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Taxation of the Really Big House

By Calvin H. Johnson

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The tax advantages of personal-use property induce taxpayers to buy more housing than they would without tax. Two-thirds of the tax distortion occurs in the wealthiest 10 percent of families. The proposal would tax the rental value of personal use of property for aggregate property worth more than $1 million per family. The proposal would allow the deduction of home mortgage interest but disallow the deduction of property tax over the same $1 million threshold. The taxable rental value would be measured by a long-term risk-free interest rate, adjusted annually. Value would be set initially by purchase price, and then adjusted annually by a regional index. The $1 million threshold would be reduced by $50,000 annually over the coming years, but not to a point where the tax collected would not be worth the administrative effort. The proposal would tax capital gain from the sale of a residence even if it were reinvested.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue without raising tax rates, because the best systems have taxes that are unavoidable and have the lowest feasible tax rates. Shelf Project proposals defend the tax base and improve the rationality and efficiency of the tax system. Given the current calls for economic stimulus, some proposals may stay on the shelf for a while. A longer description of the Shelf Project is found at ''The Shelf Project: Revenue-Raising Proposals that Defend the Tax Base,'' *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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A. Overview

Serious long-term tax reform will need to limit the considerable tax advantages now available in owning the very largest houses and other personal-use properties. The primary return from the investment in residences and similar property is the rental value of the personal use of the house, which is always tax exempt. If the property appreciates, the gain from a principal residence is usually tax exempt. The primary costs of a house are the property taxes and interest, which, with limitations, are itemized deductions. The combination of exempt returns and deductible costs means that the tax imposed on the investment has an expected value of less than zero. That treatment is not a tax or revenue-generating system, but a vehicle to deliver a subsidy.

Judged as a subsidy or welfare program, the treatment does not make any sense. The subsidy causes buyers to purchase expensive properties they would never pay for in the absence of tax, and it diverts capital away from uses that would make a greater contribution to the general welfare. The largest subsidy goes to the largest houses and recreational properties. The subsidy is also measured by the negation of taxable income, and the value of avoiding taxable income depends on tax rates. The combined structure of tax-rate dependency and per-dollar expenditure on housing means that two-thirds of the value of the tax subsidy goes to the richest 10 percent of families (measured by net worth), and only 3 percent goes to those representing the bottom half of net worth. The largest subsidy goes to the biggest houses, such as those modest bungalows selling for $75 million to $165 million each.[1] The structure means the subsidy is

[1]Bill Gates's house is said to have cost $153 million. *See* http://en.wikipedia.org/wiki/Bill_Gates'_house. The *Forbes* list of the 10 most expensive houses in 2008 ranged from selling prices of $75 million to $165 million. *See* http://

(Footnote continued on next page.)

never delivered to people who would be without adequate shelter. I doubt Congress would deliver the subsidy in that way if it thought it was using real money.

The subsidy also increases housing prices because ordinary sellers increase the sales price for their properties to capture as much of the subsidy as possible. And because the subsidy depends on the buyers' tax rate, the price increase is greatest where tax rates are high, which tends to segregate neighborhoods into economic tiers. The price increases make houses too expensive for buyer's in lower tax-rate brackets.

The government acts rationally, weighing costs and benefits only through a competitive federal budget. Costs are considered to be real money only if they are categorized as government spending. Subsidies that are off budget are not engineered to maximize benefit and minimize government cost. The structure of the housing subsidy seems to prove that off-budget subsidies have no intelligent design, divine or secular.

The federal budget is running large, unsustainable deficits. The deficits are necessary in the short term as a stimulus. But we need to be prepared to find revenue sources for trillions of dollars in revenue that will do the least damage to the economy when the stimulus has run its short-term course. Increasing tax rates does economic damage that can be avoided by going after the low-tax troughs first. Reducing — even eliminating — the subsidy to the largest houses would stop the richest investors from buying housing they would not pay for in the absence of tax, and it would stop the diversion of precious capital away from productive investment into what is basically a selfish large use of resources.

The proposal would tax the rental value of personal-use of property, measuring that value by looking at the investment return the owner gave up by buying or keeping the residence. The value would be set at the rate for long-term no-risk bonds, now at 3.6 percent. Initially, the value of personal use would be taxed only on personal-use properties with an aggregate value in excess of $1 million per family. Focusing on the largest houses first would repair the most tax-caused damage and collect the most tax for the least administrative effort.

A third of the housing overconsumption problem is found below the level of the richest 10 percent. The tax advantages of the homes need to be squeezed out, not shocked out. The proposal would phase in the remedy over a transition period. Over the coming years, it would reduce the threshold value of residences on which rental income is taxed, beginning with a $1 million threshold to be reduced by $50,000 annually.

