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2018 Tax Filing Season: The Mortgage Interest Deduction

P.L. 115-97, often referred to as "The Tax Cuts and Jobs Act" (the "act" for this In Focus), changed how homeowners can treat mortgage interest for tax purposes starting in tax year 2018. While the mortgage interest deduction is still generally available, the revision reduced the maximum mortgage balance eligible for the deduction and restricted the deduction for interest associated with home equity loans. The law also increased the standard deduction, which will reduce how many homeowners claim the itemized deduction for mortgage interest. This In Focus explains the changes made to the mortgage interest deduction by the act and discusses the potential impact of the changes.

Summary of Current Law

A taxpayer may claim an itemized deduction for "qualified residence interest," which includes interest paid on a mortgage secured by a principal residence and a second residence. The amount of interest that is deductible depends on when the mortgage debt was incurred. For mortgage debt incurred on or before December 15, 2017, the combined mortgage limit is $1 million ($500,000 for married filing separately). For mortgage debt incurred after December 15, 2017, the deduction is limited to the interest incurred on the first $750,000 ($375,000 for married filing separately) of combined mortgage debt. These limitations apply for taxable years 2018 through 2025.

If a taxpayer has mortgage debt exceeding the applicable mortgage limit ($750,000 or $1 million), he or she may still claim a deduction for a percentage of interest paid. The percentage of interest that is deductible is equal to the applicable mortgage limit divided by the remaining mortgage balance. For example, a homeowner whose mortgage was originated after December 15, 2017, and has a balance of $1 million could deduct 75% ($750,000 divided by $1 million) of their interest payments.

Mortgage debt resulting from a refinance is treated as having been incurred on the origination date of the original mortgage for purposes of determining which mortgage limit applies ($750,000 or $1 million). The balance of the new loan resulting from the refinance, however, may not exceed the balance of the original loan.

For purposes of the deduction, mortgage debt includes home equity loans secured by a principal or second residence that are used to buy, build, or substantially improve a taxpayer's home. Mortgage debt *does not include* home equity loans the proceeds of which are used for purposes unrelated to the property securing the loan. For example, interest associated with a home equity loan that is used to pay off a credit card balance, go on a vacation, or send a child to college does not qualify for the mortgage interest deduction. The restrictions on the use of home equity loans are irrespective of when the loan was originated.

After 2025, the mortgage limit for all qualifying mortgage interest will be $1 million, plus $100,000 in home equity indebtedness regardless of its use.

Comparison to Prior Law

Under prior law, a homeowner was allowed an itemized deduction for the interest paid on the first $1 million of combined mortgage debt associated with a primary or secondary residence. As with current law, a homeowner could deduct a percentage of interest paid if the mortgage balance exceeded the $1 million limit. Additionally, a homeowner was allowed to deduct the interest on the first $100,000 of home equity debt regardless of whether or not the taxpayer incurred the debt to finance costs associated with the home. For example, under prior law, a homeowner could use a home equity loan to purchase a boat, pay for a child's college, cover medical costs, or any number of other things not involving the property that secured the loan and still deduct the associated interest.

Economic and Budgetary Impact of the Change

While the reduced applicable mortgage limit will decrease the amount of interest that is deducted, the reduction itself will likely not have a significant impact on the number of homeowners claiming the deduction. However, other changes enacted by the act are expected to reduce the itemization rate generally, and will therefore reduce the number of homeowners claiming the mortgage interest deduction. Specifically, the near doubling of the standard deduction and the $10,000 limit placed on the deduction for state and local income taxes (SALT) is expected to reduce the overall itemization rate from its historical average of approximately 30% to around 10%. Because one must itemize to claim the mortgage interest deduction, fewer homeowners are expected to benefit from the deduction.

The reduction in the itemization rate and the fact that higher-income homeowners on average have larger mortgage balances means that the benefits of the mortgage interest deduction will disproportionately accrue to taxpayers in the upper end of the income distribution, and more disproportionately than under prior law. This does not necessarily mean that homeowners who no longer claim the mortgage interest deduction will pay higher taxes, since the standard deduction and other changes enacted by the act may more than compensate for the loss of the deduction.

It may be important to note that before the act, slightly less than half of homeowners claimed the mortgage interest deduction. Some homeowners have no mortgage, and hence no interest to deduct. Others claimed the standard deduction because they were either toward the end of their mortgage repayment period and interest payments were a small proportion of their total mortgage payment, they lived in a state with low state and local taxes, or they lived in a low-cost area and therefore had relatively small mortgages.

While it is expected that fewer homeowners will benefit from the deduction under current law, the effect on the homeownership rate will likely be small. The economic literature has generally found that the structure of deduction prior to the act did little to promote homeownership. This is because the deduction was not well targeted to the largest barriers to homeownership—the down payment required by banks and closing costs. Since the act did not change the deduction's structure, the analysis of the deduction's effect on homeownership remains unchanged. Where the changes could show up is in slightly lower home values, as the literature suggests that the deduction is partly capitalized into home prices.

Limiting the mortgage interest deduction is expected to increase federal tax revenues through 2025. However, the Joint Committee on Taxation's (JCT's) revenue estimates do not isolate the revenue effects stemming from the changes to the mortgage interest deduction. Estimates published while the act was being considered, and more recent line-item tax expenditure estimates, reflect not only the temporary reduction in the combined mortgage amount, but also the revenue effects from increasing the standard deduction and modifying a number of other itemized deductions, which is expected to significantly reduce the itemization rate. Given the important interactions between the mortgage interest deduction and other features of the tax code, the deduction is estimated to produce a revenue loss of $33.7 billion in 2018 compared to a revenue loss of $66.4 billion in 2017 under prior law.

The revenue gains resulting from the act will be reversed after 2025 as the mortgage interest deduction, the standard deduction, and other itemized deductions revert to their 2017 parametrizations, barring further congressional action.

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