Pocketbook Issues - The Home Interest Mortgage Deduction And What Its Elimination Would Mean To You

November 29, 2012 - This is our second report on how the debate over the so called "fiscal cliff" is shaping up and what the politicians in Washington are considering doing to avoid it. Unlike many organizations and media outlets, we're predominantly interested in how the outcome of the debate will actually impact you as an individual. And make no mistake about it, regardless of what is decided, millions of Americans will be in a great deal of financial pain once a final decision is reached. In this report, we're going to look at the mortgage interest deduction. We're focusing on this because a large number of senators and representatives are suggesting reducing or eliminating it.

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The mortgage interest deduction is a tax deduction. Most people think that it is only available to homeowners. That is actually not the case. It is also available to those who own mobile homes, RV's, boatsâ€¦ pretty much anything that has a kitchen and a bed is covered by the deduction.

And many people who don't own homes believe that it is a deduction that is only available to those who are wealthy or well to do. The truth is, those who are very wealthy are already capped in how much they can deduct in mortgage interest. If this deduction is reduced or eliminated, the cost of this change will fall solely on middle class Americans. Those who are truly wealthy may see no change in their taxes.

The way that the deduction works is like this. Let's say that you purchase a home for $250,000. You put $50,000 down and finance the other $200,000 at 3.875% interest rate for 30 years. You are currently in a 30% tax bracket.

In this scenario, you would be paying $646 per month in interest to start. Because you are in the 30% tax bracket, you will get 30% of the amount you pay in interest during the year back from the IRS. In the first year you own the home, that would mean a savings (or tax refund) of $2,325. Put another way, the deduction is just like getting a $200 per month reduction in your mortgage payment during that first year. Keep in mind that banks take this into account when they decide how much to lend you. If the deduction is reduced or eliminated, you may not qualify for a loan and may actually not be able to purchase the home that you want. That means that even if you don't currently own a home, changes to the deduction could make it much more difficult to you to become a home owner in the future.

Because of the way interest is calculated on mortgages, tax payers get more benefit from the deduction in early years or ownership than they do later on. But assuming that you pay the loan off over a 30 year period, and that you remain in a

30% tax bracket, the deduction would save you roughly $26,500 over the life of the loan.

There are two scenarios for changing the deduction being tossed around in Washington. The first one is to eliminate it completely. That probably won't happen. The other one is to reduce it.

Currently, borrowers can deduct interest on the first $1 million they borrow to acquire or build a home. They can also deduct interest on up to $500,000 of home equity debt. The focus of the discussion in Washington appears to be on the amount of money that borrowers can use to purchase a home. And the suggestion is now being floated to cap that amount at $500,000.

Here is how that would look. Let's say you purchase a $1 million home. You put $200,000 down and finance $800,000. You would still be able to deduct the interest you pay on the first $500,000 financed, but get absolutely no deduction on the additional $300,000 you finance. In your first year, the change in the law would cost you nearly $3,500 and over the course of 30 years, you would pay an additional $62,000 in taxes.

Now you may think that a $1 million home is excessive. The truth is, it really depends upon where you live. According to Tulia, the state with the lowest average listing price is Ohio. At the time of this writing, the average home is being listed for $173,335. But just two states away, in New York, you will find the highest average listing price; $729,123.

In fact, there are presently six states where the average listing price is in excess of $500,000; California, Montana, Colorado, New York, New Jersey, Connecticut and Massachusetts. And Wyoming is less than $10,000 below this level for average listing prices. Each of these states has a wide variety of middle class neighborhoods with housing prices approaching $1 million and where the residents are hardly living in the lap of luxury. The housing markets in all of these states are likely to see an immediate negative impact if any of the proposals are adopted.

But even in other states, the change would have a negative impact on home sales. There are two reasons for this. First, in many states with lower housing prices overall, the prices in their largest cities exceed the proposed $500,000 limit. Second, the way that the deduction is currently setup, it is an overall limit on up to two properties. That means if you own two homes for which you borrowed less than $1 million combined to acquire them, you can write off the interest on both. Or if you own a home and boat, or a home and an RV with a combined perchase price of under $1 million, you can write off the interest on both of them.

The problem here isn't just limited to how eliminating or reducing the deduction will impact homeowners. It could very well impact businesses and their employees who don't own homes. For instance, if you make a living manufacturing, selling or servicing boats or RV's, you could find yourself out of a job if this change is made. You would be impacted directly. That's because without the deduction, these items will become much less affordable for many buyers.

Indirectly, reducing this deduction would suck hundreds of Billions of dollars out of consumers' hands which is spent on virtually everything sold in the United States. That could mean tens of thousands of lost jobs and deepening the recession. If you think that's an exaggeration, just remember that this recession started because of a crash in housing markets. And that crash was largely fueld by government intervention in those markets. That is precisely what the government would be doing here.

And finally, because of the current cap on the deduction, as I've said before this change it really wouldn't impact anyone with real money. All of those stars you see living in $10 million mansions on the beach in California or the media moguls in the New York penthouses are already capped out under the current law. If this proposal comes to pass, it will be aimed precisely at those who can least afford it. Families, with kids living in middle class neighborhoods all over this country. Anyone telling you anything else either hasn't looked at the law closely, or isn't being honest.

byJim Malmberg
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