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United States General Accounting Office

GAO

Briefing Report to
the Honorable Bill Frenzel
House of Representatives

March 1986

TAX POLICY

Nonbusiness Interest Deductions

GAO/GGD-86-53BR

034803

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

March 13, 1986

The Honorable Bill Frenzel
House of Representatives

Dear Mr. Frenzel:

On November 19, 1985, we briefed a staff member of the Ways and Means Committee on the amount and distribution of (1) nonbusiness interest deductions claimed by individual taxpayers, (2) consumer credit, and (3) home equity. We were asked to elaborate on some of the data and to provide you a report containing the substance of the briefing.

As you know, current law generally allows individuals an unlimited itemized deduction for nonbusiness interest expense. In this regard, figures 1 through 4 illustrate the average deductions claimed in 1983, the latest available statistics, by individuals for mortgage interest, credit card interest, and other nonbusiness interest.

The House-passed Tax Reform Act of 1985 (H.R. 3838) and other reform proposals include provisions that generally are designed to restrict the amount of nonbusiness interest deductions other than home mortgage interest. Figures 5 through 8 illustrate the dollar value of home equity and the dollar value of outstanding consumer credit. The data show that the potential exists for some homeowners to avoid these proposed restrictions because they can use their home equity as collateral to finance purchases of consumer items and nonbusiness investments, then deduct the related interest as home mortgage interest.

We developed the eight figures between October 1985 and November 1985 using data from both publicly available and unpublished sources. The source(s) and methodology used are explained opposite each figure.

To determine what types of opportunities are currently available to homeowners wanting to use their home equity to finance loans for nonbusiness purchases, we gathered information from publications and lending institutions in the Washington, D.C., area. However, a representative of the American Bankers Association told us that lending institutions throughout the country offer similar borrowing plans.

We hope that you will find this information useful in your deliberations on reform proposals pertaining to rules governing nonbusiness interest deductions. As arranged with your office, we will make copies of this document available to Senator Bob Packwood, Senator Russell B. Long, and other interested parties at the same time as you receive it. If you or your staff have questions regarding the information, please contact either Robert Katcher or Chuck Vehorn of my staff on 376-0023.

Sincerely yours,

Johnny C. Finch

Johnny C. Finch
Senior Associate Director

CURRENT FEDERAL INCOME TAX RULES

In computing taxable income, an individual can generally take an itemized deduction for all nonbusiness interest payments made during a tax year.[1] No limitation is imposed on the deductibility of nonbusiness interest payments on loans used to purchase consumption goods or personal residences. For example, an individual who itemizes may deduct interest on a car loan, a typical credit card balance, a mortgage secured by the individual's residence(s) and/or vacation home(s), or other borrowings for personal items.[2] However, in certain cases other types of nonbusiness interest payments are not fully deductible. For example, the deductible amount of interest payments on loans used to buy investment property ("investment interest") is limited for all noncorporate taxpayers. In general, the amount of investment interest an individual may deduct annually equals the sum of (a) $5,000 ($10,000 on a joint return), (b) net investment income, and (c) certain deductions attributable to leased property.[3]

Using data compiled by the Internal Revenue Service (IRS), we calculated the average home mortgage interest, credit card interest, and other nonbusiness interest deductions claimed in 1983 by individuals in various classes of adjusted gross income who itemize their deductions. (See figures 1, 2, and 3, respectively.) According to IRS' explanation of the data, "other interest" includes nonbusiness interest deducted by individuals other than home mortgage interest and credit card interest. However, because of the way IRS collected and aggregated its data we were unable to determine the percentage of the various components (such as deductible investment interest) that were included in the "other interest" category. Figure 4 is a compilation of figures 1, 2, and 3.

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[1]Section 163 (a) of the Internal Revenue Code of 1954, as amended ("Code").

[2]Department of the Treasury, Internal Revenue Service, Your Federal Income Tax, (Nov. 1985) p. 127.

[3]The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985), p. 322. See also, section 163(d) of the Code.

