



A FairTaxSM White Paper

The FairTax treatment of housing

Advocates of tax reform share a common motivation: To iron out the mangled economic incentives resulting from statutory inequities and misguided social engineering that perversely cripple the American economy and the American people. Most importantly, ironing out the statutory inequities of the federal tax code need not harm homebuyers and homebuilders. The FairTax does more than do no harm. The FairTax encourages home ownership and homebuilding by placing all Americans and all businesses on equal footing – no loopholes, no exceptions.

A specific analysis of the impact of the FairTax on the homebuilding industry/the housing market shows that the new homebuilding market would greatly benefit from enactment of the FairTax. The analysis necessarily centers upon two issues:

- (1) Whether the FairTax's elimination of the home mortgage interest deduction (MID) adversely impacts the housing market (new and existing) in general, and home ownership and the homebuilding industry specifically; and
- (2) Whether the FairTax's superficially disparate treatment of new vs. existing housing has an adverse impact on the market for new homes and homebuilding.

The response to both of the above questions is *no*.

Visceral opposition to the repeal of a “good loophole” such as the MID is understandable, absent a more thorough and empirical analysis of the impact of the FairTax vs. the MID on home ownership and the homebuilding industry. Such an analysis demonstrates that preserving the MID is the classic instance of a situation where the business community confuses support for particular businesses with support for enterprise in general. In actuality, these seemingly similar ideas or objectives are directly contradictory. The way to support free enterprise is to eliminate all subsidies that are artificial incentives to spending in a particular segment of the economy while putting more income in the hands of the American people so that demand, not legislative fiat, instructs the marketplace. By allowing the market to operate in a manner that benefits enterprise in general, the FairTax benefits the homebuilding industry in particular. What follows is a summary of the positive economic impact the FairTax has on home ownership and the market for new homes. As a prerequisite to accepting the economic arguments related to the specific provisions of the FairTax on a particular industry, especially the housing industry, one must first accept: (1) the general philosophical thrust of the FairTax and (2) the factors that buyers consider in the purchase of a home in general and the decision to select a new vs. existing home.



The FairTax: Impact on home ownership

Some have attacked the FairTax on the grounds that it eliminates the MID. When they do so, they oversimplify, by judging the proposed consumption tax through the mechanisms of an income tax. The FairTax does impose a tax on all purchases of newly constructed homes and repeals the MID. But other provisions of the FairTax operate to encourage more home ownership than the current code's perceived tax-advantaged treatment.

The current code requires homebuyers to pay for a new home with after-payroll and after-income tax dollars. No deduction is allowed for the purchase of a home, and the price of that home already reflects the taxes and compliance costs imposed upstream, from timber costs to framing labor. The largest tax incentive today for reducing the cost of buying a home is the MID, an expenditure worth an estimated \$72.6 billion by the Joint Committee on Taxation. In addition to this benefit, the tax code partially excludes capital gains (estimated at \$22.9 billion) and allows local property taxes (estimated at \$19.6 billion) to be deducted against income taxes. Unlike the current regime, the FairTax does not tax interest, imposes a lower marginal tax rate on new home purchases (see page 3 for a discussion of this point), fully untaxes capital gains from the sales of used or new property, and terminates cost-raising tax and compliance expenses imposed on upstream labor and materials.

Under the FairTax, potential homebuyers can save for the purchase of a home faster, which increases and accelerates the volume of all home sales. The current tax system takes three bites out of the savings apple. First, it taxes wages and salary income from which savings are generated. Second, it taxes the income earned from savings as that income is generated. Third, if the investment (a stock, bond, real property interest) is sold for more than it cost, the capital gain is taxed again. Under the FairTax, a family can save for a down payment without fighting against cascading taxes on savings. Homebuyers can qualify more quickly to move up to a new home or purchase their first home.

Finally, the sales of existing homes, the most common properties bought by first-time homebuyers, are not taxed upon purchase or sale and this has a corresponding downstream positive impact on the sale of new homes. The seasonally-adjusted statistics for 2005 show that about three-quarters of all home sales are projected to be existing homes. Most important to this analysis, it must be understood that the proceeds from the sales of existing homes most often provide the ultimate resources for the purchase of new homes. Since these proceeds are no longer taxed, the market for new homes benefits.

