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IN FOCUS

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Homeownership: Tax Policy Options and Considerations

This In Focus discusses three selected demand-side options and three selected supply-side options for *potentially* promoting homeownership. Pursuing any of the presented options would require careful consideration about the specific design of each. This In Focus does not address the economics or desirability of promoting homeownership. For more on that topic, see CRS In Focus IF11305, *Why Subsidize Homeownership? A Review of the Rationales*, by Mark P. Keightley.

In order to increase the homeownership rate, tax incentives must help households on the verge of homeownership overcome the barriers they face—mainly the down payment requirement and, in hot housing markets, high home prices (relative to income). Demand-side policies may address both barriers if properly structured, but may also benefit those who would become owners regardless, or sellers that respond by raising prices. Supply-side policies may address high home prices by increasing the housing supply, but may also subsidize construction that would occur anyway rather than expand the overall stock of housing.

The impact of any tax incentive will vary depending on the specifics of each market. For example: Is the supply and demand of housing of the local market in balance? Is there available land to build on? What are the state and local zoning and land-use laws and building codes? Variation in these factors across markets raises the potential that modifying state and local housing policies could be more impactful in certain markets. There is also the potential that changes to federal nontax housing programs and regulations could be more effective at promoting homeownership than federal tax initiatives.

Tax Options and Considerations

Demand: Modify or Eliminate The MID

The mortgage interest deduction (MID) is the tax provision most closely associated with homeownership. Current law allows an itemized deduction for interest paid on a mortgage secured by a principal or secondary residence. Past proposals to reform the MID have included reducing the maximum mortgage limit (currently $1 million or $750,000 depending on when the home was purchased), replacing the deduction with a credit, disallowing it for second homes, and eliminating it entirely.

Most economic research indicates that the MID in the United States and MIDs in other countries have little to no effect on homeownership rates, but may encourage purchases of larger homes. This is primarily because the MID does not address the down payment barrier to homeownership or high home prices (it may, in fact, cause higher prices). Recent research suggests that removing the deduction could *increase* the homeownership rate if home prices, rents, and mortgage rates adjust in a manner that makes it easier to become a homeowner. Thus, it is unlikely any of the proposed modifications would significantly alter the deduction's effect on homeownership, though certain modifications could make it more equitable. For more information, see CRS Report R46429, *An Economic Analysis of the Mortgage Interest Deduction*, by Mark P. Keightley.

Demand: Homebuyer Tax Credit

Proposals to provide a tax credit to assist homebuyers have appeared over the years. Examples of bills that would provide a homebuyer tax credit in the 117th Congress include H.R. 2863 and S. 2820. A homebuyer tax credit was available to first-time buyers from April 2008 through 2010 with the objective of stabilizing *falling* home prices resulting from the 2007-2009 financial crisis. The credit was originally $7,500, but was later increased to $8,000.

An advantage of a homebuyer tax credit over the MID is that it more directly targets home buying compared to the MID. A tax credit may also be more equitable since its value does not depend on one's tax rate, as with the MID (but may depend on the home's purchase price); does not require one to itemize; and can be made refundable, which can benefit more middle- and lower-income households.

Critics point to two issues with a homebuyer tax credit. First, a credit may not help households overcome the down payment barrier unless there is a mechanism to advance the credit to buyers ahead of closing. Thus, a credit may benefit those already positioned to become homeowners rather than assisting those on the margin of ownership. Second, a tax credit could exacerbate high home prices in hot markets if sellers raise prices in response (and capture the credit's benefit). To the extent this happens, homeownership would be farther out of reach for more households.

Demand: Down Payment Savings Account

Allowing individuals to claim a tax deduction or credit for contributions to down payment savings accounts may assist more households in becoming homeowners than current incentives do by directly addressing the down payment barrier. Employers could also be allowed to make tax-deductible matching contributions to these accounts. Limited research on a Canadian program in existence from 1974 to 1985 suggests these types of accounts could boost homeownership. Still, there are a number of issues with this approach that policymakers may want to consider.

First, down payment savings accounts could lead savings to be diverted away from other tax-preferred accounts used for retirement, education, and health care expenses, as well as traditional savings accounts households use, for example, for emergencies. Second, these accounts may be of little use

to middle- and lower-income households that do not have the resources to save. If, however, contributions to these accounts were allowed as an above-the-line deduction or a credit, this approach would better target these households relative to the mortgage interest deduction. Contributions by high-income savers could also be limited or prohibited.