Explanation of
Figure 1

Data on the number and amount of home mortgage interest deductions claimed by adjusted gross income categories are from table 2.1 of Statistics of Income, Individual Income Tax Returns, 1983 (Nov. 1985), published by the Internal Revenue Service (IRS). The IRS statistics are estimates based on a stratified probability sample of individual income tax returns, selected before audit. The estimates represent coverage of the 96.3 million Forms 1040, 1040A, and 1040EZ filed by the nation's taxpayers for income year 1983. Those taxpayers who filed itemized returns total 35.2 million (or 36.6 percent of all taxpayers), and those who claimed the mortgage interest deduction represent 72.7 percent of all itemizers. Using these data, we calculated the mean values shown in the figure. These means represent the average amount deducted by those in specific income classes claiming this deduction. The income class categories (for this and other figures) represent the lower bound of the income range. For example '0' represents those taxpayers whose adjusted gross incomes (AGIs) were less than \$5,000, '5' represents taxpayers with AGIs of \$5,000 but less than \$10,000, and so on.

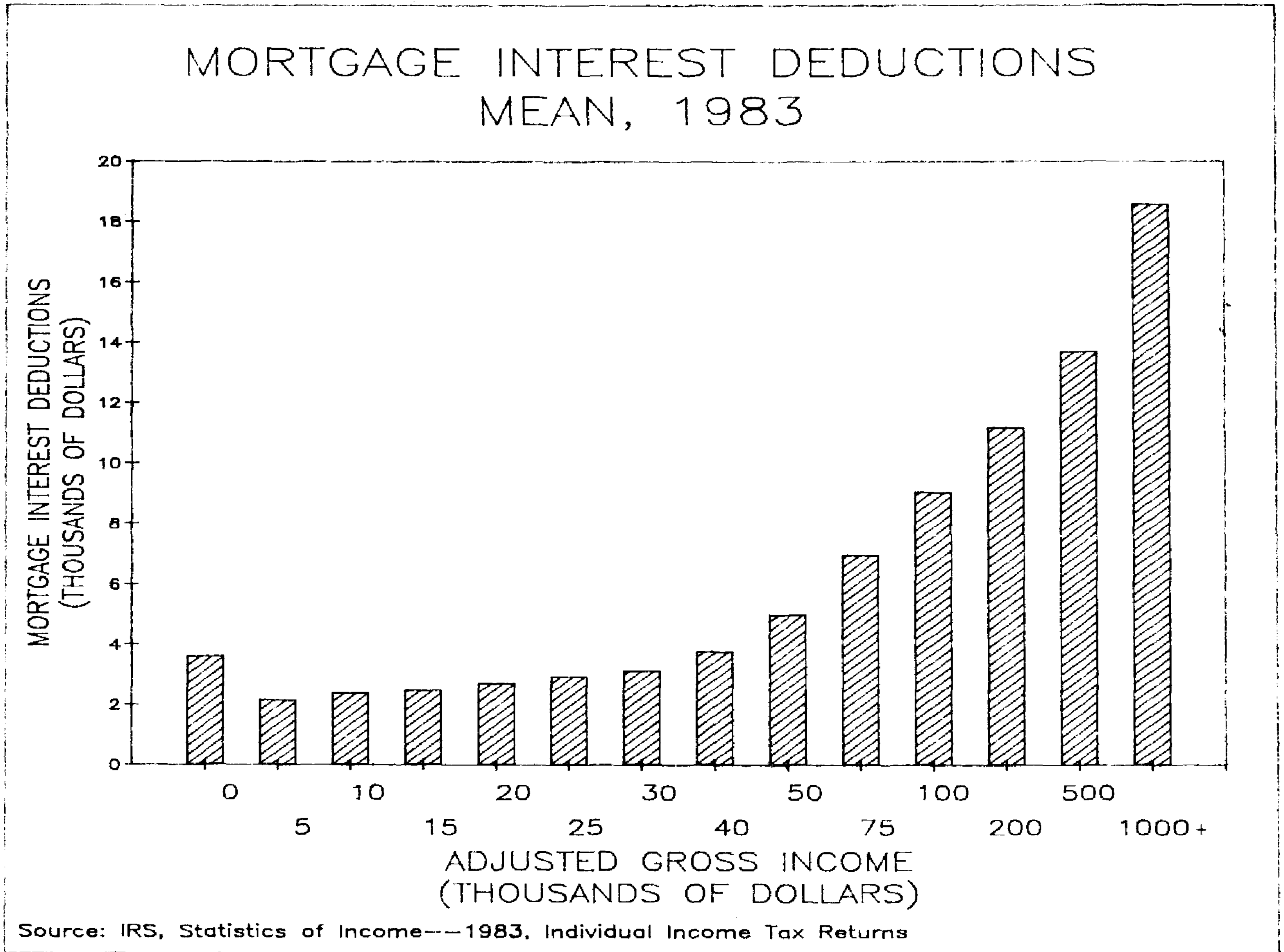
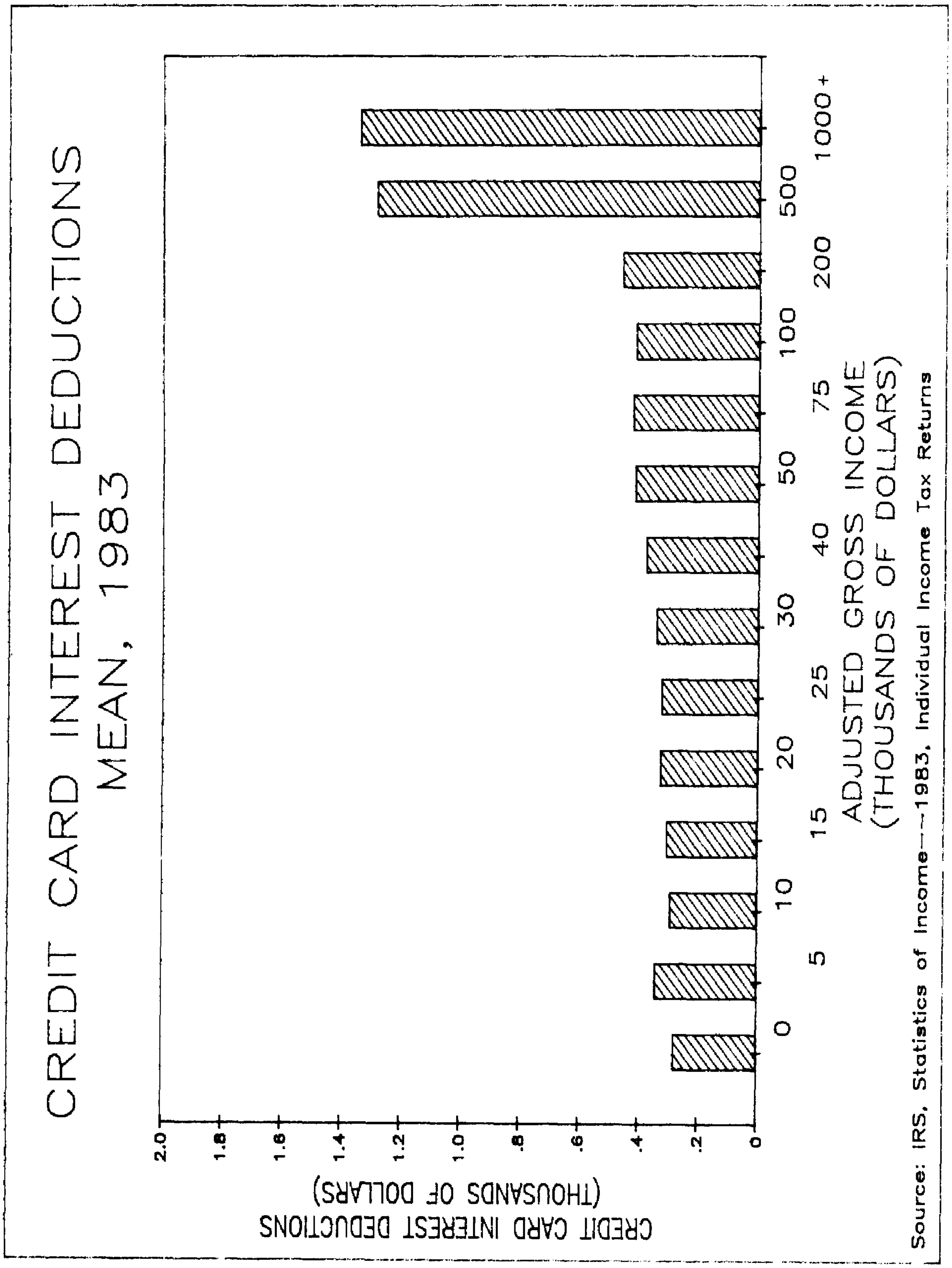