Ultimately, tax should not be extended to the point at which the amount of tax potentially collected is not worth the administrative effort of calculating it. I suspect that the not-worth-the-effort level is for houses costing less than about $100,000-$136,000, the range where the standard deduction makes records for housing costs unnecessary.

The value of the residences on which interest would be taxed (currently at a 3.6 percent rate) would initially be set by the property's purchase price. The value would then be adjusted annually by a Treasury-maintained index similar to the Case-Shiller regional home price index.[2] Contesting the value would be allowed no more than every five years, and changes would need to depart from the index by 10 percent to be recognized. Personal-use property would best be identified as real property suitable for living or recreational use, but it could also include boats and cars costing more than $50,000. If a property suitable for personal use yielded some minor rents but less than the 3.6 percent applicable rate, the real and imputed rental would together equal the applicable federal rate.

The proposal would also disallow the deduction of property tax on houses worth over the same $1 million value (phased down by $50,000 a year). Property taxes are part of the cost of personal use, imposed by localities as a condition of continued ownership. Homeowners pay those taxes because of the benefits they get from the location of the property, from local government services, or from some combination of the two. Using interest to measure the value of personal rental use entails using a net income or profit figure from which expenses have already been subtracted. It is therefore inappropriate to subtract depreciation, property tax, or other expenses again.

The proposal would replace the section 121 exemption with a 15 percent tax on gain from houses, even if the gain is reinvested. Under standards going back to the first adoption of the capital gain preference, the 15 percent capital gains tax is the normal tax for reinvested capital. Moreover, if a risk-free interest rate is going to be used to impute rent, gains will need to be taken into account separately.

B. Current Law

A purchase of a residence is an investment in which the primary return is the rental value of the right to live in it. By using capital to buy a residence, the investor has given up available interest on alternative investments for the right to live in the residence. The rental value return is not so inchoate as to be immeasurable or incomprehensible. Current law will indeed tax a shareholder on the value of personal use of a residence (or a yacht) if the asset is owned by the corporation, although not if it is owned by the user.[3] The benefit of use is not in cash, but a tax-cash-only tax system would be unjust and too easily avoided.

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www.forbes.com/realestate/2008/05/19/property-expensive-homes-forbeslife-cx_mw_0519realestate.html.

The values undoubtedly do not reflect the collapse of the real estate bubble. But even if the prices are now 10 cents on the dollar, with the most expensive houses being between $7.5 million and $16.5 million, the point is the same.

[2]*See, e.g.*, Case-Shiller index, *available at* http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,1,1,0,0,0,0,0.html.

[3]*International Artist, Ltd*, 55 T.C. 94 (1970) (Liberace's personal use of upper floors of the house as a residence was taxable income to him measured by value of the use); *Challenge Manufacturing Company v. Commissioner,* 37 T.C. 650 (1962) (shareholder's personal use of yacht was taxable dividend measured by

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There is a worldwide market for capital, and users of capital are willing to pay a rent for the capital (interest) that is above the amount needed to cover the inflationary shrinkage of repayment and risk of default. An investor who buys a house or similar personal-use property has access to interest returns and has given up the opportunity to collect interest. The opportunity cost of foregoing interest underlies all modern time-value-of-money concepts and financial analysis. For an investment alternative to personal use property, the investment return is taxed, but when the return is in the form of personal use, current law does not tax it.

Current law also allows taxpayer a delineated exclusion if the house appreciates in value. Structures depreciate physically and remaining life grows shorter over time, and the depreciation is a nondeductible personal living or family expense to the owner.[4] But because prosperity and population growth increase the demand for land and location, houses commonly appreciate overall, even in the face of the structure's depreciating value. Section 121 exempts $250,000 of gain on the sale of a primary residence per taxpayer ($500,000 for joint returns). The exclusion may not be used more often than every two years. For the full exemption, the house has to have been used as a primary residence for five years, although there are special rules for divorces and for cases in which the holding period is not met because of a change in health or employment.

Beyond the section 121 exemption, appreciation in the value of the house is taxed as capital gain (currently at 15 percent) if the property is sold during life. Appreciation on property held until death is not taxed,[5] and taxpayers may time losses on diversified portfolios to shelter gains. Most appreciation, therefore, never becomes reported capital gain. The combination of deferral until sale and permanent escape from tax means that the effective rate of tax is less than 5 percent, even for gain outside the section 121 exemption.[6]

value of the use) *J.F. Smith v. Commissioner,* T.C. Memo. 1995-410 (value of portion of the condominium used for shareholder's personal residence was taxable dividend); Rev. Rul. 58-1, 1958-1 C.B. 173 (value of apartment over rent paid was dividend).