In order to equal the benefits to home ownership and the sale of new homes provided under the FairTax, the current tax system would have to be radically altered. To do so, Congress would have to enact legislation that implements the following six modifications to the existing code:

- (1) Allow all taxpayers to fully deduct the purchase of used property against income and payroll taxes;
- (2) Expand the MID so that it permits a deduction against payroll taxes, is eligible whether one itemizes today or not, and eliminates any phase out;



The FairTax treatment of housing

- (3) Untax the mortgage interest received by banks and lending institutions to allow them to reduce the rates on such loans;
- (4) Allow a credit for all upstream taxes paid by homebuilders so that these taxes do not elevate the purchase price of new home;
- (5) Totally untax returns on savings used to buy homes; and
- (6) Fully untax any gain from home sales.

The MID myth

The MID deserves special comment as it is viewed as a ‘sacred cow’ to be protected at all costs by defenders of the current system. In short, the MID does little, if anything, to promote home ownership and the home building industry when analyzed on its own or when compared to the FairTax. Although touted as one of the most potent weapons to promote home ownership today, the MID is an extremely blunt tool despite its revenue costs. For instance, the intended result of the MID is the non-taxation of mortgage interest (or more precisely, the funds used to pay mortgage interest). It seeks to offset the income taxes that would otherwise be paid on income used to pay mortgage interest. It is often touted as allowing the payment of mortgage interest with “pre-tax” money.

However, the MID is only permitted for servicing the interest on mortgage debt by itemizing homeowners. The staff of the Joint Committee on Taxation estimates of Federal Tax Expenditures for 2005 predict that 38.8 million taxpayers will utilize the MID. Only 35 percent of taxpayers, slightly over one-third of all taxpayers, itemize.¹ Moreover, even if they take the MID, the intended result of the MID is the *non-income* taxation of mortgage interest (or more precisely, the funds used to pay mortgage interest). Because payroll taxes account for 41 percent of combined income and payroll taxes², taxpayers cannot take the mortgage interest deduction against one of the most significant forms of taxes that apply to them – payroll taxes. More than three-quarters of all Americans pay more payroll taxes than income taxes and they are the first time home buyers.

Under the FairTax, mortgage interest is not taxed. The FairTax repeals both the income tax (including any tax on interest income) and payroll taxes. Interest payments, therefore, are made with both *pre-income* and *pre-payroll* tax dollars. In order for the income tax to treat mortgage interest that favorably, the MID would have to be deductible against payroll taxes as well as income taxes. Likewise, under the FairTax, principal payments to purchase a previously owned home are made with both *pre-income tax* and *pre-payroll tax* dollars. This can be contrasted with current law where the taxpayer pays for the principal payments of both existing and new homes with *after-payroll* and *after-income* tax dollars. The current system both directly and indirectly results in dramatic increases in the real costs of purchasing a home.

¹ 2002 IRS Statistics of Income data (the latest publicly available IRS data on individual returns).

² IRS Summary of Collections Before Refunds by Type of Return, FY 2003 (in \$ millions): Individual income tax 987,209; Corporation income tax 194,146; Employment taxes 695,976; Gift tax, 1,939; Excise taxes 52,771; Estate tax 20,888.



Other factors that debunk the myth that the MID has a positive impact on home ownership include:

- The tax treatment of mortgage interest under the current code creates a tremendous bias in favor of borrowing, i.e., the growth in zero principal payment (interest only) loans today. The removal of this harmful distortion eliminates one of the main ways that households are encouraged to take bigger financial risks than they would if left to their own devices. Speculation through excessive use of debt in the purchase of a primary residence is not necessarily a sound strategy for most households. One must wonder if it makes sense to stretch for a purchase with a larger mortgage by paying \$1 more in mortgage payments to save 25 to 35 cents on the interest of that dollar especially when the “advantage” diminishes as the note amortizes.
- The elimination of payroll taxes places more money in the hands of the homebuyers. More take-home pay enables households at every level, especially “entry level” and step up homebuyers (typically new home purchasers), to afford “more house for the money.”
- Home ownership in this country, especially the market for new homes, is spurred by low interest rates, higher savings rates, and other economic variables specific to the purchaser of a new home – not MID, and the FairTax increases savings, lowers interest, and increases national prosperity.
- The elimination of the home MID is more than offset by the FairTax’s removal of embedded costs of new housing under the current tax code.
- Only 35 percent of all taxpayers itemize. Of these, many get only partial benefit from the MID while the overwhelming majority receive no benefit at all.