MORTGAGE INTEREST DEDUCTIONS
MEAN, 1983
MORTGAGE INTEREST DEDUCTIONS
(THOUSANDS OF DOLLARS)
0
2
4
6
8
10
12
14
16
18
20
0
5
10
15
20
25
30
40
50
75
100
200
500
1000+
ADJUSTED GROSS INCOME
(THOUSANDS OF DOLLARS)
Source: IRS, Statistics of Income—–1983, Individual Income Tax Returns

FIGURE 1

Explanation of Figure 2

Data on the number and amount of credit card interest deductions claimed by adjusted gross income are from table 2.1 of Individual Income Tax Returns, 1983. Using these data, we calculated the mean values.

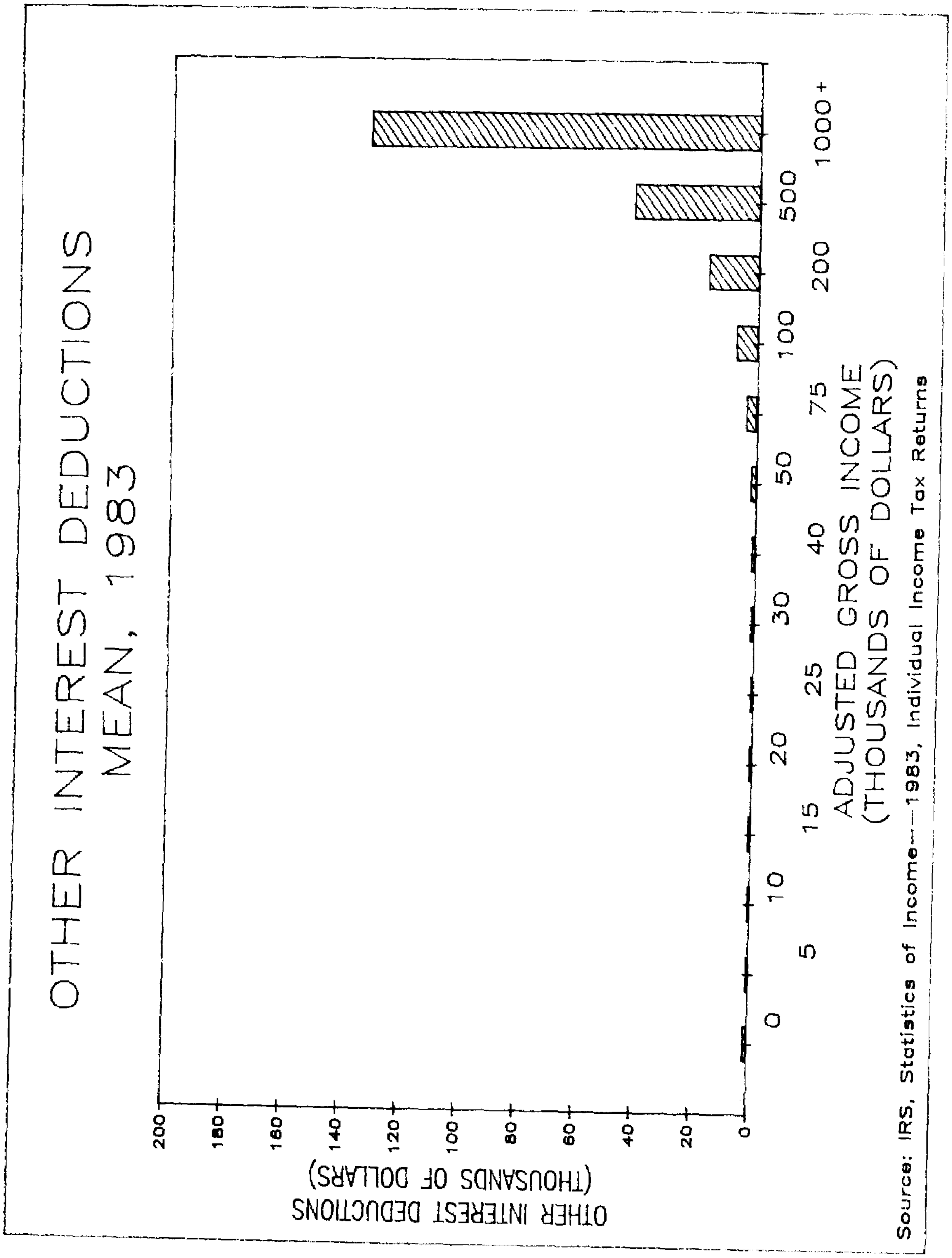
FIGURE 2


CREDIT CARD INTEREST DEDUCTIONS
MEAN, 1983
CREDIT CARD INTEREST DEDUCTIONS
(THOUSANDS OF DOLLARS)
0
.2
.4
.6
.8
1.0
1.2
1.4
1.6
1.8
2.0
0
5
10
15
20
25
30
40
50
75
100
200
500
1000+
ADJUSTED GROSS INCOME
(THOUSANDS OF DOLLARS)
Source: IRS, Statistics of Income--1983, Individual Income Tax Returns

Explanation of
Figure 3

Data on the number and amount of other interest deductions claimed by adjusted gross income categories are from table 2.1 of Individual Income Tax Returns, 1983. According to the information contained in this publication, the term "other interest" includes interest paid on personal debts, bank loans, and installment purchases of real or personal property; it does not include home mortgage or credit card interest deductions. Also excluded is interest paid on money borrowed to buy tax-exempt securities or single premium life insurance and endowment contracts, since this interest is not deductible. IRS notes that the amounts deductible as an interest expense included "investment interest" (that amount paid or accrued on indebtedness incurred, or continued, to purchase or carry property held for investment) as reported on Form 4952, Investment Interest Expense Deduction, subject to the limitations prescribed in the law. IRS also noted that (1) interest relating to business, royalty, and rental income was deducted directly from these items and was, therefore, not reflected in the interest paid statistics and (2) for installment purchases, interest paid included amounts stated in the contract, certain unstated amounts of interest, and finance charges. Using these IRS data, we calculated the mean values.

