> Ideally, any change to the home mortgage interest deduction should: (1) maintain current home ownership levels; (2) improve the distributional equity of the home mortgage interest deduction; and (3) reduce suburban sprawl. From a structural standpoint, the simplest change to the home mortgage interest deduction would be to eliminate it entirely.

Id.; *see also* Morrow, *supra* note 18, at 799.

184. *See* Mann, *supra* note 170, at 1359–61; Ventry, *supra* note 22, at 282.

185. Dorothy A. Brown, *Shades of the American Dream*, 87 Wash. U. L. Rev. 329, 368–70 (2009).

186. *Id.* at 369.

187. Morrow, *supra* note 18, at 815 ("There is no doubt that the mortgage interest deduction is an incredibly popular tax incentive. A recent article in The New York Times included a poll showing that about 90 percent of Americans support the mortgage interest deduction."). *See generally* Dennis J. Ventry, Jr., *Misinformed and Misled About the Benefits of the Mortgage Interest Deduction*, 16 Cityscape 219 (2014); *The Full Results from The New York Times and CBS News Poll*, N.Y. Times (June 29, 2011), http://www.nytimes.com/interactive/2011/06/30/business/20110630poll-full-results.html?ref=business&_r=0.

188. *See* Background Information on Tax Expenditure Analysis, *supra* note 8, at 17.

> The list of top individual tax expenditures is persistent. Four of the items that appear on the list in 1975, the deduction for State and local taxes, net exclusion of pension contributions and earnings, deduction for mortgage interest on owner-occupied homes, and the exclusion of employer contributions for health, appear on all eight lists.

Id.

189. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, tit. V(B), § 511(b), 100 Stat. 2085.

By using a phase-out, the government can save billions of dollars in lost revenue without impacting a majority of taxpayers.[190] Limiting eligibility for a deduction based on income of taxpayers and home purchase price substantially increases the potential for additional revenue by eliminating the preferences for high-income taxpayers.[191]

Taxpayers, independent of their income level, would still have the option to deduct real estate taxes for their homes.[192] Since homes in high-income areas have higher taxes associated with a principal residence, those taxpayers would continue to receive a substantial tax benefit. With this proposal and other existing policies, taxpayers at all income levels would receive some tax benefit associated with their home purchase.

D. Vanishing Exclusion

By continuing to subsidize select taxpayers through indirect subsidies, the government has put the needs of the few above the needs of the many. If the objective is an increase in homeownership rates, there are a number of ways to better facilitate this admirable goal.

Some of the inequities associated with the PRE are: (1) the frequency with which it can be used; (2) the high-dollar exclusion amount; and (3) the additional tax benefits of the MID.[193] If the PRE purports to promote homeownership in order to stabilize neighborhoods, then making the exclusion available every two years directly contradicts that goal since selling a home every two years would likely destabilize neighborhoods. The longer a homeowner remains in his home, the more likely he will gain equity (building potential wealth), invest in the neighborhood, and become politically and civically involved.[194] These are all goals promoted by homeownership, which are undermined by encouraging a turnover within two years.[195]

Annette Nellen and Ron Platner proposed a total exclusion to better satisfy the goals, free taxpayers' financial resources, and reduce instances in which basic records must be maintained.[196] Mark Snider indicated that the wealthy are not "fully insulated" from recognizing the gain when the home is sold because the exclusion is

190. Cong. Budget Office, Pub. No. 3191, 2 Budget Options 187 (2009), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/102xx/doc10294/08-06-budgetoptions.pdf (reducing the maximum mortgage eligible for the deduction would boost revenue by over $41 billion over a ten-year period).

191. *Id.* at 187–89.

192. I.R.C. § 164(a)(1) (Westlaw 2011).

193. *See* Bybee, *supra* note 165, at 129–30.

194. Nicholaus W. Norvell, *Transition Relief for Tax Reform's Third Rail: Reforming the Home Mortgage Interest Deduction After the Housing Market Crash*, 49 San Diego L. Rev. 1333, 1342 (2012) (citing Robert D. Dietz & Donald R. Haurin, *The Social and Private Micro-Level Consequences of Homeownership*, 54 J. Urb. Econ. 401, 404, 434, 439 (2003) (collecting studies)); *see also* Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, 17 Tax Pol'y & Econ. 37, 68 (2003).

195. *See supra* notes 63–92 and accompanying text.

196. Annette Nellen & Ron Platner, *Disposition of a Principal Residence After TRA '97: Perspectives, Planning, and Problems*, 25 J. Real Est. Tax'n 319, 333 (1998).

not unlimited.[197] Neither addressed the fact that a homeowner who would likely sell a home for a substantial gain has also received substantial benefits from the MID and other tax subsidies resulting from homeownership.[198]

I agree that the exclusion should be reformed, but I propose limiting the exclusion based on household income. In my proposal, the exclusion would vanish for households with income of $100,000 or more ($200,000 for taxpayers filing jointly). Since capital gains property still receives a preferential rate, taxpayers with a household income of more than $100,000 would continue to receive a tax benefit.[199]

By limiting the taxpayers who qualify, the tax benefit would be limited to those who may have an ability to pay but are not as financially stable as those earning more than $100,000. The minimum residency period should be raised to five years while maintaining the safe harbor provisions for hardship, job transfers, etc.[200] The exclusion amount should be reduced to $100,000. Receiving $100,000 tax-free after the sale of a personal residence is a substantial savings.

Finally, this proposal suggests that taxpayers be required to select which tax benefit to apply to homeownership—the MID or the PRE. They should not receive the benefit of both. By making the proposed changes to the MID and the PRE, tax policy for homeownership will be more effective, efficient, and equitable for taxpayers.

V. CONCLUSION

Our current tax policies have shaped the tax structure and economic climate with overwhelming favor toward wealthier taxpayers. If the success of our taxing system is measured by its progressivity, then our taxing system has failed.[201] In the earliest stages of the tax code, the wealthiest taxpayers shouldered the burden of raising revenue through taxation.[202]

Tax preferences, such as the MID and the PRE, have substantially reduced the effective rate of high-income taxpayers and simultaneously reduced the overall tax burden on the wealthiest taxpayers. The government has overinvested in expenditures for the wrong taxpayers in the name of homeownership. By restructuring our tax policies to reduce unjustified expenditures, the government can raise revenue, make homeownership more affordable, and target specific homeownership programs towards taxpayers who need the financial assistance.

After a century of tax policy favoring the wealthiest taxpayers, it is time to reverse the current housing policies in order to reduce inequities in the tax code. By shifting

197. Snider, *supra* note 160, at 186.

198. *See generally* Nellen & Platner, *supra* note 196; Snider, *supra* note 160.

199. I.R.C. § 1(a), (h) (Westlaw 2013). The current tax rate for long-term capital gains for the top marginal rate is 20% compared to the top marginal rate for ordinary income tax at 39.6%. U.S. Dep't of the Treasury Internal Revenue Serv., Publ'n 17, Tax Guide 2013 (Nov. 26, 2013), *available* at http://www.irs.gov/pub/irs-pdf/p17.pdf.

200. Treas. Reg. § 1.121-3(b) (Westlaw 2004).

201. *See* Morrow, *supra* note 18, at 795.

202. *See* Cooper, *supra* note 5, at 885–86.

preferential treatment and financial assistance to low- and middle-income taxpayers, homeownership will be based on efficiency, equity, and fairness. Since tax policy has long been a part of the problem, it is now time to make it part of the solution.