[4]Section 262.

[5]Section 1014.

[6]Jane G. Gravelle, ''Limit to Capital Gains Feedback Effects,'' Congressional Research Service Report for Congress at 4 (1991) (taking out timber, housing, and nonprofit results and finding that 54 percent of accrued gains are never realized). Laurence Kotlikoff and Lawrence Summers argue that most savings, once made, are never drawn down and that only 20 percent of individual wealth is consumed by the household later in life so that 80 percent of wealth is transferred to the next generation. Kotlikoff, ''Intergenerational Transfers and Savings,'' 2 *J. of Econ. Persp*. 41, 43 (Spring 1988); Kotlikoff and Summers, ''The Role of Intergenerational Transfers in Aggregate Capital Accumulations,'' 89 *J. of Pol. Econ*. 706 (Aug. 1981).

If we assume that 46 percent of gain is eventually taxed, that the gain realized will be realized 10 years after it arises, that there is a 15 percent tax rate on capital gain, and that there is a 3.6 percent risk-free discount rate, then $15 tax owed on $100 current appreciation could be satisfied by setting aside $\$15 * .46/(1.036)^{10}$ or $4.84 per $100 of gain.

In general, expenses allocated to tax-exempt income are not deductible.[7] An expense matched with tax-exempt revenue merely reduces the amount of the tax-exempt income and is otherwise not recognized for tax purposes. Interest incurred, other than for business or investment profit, is nondeductible personal interest.[8] Despite the general and neutral accounting rule, however, limited itemized deductions are allowed for the expenses of owning a house, including property taxes and home mortgage interest.

Section 163(h)(3) allows an itemized deduction for interest on up to $1 million of home mortgage debt incurred to buy the residence and secured by the residence. Section 163(h)(3) also allows interest on up to $100,000 of subsequent home equity borrowing. The Joint Committee on Taxation has estimated that the mortgage interest deduction represents a tax expenditure, akin to government spending, of $86 billion a year.[9]

Property taxes incurred by reason of ownership of a house or other personal-use property are also allowed as deductions for taxpayers who itemize deductions.[10] Homeowners bear state and local taxes that they would not pay without owning the property. They do so because of the value of the property's location and to pay for government services, such as police and roads. Local government can charge property taxes as an entry fee to its locality, like a theater or stadium ticket, because the municipality can exclude owners who do not pay the taxes. Property taxes are annual expenses of the right to use the personal-use property. Property taxes are costs of personal-use property because a rational homeowner will buy only if the value of the personal use exceeds the cost of forgone interest (or interest paid) plus the property taxes. The Joint Committee on Taxation has estimated that the deduction of property taxes on residences represents a tax expenditure, akin to government spending, of $17 billion a year.[11]

Both interest and property tax deductions are allowed only for taxpayers who itemize their deductions. If a taxpayer, filing a joint return, has itemized expenses of less than the standard deduction (now at $11,400 for joint returns), he rationally will take the standard deduction in lieu of itemized deductions. In that case, the payment of home mortgage interest and property taxes on the home will save no federal tax.[12] Overall, only 38 percent of taxpayers itemize their deductions.[13]

[7]Section 265(a).

[8]Section 163(h)(1) and (2).

[9]Joint Committee on Taxation, ''Estimates of Federal Tax Expenditures 2007-2011'' (JCS-3-07) at 27, *Doc 2007-21689, 2007 TNT 186-12*.

[10]Section 164(a)(1).

[11]JCT, ''Estimates of Federal Tax Expenditures 2007-2011'' (JCS-3-07) at 27, *supra* note 9.

[12]Rev. Proc. 2008-66, 2008-45 IRB 1, *Doc 2008-22101, 2008 TNT 202-9* (inflation adjustments for various tax computations including standard deduction).

[13]IRS Publication 1304, *Individual Income Tax Returns*, Complete Report 2006, Table 1.2, row 1 (138 million returns), and Table 1.3, row 55 (86 million returns with standard deduction).