The bottom line is that elimination of this loophole positively impacts many individual households and especially a homebuilder’s clientele.

New vs. existing housing under the FairTax

There is also a concern that the FairTax promotes the sale of existing homes to the detriment of the market for new homes. The merits of this position are dubious for the following reasons:

- There are logically a finite number of existing homes, and therefore, an equilibrium is established between existing and new home prices.
- All housing, new and existing, is treated identically under the FairTax with the elimination of the MID loophole. Thus, there is no bias in favor of existing homes vs. new homes (and vice versa new vs. existing) under the FairTax, just as before.
- The FairTax eliminates the embedded, upstream costs in new homes. It is estimated that the removal of these embedded costs could reduce the purchase price of a new home by as little as 12 percent and as much as 20 percent in normal markets. Anomalous markets where builders are unsuccessfully using price hikes to limit sales are certainly exceptions.
- By contrast, under the current system the embedded, upstream costs already included in existing homes will remain embedded. Even though the sale of an existing home containing the embedded costs is not taxed under the FairTax, it is logical to conclude



that the seller's price will include the embedded, upstream costs imposed under the current system.

- Under the FairTax, the combined effect of (1) the greater affordability of new housing and (2) increased savings rates which increases the number of potential buyers for new homes, becomes more pronounced in a rising interest rate environment (the FairTax results in the immediate elimination of the interest differential between tax-free and taxable debt).
- The equilibrium that exists between new homes and existing homes under the current tax code remains under the FairTax.
- Disparities in existing vs. new home prices brought about by tax changes are nothing new. Embedded costs from taxes imposed on homebuilders and their suppliers along the chain of production have varied greatly over the years. Annual changes to the tax code, and changes to marginal rates during different time periods in which homes were built have fluctuated erratically (marginal rates have ranged from 90 percent to 28 percent). And these significant disparities induced by the tax code have occurred over the years without any concerns over transition.

The FairTax ensures that the transition to an entirely new system is smooth by eliminating the distortive effects of taxes between new and existing homes. All housing, new or existing, is treated identically under the FairTax to compliment elimination of the MID loophole, thus eliminating any bias in favor of existing vs. new homes. The FairTax eliminates embedded, upstream costs now included in the price of new homes. Like other businesses, homebuilders pay corporate taxes and payroll taxes that are embedded in producer prices. With the repeal of the corporate income tax and payroll tax system and its associated compliance costs, economic research suggests that producer prices in the construction industry will decline by 12 percent.³ The embedded, upstream costs that have already been imposed by the current system remain embedded. Thus, the imposition of the FairTax on new homes, coupled with the non-taxation of existing homes causes the relative prices to remain essentially the same.

Homebuyers purchase homes based on numerous economic and non-economic considerations that have little, if anything, to do with the tax-affected basis or treatment of new vs. existing housing under the current tax code or under the FairTax. The factors in this analysis typically include:

- The type of home (step-up or downsize) that satisfies a homeowner's current and/or future housing needs.

³ FairTax.org estimate based on an analysis of business taxes as a percent of private business GDP by Robbins, Gary and Aldona, "How the Current Tax System Works," Center for Tax Analysis, Institute For Policy Innovation, Policy Report 154, September, 2001. The Robbins's study calculations were adjusted to take into account only federal income taxes incident on the business sector (520.8 billion), the employer share of payroll taxes (\$279.9 billion), and an 80 percent reduction in business compliance costs (\$82 billion). This yields a total figure of \$882 billion or 12.5 percent of the Robbins's figure for private business GDP of \$7,018.5 billion.