Third, it would likely take several years for this policy approach to impact the homeownership rate, as households would need time to save enough to make a down payment. The time needed would be longer if lawmakers imposed annual contribution limits. It is difficult to generalize whether these accounts would speed up the transition to homeownership for all savers. Some may make the transition sooner since the subsidy would allow them to save more. But others may delay their transition to maximize their tax benefit (e.g., with an annual contribution limit, a household may save less annually for a down payment than in the absence of these accounts).

An alternative to down payment savings accounts would be to modify the current rules pertaining to using tax-preferred retirement account funds to purchase a home. Current rules allow individuals with an IRA to withdraw up to $10,000 without penalty for the purchase of a first home. H.R. 4165 would increase that limit to $20,000, and H.R. 5078 would raise it to $25,000. Current rules also allow up to $50,000 of 401(k) funds to be withdrawn for the purchase of a home contingent on the funds being repaid within five years. The repayment requirement could be removed.

Supply: Neighborhood Homes Investment Act

The Neighborhood Homes Investment Act (NHIA; H.R. 2143, H.R. 5376, S. 98) would provide federal tax credits to offset the cost of constructing or rehabilitating owner-occupied homes in neighborhoods where house prices might not otherwise support such investments. Both the income of the purchaser and the sales price of the home would be capped to promote affordability. Eligible properties would be those located in neighborhoods with lower incomes and lower home prices, so this proposal would not address affordability concerns in hot housing markets. There would also be an annual state-by-state limit on the number of credits that could be awarded, so every eligible project might not receive tax credits.

A potential concern with the NHIA proposal is that developers may lower their sales prices below what they could *otherwise* receive (e.g., the sales price cap amount) or not be as cautious containing development costs. This is because a lower sales price or higher development costs would be offset dollar-for-dollar up to a maximum credit limit. All else equal, this would result in fewer total properties receiving financing and would unnecessarily increase the per-property cost to the government. A lower sales price, however, would make homeownership more affordable. Another potential concern pertains to the NHIA data-reporting requirements and whether they would be sufficient to allow for evaluation of the credit's effectiveness relative to alternatives, or for comprehensive oversight. For more details, see CRS In Focus IF11884, *Neighborhood Homes Investment Act: Overview and Policy Considerations*, by Mark P. Keightley.

Supply: Incentives for Factory-Built Homes

A tax incentive to encourage the production of factory-built homes could be an option for increasing the supply of affordable homes for ownership. Factory-built homes are built in a factory and shipped for final assembly on site. Factory-built homes include manufactured homes (which are built in accordance with federal standards), modular homes, panelized homes, and precut homes. Research suggests that factory-built homes cost less (on average) per square foot than traditional site-built homes. This is due to cost savings in the production process stemming from the division of labor and specialization, automation and technology, easier detection of construction defects, fewer weather delays, ability to locate factories in low-wage areas, and discounted bulk purchase of materials.

Since factory-built homes are already more affordable (on average) than site-built homes, it raises the question of why a tax incentive is needed. Additionally, some have pointed to nontax factors that have limited expansion of this market, specifically state and local zoning laws that limit or prohibit where factory-built homes can be located; buyers' limited access to financing; lower market appeal due to negative consumer perceptions; and lower consumer demand due to fewer customization options. Because a production tax incentive would not address these factors, such a tax incentive may have limited effect and could result in a windfall to builders. An alternative would be to address the regulatory and financing aspects that are restraining the market for factory-built homes.

Supply: Taxing Large Institutional Investors

Some have expressed concern that institutional investors are contributing to the lack of affordable homes for ownership by purchasing properties for rental purposes that could otherwise be purchased by individual owners. While media reports have highlighted this situation occurring in certain markets, it is not clear that it is the primary force impacting affordability in most markets.

Several tax options pertaining to institutional investors are available. One option would be to increase the effective tax rate these investors face by either applying a higher tax rate on their real estate-related income or removing certain tax deductions available to them (e.g., for accelerated depreciation or interest payments). However, some or all of any tax increase could be passed through to tenants in the form of higher rents. Policymakers may also want to consider ensuring that developers that utilize federal affordable rental housing programs and existing "mom and pop" investors would not be impacted, and whether higher taxes would discourage future housing development.

Alternatively, a transfer tax could discourage future purchases by these investors. To encourage the sale of their current holdings, an exception to the tax could be provided for sales occurring within, for example, three years of enactment. Another option to encourage sales would be to levy capital gains taxes annually on a mark-to-market basis.

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