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Table 1. Distribution of Housing Tax Subsidy by Wealth Per Family[a]

	Mean value of property (in thousands of dollars)					
Wealth: Percentiles of net worth	(1) Primary residence	(2) Other residential	(3) Total residential (col. 1 + col. 2)	(4) Approximate tax rate	(5) Col. 4 x col. 3	(6) Percentage of tax benefit (col. 5 / sum)
Bottom quarter	$71.4	$0.0	$71	15%	$11	2%
Second to bottom quarter	$96.9	$39.4	$136	15%	$20	3%
Second to top quarter	$184.7	$76.1	$261	25%	$65	10%
75-89.9%	$294.6	$146.2	$441	28%	$123	19%
Top 10%	$669.7	$559.4	$1,229	35%	$430	66%
Sum for all	$1,317.3	$821.1	$2,138		$650	

[a]Federal Reserve Board, Survey of Consumer Finance, Table 8.94 (2004), *available at* http://www.federalreserve.gov/PUBS/oss/oss2/2004/scf2004home_modify. html (accessed Jan. 7, 2009). Table 1, column (1) shows the average value of residence within a percentile. The computation of percentage of total tax benefit received by each percentile of net worth can use the average; total amount of housing overall or within a percentile of net worth is not necessary.

Also, 80 percent of the itemized deductions for property tax and home mortgage are phased out once taxable income exceeds $166,800.[14] Because high-income taxpayers keep increasing itemized deductions as their incomes rise, the phaseout operates, as a practical matter, as a 1 percent surtax on income.[15]

C. Reasons for Change

Ownership of a residence or other personal-use property is an investment in which the return is the right to personal use of the property. The minimum value of personal use for any taxpayer can be measured by the interest income the homeowner gave up by buying and keeping the house. The long-term risk-free interest rates are readily available in published reports.

The exclusion of the return from an investment in personal-use property and the deduction of related expenses induce the owner to buy more or pay more for housing than he would in the absence of tax. Homeowners buy more house than they really want, and they rely on the tax subsidy to make up the difference. With a tax that provides a more neutral playing field between use of resources, taxpayers would get more value from their resources by spending less for housing and more for other uses.[16]

The overconsumption of housing also diverts capital away from investments that would increase worker productivity and increase other positive externalities of benefit to the economy as a whole. Owner-occupied housing is a relatively selfish investment with few externalities benefiting society as a whole. The subsidy to owner-occupied housing is said to be justified because owner-occupied housing is better maintained than leased property. Maintenance is largely an issue to be worked out between landlord and tenant and incorporated into the calculation of rent. Poor maintenance, however, can affect neighboring values. Still, the external benefits of maintenance are unlikely to extend beyond the neighbors. Why should taxpayers in Alabama pay subsidies for maintenance of properties in San Francisco and New York? Indeed, it's doubtful that the neighbors, who beyond the owner, benefit most from better maintenance, would be willing to take up a collection to pay subsidies, certainly not at the level given by current law. Leasing, moreover, has advantages on its side of the ledger because a tenant can move to a new job or adapt quickly to other changing circumstances. With leasing, maintenance costs can be centralized. Neither the advantages nor disadvantages of owner-occupied housing vis-à-vis leasing seem large enough to justify a federal subsidy with real money.

Taxing the return from personal use is justified because the federal government needs the money. It does less damage to the private economy to raise revenue by shrinking tax advantages than by raising tax rates. Taxes should, in general, create a level playing field between competing uses of money. Where merited, subsidies are best accomplished with government spending because government is rational primarily through a competitive budget and because Congress seems to think of subsidies as real money only when they are on the federal budget.

Taxing the return in personal use also has an equity aspect to it because the tax advantages are so concentrated at the top. The benefit of exemption depends on the amount invested in the personal-use property: The larger the house, the greater the tax advantage. The value of the tax advantage is also the tax avoided, which depends on tax rates. The combination of benefits dependent on the price of the house and benefits dependent on the tax rate means that the tax advantages of housing are distributed primarily to the richest taxpayers and the largest houses. Approximately two-thirds of the value of the tax advantage is given to the wealthiest 10 percent of taxpayers. Only 5 percent of the tax advantage is delivered to taxpayers who have less-than-average net worth; Table 1, above, illustrates the point.

Column (6) of Table 1 shows that that two-thirds of the tax benefit is given to the richest 10 percent of taxpayers by net worth and that only 5 percent of the tax benefit is

[14]Section 68; Rev. Proc. 2008-66, section 2.11 (setting inflation adjusted start of the phaseout).

[15]Calvin H. Johnson, ''Simplification: Replacement of the Section 68 Limitation on Itemized Deductions,'' *Tax Notes*, Jan. 5, 1998, p. 89, *Doc 98-605, 98 TNT 2-71* (Part II).