The FairTax treatment of housing

- Under the FairTax, the elimination of the capital gains tax on the sale of an existing home allows the purchase of a larger new or existing home.
- Location – neighborhood issues, access to schools, friends and family, transportation hubs, new urban centers, commercial activity, commute to office, etc.

If tax consequences are a driving force, it should be noted that the purchasers of existing homes incur the taxes related to the costs of new goods and services in the remodeling of existing homes. Thus, any actual or perceived advantage of new vs. existing homes is further reduced.

Impact on homebuilding

One way to properly measure the cost of a home is the wages that the family has to earn to be able to purchase that home. A fair analysis is the comparison of a family that buys a \$153,800 home⁴ under the current income/payroll tax system vs. the FairTax. The chart below compares the benefits of the MID to the homebuyer relative to the full non-taxation of interest and principal payments on mortgages under the FairTax. To purchase the \$153,800 home mentioned above (assuming a 27-year term and mortgage interest rate of 6.0 percent), the prospective home buyer would have to pay \$157,139 in interest in addition to the price of the home. To completely pay off his loan, the homeowner would have to earn \$377,790 once employee payroll taxes and income taxes are taken into account.

Under the FairTax, a prospective home buyer needs to earn \$65,691 (or 17 percent less income) to buy the average *new* U.S. house. Thus, more buyers are able to afford the average new home under the FairTax than under the current tax system. That is a result of several factors. First, there is projected to be a 25-percent drop in home mortgage rates. Also, the interest payment does not have to be paid with *after-payroll tax* dollars.

The following table assumes the MID is fully taken. It is also conservative because it ignores expected reductions in the cost of new home construction through elimination of embedded income and payroll taxes.

⁴ This was the median price of existing homes in 2002, according to the National Association of Home Builders.

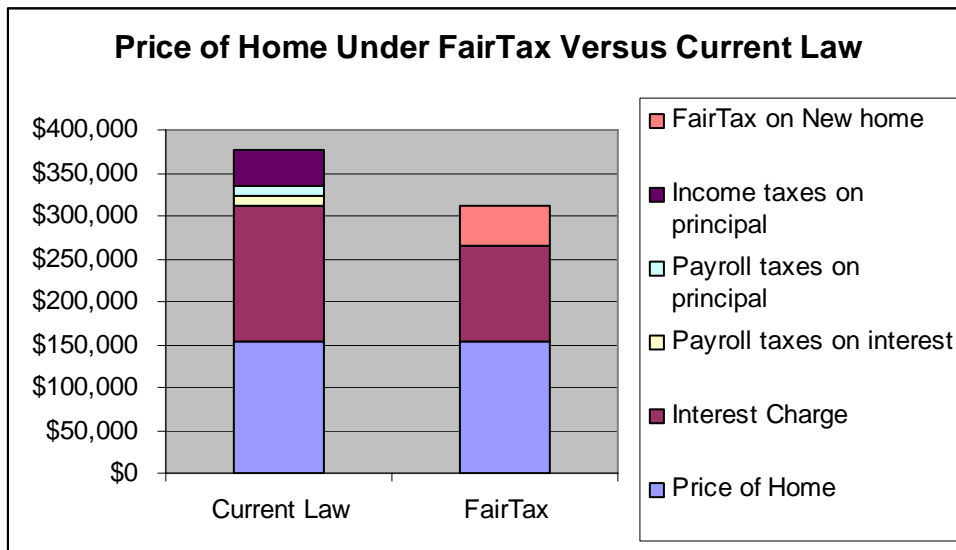


The FairTax treatment of housing

Actual cost of purchasing \$153,800 home
(Wages that must be earned to buy home)

Components of housing cost	Income and payroll tax system	FairTax (25% mortgage interest rate drop) ⁵
Home purchase price	\$153,800	\$153,800
Interest @ 6.0 for 27 years	\$157,139	\$112,159
FairTax on home purchase	\$ 0	\$ 46,140
Income taxes on interest	\$ 0	\$ 0
Income taxes on principal	\$ 43,064	\$ 0
Payroll taxes on interest	\$ 12,021	\$ 0
Payroll taxes on principal	\$ 11,766	\$ 0
Total taxes	\$ 66,851	\$ 46,140
Total housing cost including taxes	\$377,790	\$312,099

The positive impact of the FairTax is depicted in the chart below.