[16]*See, e.g.*, Martin Gervais, ''Housing Taxation and Capital Accumulation,'' 49 *J. Monetary Econ*. 1461 (Oct. 2002).

distributed to the lower half of taxpayers by net worth. The tax benefits per family depend on the rates of interest available elsewhere and on the property tax rates. But whatever the rates, they drop out in the computation of percentage of tax benefit in column (6). Column (5) is thus a measure of the relative tax benefits per family, even though column (5) does not incorporate the rates for property tax and alternative interest.[17]

The tax benefits for other family residences, beyond the first house, are even more skewed toward the top. Looking at ''other residential'' (column 2) rather than ''total residential'' (column 3), 75 percent of the tax benefit goes to the richest 10 percent by net worth and 2 percent goes to the least wealthy half of the population. Homes beyond the primary residence are not providing critical shelter.

Table 1 does not factor in that the value of deductions for interest and property tax is cut off by the standard deduction for (mostly) the bottom 72 percent of all taxpayers.[18] The expenses on houses worth less than $71,000 are unlikely to get any tax benefit above the standard deduction.[19] Then again, Table 1 also does not factor in the phaseout of itemized deductions starting at taxable income of $166,800.[20]

Table 1 also does not consider that many of the taxpayers in the bottom quarter of net worth can't get any tax benefits from a tax exemption for personal use. A taxpayer whose income is less than personal exemptions plus the standard deduction pays no tax because the taxpayer's income is too close to subsistence to require a contribution to the government. Exemptions and deductions are worthless to a taxpayer with too little income to pay taxes anyway. Thus, the tax expenditure does nothing to help the homeless. The benefits are maldistributed.

Moreover, sellers of personal-use property know about the subsidy, and they attempt to capture its value by increasing the price of the house. To the extent the capture is successful, the cost of a house goes up. The increase in price excludes poorer buyers. With the rate-dependent structure of the subsidy, housing can be expected to go up more in neighborhoods where buyers are in higher tax brackets than in neighborhoods where buyers are in lower tax brackets. A taxpayer who tries to buy a house in a neighborhood where the market price is set by buyers in tax brackets higher than his own might find that the subsidy does more harm than good, because the increase in the housing price is greater than the value of his personal tax subsidy. Homeowners willing to move among poorer neighbors will get more value from the tax subsidy than is lost in the increase in housing prices. Ordinarily, America admires citizens trying to rise, but the rate-dependency of the tax benefits punishes ''strivers'' who seek to live among neighbors with higher tax brackets.

The exemption of the value of personal use violates equal treatment principles. Within an income tax, most consumption is possible only from after-tax income. Lower-income renters who have no possibility of owning a house pay for their shelter with after-tax money. Given the strong norm that consumption takes place only out of amounts previously subject to tax, the government will improve equity when it needs revenue by also taxing the value of personal use from owner-occupied housing.

It is sometimes argued that taxes on real property are dedicated to local use under the federal system.[21] However, states and localities tax the appraised value of rental properties on a footing equal with owner-occupied properties. The value of the use of rental property is subject to federal tax because rental properties generate a taxable rental value to the landlord and no deduction to the tenant. Equality between leased and owner-occupied housing would require state and local real property taxes as well as a federal tax on the rental value.

D. Explanation of the Proposal

1. Rental value. The proposal would tax the owner on the rental value of property available for personal use to the extent the value of a family's personal use property exceeds $1 million, but the exemption level would be reduced over time. The rental value of the availability for personal use would be computed as equal to the minimum interest that the homeowner gave up to buy or keep the personal use property. Every investor has access to interest at least equal to the long-term no-risk federal rate, now at 3.6 percent.[22] Momentarily ignoring exemptions, a $10 million house would generate taxable personal-use value of $360,000 a year.

The proposal uses a risk-free rate (much as net present value calculations use a risk-free rate), so risks from alternative investments do not infect the analysis of the value of the housing use. Interest on home mortgages, now at about 5.25 percent nationally, is higher than the current risk-free long-term rate; however, part of the mortgage interest pays for the value of refinancing if interest rates drop (keeping a fixed rate if interest rates rise). The proposal uses a risk-free rate, but varies the rate annually. The applicable federal rate for rental value would be adjusted annually, so that if the long-term

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[17]For example, if we assume interest rates available elsewhere at the current 3.6 percent, and a property tax at 1 percent, the average tax benefit for the richest 10 percent of families is 35 percent * 4.6 percent * $1,229,000, or $19,790 per family. The average tax benefit for the bottom quarter is 15 percent * 4.6 percent * $71,000, or $490 per family. Column (5) drops the 4.6 percent out of its calculation.

[18]*See* note 13, *supra*, only 28 percent of returns itemize.

[19]A homeowner with a $71,000 house, the average for the bottom quarter, would pay interest of $3,727 (at current 5.25 percent) and property taxes of $710 (at assumed 1 percent). The total of $4,437 is less than the current standard deduction of $10,700 for a couple. However, the bottom quarter would avoid tax on personal use of the residency, without regard to the standard deduction.

[20]*See supra* note 14.

[21]*But see* Letter from James Madison to Alexander Hamilton (Nov. 19, 1789), *in* 12 *The Papers of James Madison*: Congressional Series 449, 450 (Charles F. Hobson and Robert A. Rutland eds., 1979) (recommending that the federal government impose a tax on land ''before a preoccupancy by the States becomes an impediment'').

[22]Table 1 of Rev. Rul. 2009-1, 2009-2 IRB 248, *Doc 2008-26620*, *2008 TNT 245-6* (3.57 percent for terms over nine years).

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federal rate dropped to 2.5 percent, the taxable rental value for a $10 million home (again ignoring the exemptions) would be $250,000.

It is important to adjust the base value on which the rental value is computed after purchase. If property was purchased for $100,000 and is now worth $10 million, the taxpayer should decide whether to keep the house by comparing alternative uses of the $10 million sales proceeds rather than alternative uses of the original $100,000 purchase price. A taxpayer should not be locked into an existing house when circumstances change because a new purchase would generate a high identified personal-use value and the existing house has an artificially low taxable income. It is also unfair to tax new purchasers on real rental value while allowing existing homeowners in identical neighboring houses to report a small fraction of the real current value of use. Moreover, interest rates and values tend to fluctuate inversely. If annual interest used to compute rental value is adjusted, value needs to be adjusted as well.

To simplify administration, it is proposed that the value of a house be indexed annually by a regional index such as the Case-Shiller housing price index. Treasury regulations would set use of the indexes, and the IRS would annually publish the index used. To minimize the administrative burden, it is proposed that reassessment (apart from indexing by regional average) be limited to once every five years and that assessments differing from the purchase price adjusted by the index be recognized only if the departure is greater than 10 percent of value.

Personal-use property needs to be identified not by subjective intent but by the level of explicit income that it generates. If the property is suitable for recreational or residential use and generates income in excess of the fixed risk-free return, it is not personal-use property. By contrast, a large second residence or recreational property does not become a business or profit-making investment just because the taxpayer runs a few goats across the property or has minimal income. A hunting lodge does not cease to be personal-use property because it is rented out for a few days. It is proposed that the combination of explicit income from real property and the imputed rental value be required to exceed the applicable federal rate.

Taxing rental value will also move amounts now reported as capital gain (or avoided as capital gain by reason of death) over to ordinary income, to the extent of the risk-free interest rate. Because capital gain is supposed to be a fluctuation of value above normal risk-free rents from the estate, the shift is consistent with more fundamental tax principles.

Computing rental value from a risk-free published interest rate and from a purchase price adjusted by a regional index is not especially burdensome, but it is not cost free. However, given the extraordinary maldistribution of the tax benefits, most of the economic distortion caused by the tax privileges can be fixed by looking only at the very largest houses held by taxpayers well within the top 10 percent of families by net worth. Two-thirds of the benefit from advantageous taxation of housing goes to the top 10 percent of high-net-worth families. Focusing on the really big houses will mean the most tax revenue can be collected for the least administrative effort. Focusing first on the largest homes focuses on taxpayers who are presumably sophisticated in time-value-of-money concepts and investment and who know (or can learn) about the opportunity cost of buying and keeping personal-use property.

It is proposed that all families, at the outset, be allowed an exemption for $1 million worth of house, recreational, or other personal-use property per family and that the rental value be computed only at the excess by which a family's aggregate personal-use property exceeds $1 million. The average family in the top 10 percent of net worth has residential property worth $1,229,000. Initial taxation of the rental value would be $2,885 (3.6 percent x 35 percent x $229,000). A $100 million house would bear added tax of $1,247,000 annually (3.6 percent x 35 percent x $99 million), or 1.2 percent of value.

However, the proposal would reduce the threshold for imputing rental income by $50,000 annually over the coming years. The proposal measures economic income and is neither a penalty nor a weapon of envy. One-third of the overconsumption of housing is by families with wealth lower than the top 10 percent. As stated above, the distortion in overconsumption of houses needs to be squeezed out rather than shocked out.