Neither the table nor the chart takes into account one important consideration: The timing of the tax obligation under each tax plan. That in turn depends on the amount financed. To elaborate, the payroll taxes on interest and principal in the first column, coupled with income taxes on principal are – to the extent the property purchase is financed – taxes paid out over time. Hence, to the degree a buyer finances a property, the buyer will have the use of the deferred

⁵ By not taxing lenders on interest they receive, it is estimated that the FairTax lowers mortgage interest notes by 250 basis points which further reduces the carrying costs of a home purchase.



The FairTax treatment of housing

taxes for investment purposes, i.e., the time value of the taxes that were deferred. By comparison, the FairTax requires payment of the taxes at the time of the sale, although the taxes might be capitalized in the loan and the interest on those taxes is not taxable. The question becomes: What is the present discounted value of the future income stream from the investment of deferred taxes under present law?

Assuming a home buyer earns six percent on deferred taxes, discounting the future taxes due at a six percent interest rate reduces the total cost of purchasing a home under the current tax code by \$39,263 to \$332,740. Applying a six percent discount rate, the cost under the current system is \$32,057 or 11 percent more than under the FairTax. It is unlikely that, in the current investment environment, many homeowners can (or will) invest their money in a manner so that the average annual returns will exceed six percent. Thus, even when taking into account the time value of money, the FairTax proves more beneficial to home ownership.

It is important to point out that the benefit a home buyer realizes from paying taxes over time rather than immediately is a function of both the amount financed as well as the discount rate, and the effect is most dramatic with a high discount rate and a high degree of leveraged financing. If, on the other hand, one pays cash for the home (or simply increases the down payment as could be the case in the sale of an existing home to purchase a new home), the effect seen above which mitigates the advantages of the FairTax (but does not eliminate those advantages) is actually reversed. The savings a home buyer must accumulate to make a large down payment or to finance less of the purchase price of property is a capital asset that has been pre-taxed (under the current law), meaning the saver lost the opportunity cost of the taxes paid on his earnings as he was accumulating savings. In this scenario, the FairTax is even more favorable because the taxes on those savings are deferred until the point of purchase. Thus, one of the greatest perversions of the income tax can be seen in this example: The favoritism shown to debt vs. savings.

The bottom line is that taking into account the fact the FairTax requires taxes to be paid upon purchase instead of deferred does affect the level of relative benefit to home buyers who finance their purchase when the FairTax is compared to the current system, but it does not eliminate that benefit and in some cases enhances the benefit of the FairTax. And it is important also to note that the chart draws several conservative assumptions that underestimate the advantage. For example, our scenario assumes home buyers are able to fully utilize the MID while the statistics show otherwise. It is also conservative because it ignores expected reductions in the cost of new home construction through elimination of embedded income and payroll taxes. For the home buyer accumulating a down payment, the opportunity costs can be considerable.

In addition, since the FairTax does not tax savings and investment and makes the payment of the tax largely elective, it enables new home buyers, second home buyers or buyers stepping up, to save for their purchase *faster*. Buyers are able to qualify for a mortgage faster and existing owners should be able to sell their homes faster. The current tax system takes three bites out of the savings apple. First, it taxes wages and salary income from which savings are generated. Second, it taxes the income earned from savings as that income is generated. And third, if the investment (a stock, bond, real property interest) is sold for more than it cost, the



capital gain is taxed again. Under the FairTax, the down payment can be saved without swimming upstream against cascading taxes on savings. The ability to save tax free can reduce the time spent accumulating a down payment by 25 percent.

Finally, the FairTax is a system that neither discourages savings and investments nor favors one investment type over another while effectively lowering marginal rates.

These positive economic effects will cause the economy to grow significantly, increasing the real wages of the American worker. Economic growth and real wage growth benefit home ownership and larger home purchases.