A tax should not be imposed when the administrative costs of computing and collecting the tax are not worth the administrative effort. Compliance for smaller items is taken out of the system if the administrative burden would exceed the tax issue. Some examples are the standard deduction, given to all taxpayers without regard to provable itemized deductions, and floors for casualties and medical deductions. My judgment is that tax of roughly $1,000 should be exempted out of the system as not worth the effort of collection. The implication for a taxpayer in the 15 percent bracket under current rates is that a house worth $100,000 should not be subject to tax.[23] Accordingly, the exemption level would be reduced from $1 million to $100,000 in $50,000 increments over the next 18 years. An exemption of more than $136,000 per family would, under current conditions, keep the majority of families (and voters) out of the system permanently and would miss only 5 percent of the tax distortion. Indeed, given the distribution of current tax advantages, a purely political decision to stop the ratcheting down of the exemption level considerably short of the $136,000 house value would still address the preponderance of the problem.

In high theory, a taxpayer receives income from personal use of cars and refrigerators and other consumer durables. It is proposed that most non-real property be exempted from the taxation-of-personal-use system, not because the theory is incorrect, but because the revenue

[23]This is a back-of-the-napkin valuation because $100,000 (value of the house) times 15 percent tax rate (middle-income tax rate) times 5.25 percent (home mortgage rate) plus property tax rate (say 1 percent) equals $975 ($100,000 * 15 percent * 5.25 percent).

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involved is generally not worth the administrative burden at the exemption levels being considered. The revenue is worth the effort, however, if a family purchases a luxury car or yacht for an amount exceeding $50,000. Treasury needs the revenue. It is proposed that there be a separate exemption for personal property of $50,000. For cars and boats, the value from which use is measured would be adjusted annually to Kelley Blue Book sale values.

2. Property taxes. The proposal would also disallow the deduction of property tax on value exceeding the same $1 million value (ratcheted down by $50,000 a year). Property taxes are part of the cost of personal use, imposed by localities as a condition of continued ownership. Property taxes are paid by homeowners because of the benefits they get from the location of the property, local government services or some combination of the two.

Identifying personal-use value by the applicable federal rate also implies that property taxes should be nondeductible. An interest rate measures net income after the payment of expenses. The use of an interest rate to measure the rental value of personal use implies that not only should the interest be taxed, but also that deductions for personal expenses of shelter and recreation be disallowed. Many costs of housing are already disallowed. The costs of maintaining the house and depreciation due to age and wear and tear are personal expenses that may not be deducted even under current law.[24]

3. Reinvested gain. The proposal would replace the section 121 exemption with a 15 percent tax on gain from houses, even if the gain is reinvested. The view under general law is that lower rates for capital gain were enacted because of the expectation that capital gain must be reinvested. The lower (now 15 percent) tax on capital gains was adopted by Congress in reaction to a specific case, *Merchants' Loan & Trust Co. v. Smietanka*,[25] in which the Supreme Court allowed a trust to be taxed at ordinary rates when it sold corpus stock at a gain. The proceeds of the sale had to be reinvested for the benefit of corpus interests. Income beneficiaries got no distributions and had no access to the gain. British law at the time exempted capital gains, which usually had to be reinvested. Within months of the *Smietanka* decision, Congress gave a maximum 12.5 percent tax to capital gains whereas the maximum tax rate on ordinary income at the time was 54 percent.[26] Lawmakers said they were adopting an ''intermediate position'' between the full taxation of reinvested gain and the then existing British exemption for capital gain.[27]

Given that capital gains rates represent the general norm for reinvested capital, the same system should be imposed on housing, including both primary and secondary residences. Moreover, if a risk-free interest rate is going to be used to impute rent, gains will need to be taken into account separately.

4. Home mortgage interest. If the rental value of personal use is taxable, interest paid on a home mortgage for access to the use should be deductible. If the rental value of use of some property is $100x and the taxpayer pays $100x worth of interest from salary to carry the loan that made the home purchase possible, $100x of consumption use should be taxed. But taxing both rental value and the salary that pays for it would create $200x of income for $100x consumption. When the taxpayer has paid for the personal use by paying the mortgage interest, imputing income and disallowing a deduction constitutes a double tax on the same items. By contrast, if a taxpayer pays $100x interest and $20x property tax annually, the taxpayer is getting $120x value from the personal use so that the property taxes, as well as maintenance and depreciation, need to be nondeductible to capture the rental value of the use.

Current law allows a deduction for interest for as much as $1 million of a purchase-money mortgage on a house and as much as $100,000 for a home equity second mortgage. Under the proposal, the exemption for rental income taxes stops at $1 million. Between the proposed taxation of rental value exceeding $1 million and the continuation of the current deduction for interest on home mortgages less than $1 million, interest on home mortgages would seem to be appropriately deductible in full.

The proposal would, however, end the automatic deduction of interest on home equity second mortgage borrowing, now allowed on up to $100,000 of borrowing.[28] A second mortgage uses the house as collateral, but borrowing takes money away from the house and puts it into some other use. If the proceeds of the borrowing are used for business or investment, the interest would be deductible, but it is proposed that there be no automatic itemized deduction for home equity borrowing.

E. Alternatives Considered but Not Adopted

1. Home mortgage interest. An alternative considered but not adopted would have disallowed mortgage interest deductions and not taxed the value of personal use. That alternative would have had no impact on $1 million-plus houses and recreational properties, because home mortgage interest deductions are already limited to interest on $1 million of borrowing on a residence.

The remedy would also have had no impact on the richest taxpayers, who can substitute equity for debt-financing of houses. A well-to-do taxpayer could, for example, liquidate taxable bonds to buy a house. The liquidation of bonds would make taxable income disappear just as the interest deduction makes income from salary and unrelated income disappear. Middle-income taxpayers must borrow to buy a house, and only the wealthiest of taxpayers can substitute equity. A remedy

[24]Section 262.

[25]255 U.S. 509 (1921).

[26]Revenue Act of 1921, P.L. 98, 42 Stat. 227, 237, H.R. 8245, 67th Cong., 1st Sess., section 210 (4 percent normal tax), section 211(a)(2) (50 percent surtax), section 206(b) (12.5 percent tax on capital gain).

[27]Senate Finance Committee, S. Rep. No. 275, 7th Cong., 1st Sess. (Sept. 26, 1921) reprinted in 1939-1(Part 2) Cum. Bull. 181, 190.

[28]Section 163(h)(3)(C).

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that goes after middle-income earners but not the richest taxpayers is subject to the objection that it is class discriminatory and unfair.

2. Credit varied by geographic area. The 2005 President's Advisory Panel on Federal Tax Reform proposed disallowing the deductions for home mortgage interest and property taxes and replacing them with a tax credit of 15 percent of mortgage interest paid. The credit would extend only to interest on borrowing up to the average amount for homes in a geographical area. Thus, a homeowner with a mortgage three times the value of an average house for the area would get the credit only on the first third of his interest costs. In hot markets like the San Francisco Bay area, New York, Boston, and Washington, the credit would be on interest on $411,704 at current levels and on only $227,147 in less-favored markets. The credit would not be available beyond the primary residence, and it would not be available for home equity second mortgages that allow cash to be borrowed after ownership is established.[29]

Compared with current law, a 15 percent credit would increase the resources going into housing for most families. The 62 percent of taxpayers who do not itemize get nothing from the deduction of interest and property taxes, and the panel's credit would increase housing consumption at the lower levels.

A tax credit is superior to a tax exemption or deduction because the latter are rate-dependent: Taxpayers in the 35 percent bracket get 35 cents on the dollar from an exemption or deduction but only 15 cents on the dollar from the proposed credit. There is, in fact, no reason to think that a rich person's home should be subsidized at 35 percent — more than twice the rate of a home belonging to a middle-income earner in the 15 percent tax bracket. Nonetheless, the amount of the panel's subsidy depends on the amount incurred to pay for property, up to the average of the area. The subsidy would be higher for those families able to afford bigger houses (up to the average), and it would be smaller for those families who can't afford the average house. A subsidy that was trying to "encourage home ownership, not big homes"[30] would focus all of its costs on the ownership of small houses in which the critical decision between owning some house or no house at all is made. Indeed, because a rental provides adequate shelter, a subsidy that was trying to give the maximum adequate shelter per dollar spent would spend all money on the homeless who were otherwise on the streets. As noted, limiting interest deductions, without taxing the personal-use return from an investment, would have no impact on the wealthiest taxpayers buying homes exceeding the $1 million level for deductible interest home mortgages. The proposal here rests on the assumption that a subsidy to housing should be delivered through budgeted government spending — the precondition for decision-maker's considering the subsidy as real money worth the care of maximizing the benefit per cost.

Varying the subsidy ceiling by geographical area does not yet seem justified. A dollar is the uniform measure of currency for the entire country. Dollars do not vary in value in different parts of the country, because everybody's dollar is the same. Every day thousands of taxpayers move or are considering a move from one area to another. They buy houses or move only when the value they get from their new location improves their welfare beyond the dollars spent. As long as migration from one area to another is not artificially restricted, buyers who are considering moving keep the value of the house exactly equal to cost, across the entire country. The buyers of the most expensive homes are buying something valuable — perhaps the excitement of a big city or access to cultured neighbors — and are willing to pay for it. House prices reflect real resources diverted from other uses, even in hot markets.

[29] President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* 73 (2005).

[30] *Id.*

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