Conclusion

The FairTax is, at worst, neutral and at best is extremely positive for home ownership generally and the new home building industry specifically because:

- Non-economic issues such as location, size, and neighborhood amenities as well as “newness” affect resale value and, thus, the ultimate value of a home. Although critics may argue to the contrary, the FairTax does not accord a differential tax treatment biased in favor of existing home sales over new home sales (and vice versa).
- The benefits of non-taxation of mortgage interest far exceed the deduction against income taxes that can be taken by itemizers under the MID today.
- The elimination of the MID results in housing purchases based on issues specific to the dynamics of home purchases rather than the perceived benefits the MID provides to individuals in the higher tax brackets with the ability to itemize.
- New and existing homes become more affordable to more households as a result of the elimination of payroll and income taxes.
- The benefits of lower interest rates due to the non-taxation of interest income by lending institutions reduce mortgage carrying costs by at least 250 basis points.
- The removal of the embedded costs and inefficiencies of the current tax code sufficiently lowers the price of new homes to offset, or more than offset, the 23-percent (tax inclusive) sales tax on new homes, while retaining the same level of net profit.⁵

⁵ Tax inclusive and tax exclusive – the FairTax is a replacement for the current tax system and is often compared to the flat tax. The current tax system and the flat tax are imposed on a tax base before payroll taxes and before federal income taxes are deducted. They are, therefore, tax inclusive. Typically, state sales taxes are imposed on a tax-exclusive basis. To compare apples to apples, the FairTax, unlike most state sales taxes, is imposed on a tax-inclusive basis. On a tax-exclusive basis, a 23-percent tax-inclusive rate is a 29.9-percent tax. But on that basis, the current tax system imposes marginal tax rates on middle-class taxpayers of 55 percent (76 percent if you take into account the hidden employer payroll tax that most economists believe is borne by workers). It would be wrong and misleading to compare apples to oranges.

For example, assume a worker earns \$100 and uses this amount to pay for a CD player at Wal-Mart. Under the income tax, the worker would earn \$100, pay \$20 dollars in income tax, and have \$80 left over to buy the CD player. This tax rate is 20 percent. In a typical sales tax, the worker earns \$100, pays \$80 for the CD player and pays \$20 in sales tax. To determine the rate, \$20 is divided by \$80 and the resulting rate is 25 percent. Using this method, the sales tax rate is 25 percent and the income tax rate is 20 percent, even though the tax burden is precisely



The FairTax treatment of housing

- Most new homeowners were able to purchase those new homes by selling existing homes and the elimination of the capital gains tax will encourage the purchase of new homes. Today, a single buyer can exclude \$250,000 of gain, provided the buyer meets the conditions of that exclusion⁷.
- The FairTax increases savings rates and lowers interest rates, thereby enhancing the ability of a larger number of potential homeowners to purchase both new and existing homes. The FairTax results in the faster accretion of capital for down payments and a reduction in interest rates resulting in the ability to afford larger mortgage (principal and interest) payments.
- There is no credible economic evidence that suggests that sales of new vs. existing homes will lag because of the “disparity” in the tax treatment of new vs. existing homes under the FairTax. The evidence demonstrates that affordability, increased savings rates (the ability to save for a down payment faster), and interest rates – a major component of affordability – affect home buying decisions. The positive effect of the FairTax on the cost of new homes, lower interest rates, and increased savings rates has a corresponding positive effect on the affordability of housing in all segments of the housing market and home building industry.

What is the FairTax Plan?

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?

FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

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the same. If the employer share of the payroll tax is considered, this worker must earn \$176 to spend \$100. A 15-percent income tax bracket taxpayer must earn \$129 to spend \$100. This figure is \$143 if the employer share of payroll taxes is taken into account, as most economists believe it should.

⁷ Previous Internal Revenue Code Section 1034 rules involving the purchase of a replacement residence and the once-in-a-lifetime exclusion of \$125,000 for those over 55 have been repealed. Under a relatively new law, one may exclude up to \$250,000 of a capital gain provided he or she owned and lived in his or her residence for at least two of the five years prior to the sale (the “ownership” and “use” test). This exclusion is not limited in the total number of times it may be used; it applies to one home sale per two-year period. If the gain is higher than the exclusion, then taxes will be paid on the excess gain.