FIGURE 3

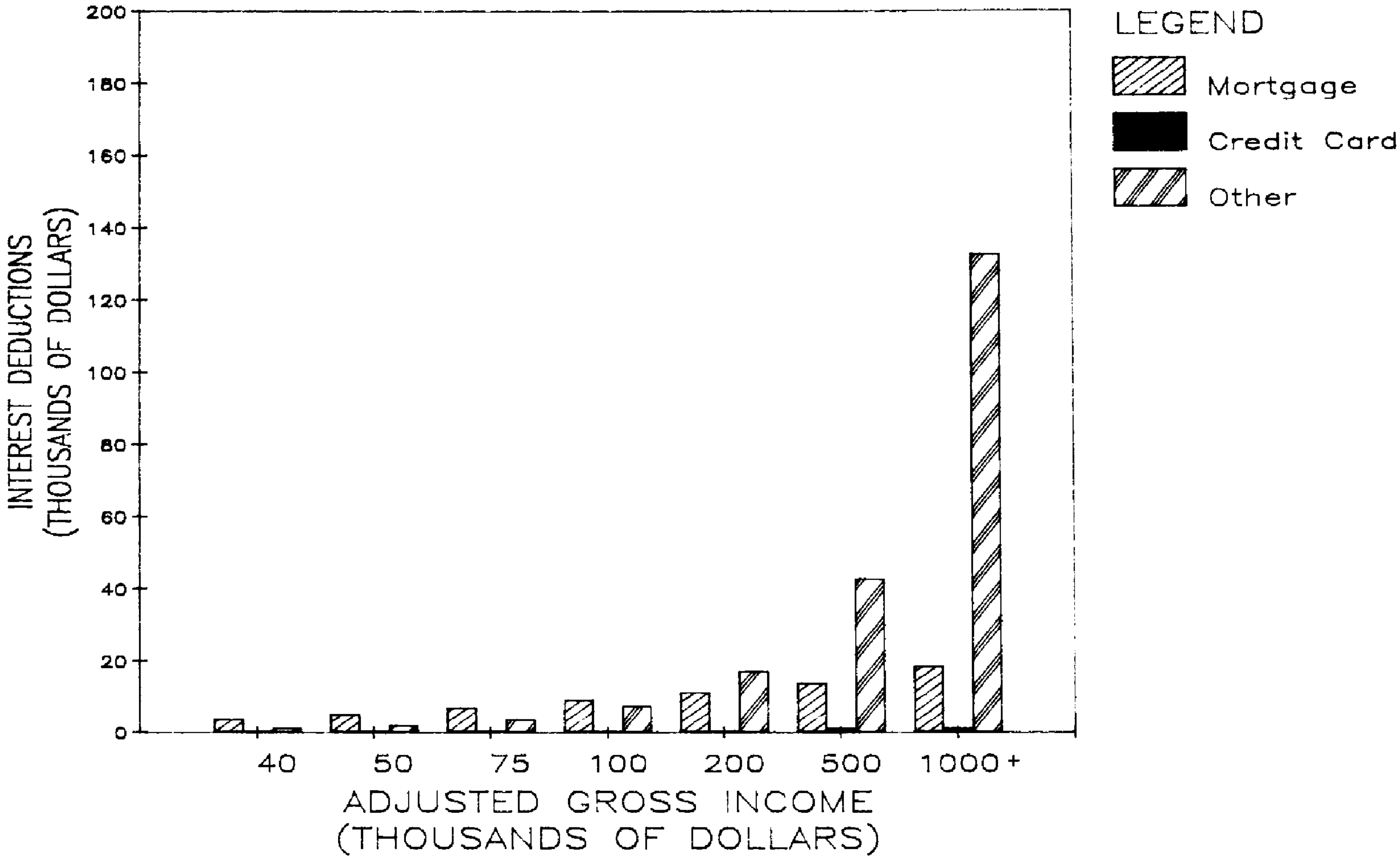

OTHER INTEREST DEDUCTIONS
MEAN, 1983
OTHER INTEREST DEDUCTIONS
(THOUSANDS OF DOLLARS)
200
180
160
140
120
100
80
60
40
20
0
0
5
10
15
20
25
30
40
50
75
100
200
500
1000+
ADJUSTED GROSS INCOME
(THOUSANDS OF DOLLARS)
Source: IRS, Statistics of Income—1983, Individual Income Tax Returns

Explanation of
Figure 4

This figure combines the data from figures 1, 2, and 3, for adjusted gross income above $40,000. Notice that the mean mortgage interest deduction exceeds the mean other interest deduction for those with adjusted gross income less than $200,000, as shown by income category '100'. (Recall that the income category '100' represents those taxpayers with adjusted gross incomes between $100,000 and $199,999.) For those with adjusted gross income of $200,000 or more the mean other interest deduction exceeds the mean mortgage interest deduction.

FIGURE 4

COMBINED INTEREST DEDUCTIONS
MEAN, 1983



Source: IRS, Statistics of Income---1983, Individual Income Tax Returns

REFORM PROPOSALS

The tax reform bill (H.R. 3838) passed by the House of Representatives on December 17, 1985, would change the rules on the deductibility of nonbusiness interest by individuals. Generally, under the bill an individual's nonbusiness interest deduction, in excess of net investment income, would be limited to the sum of (a) interest on debt secured by the individual's principal residence, as well as a second residence, plus (b) $10,000 ($20,000 on a joint return). Nonbusiness interest subject to the limitation would include consumer interest. The reasons given in the committee reports for further limiting nonbusiness interest deductions include restricting (1) an individual's ability to use borrowed funds to purchase assets, the income from which is not taxed or taxed on a deferred basis and possibly at favorable capital gains rates, and/or (2) interest deductions from investments in limited partnerships.[4] Other income tax reform proposals also include provisions that would, to varying degrees, restrict the deduction for nonbusiness interest for reasons similar to those mentioned above.[5]

The data we gathered indicate that under the provisions of H.R. 3838 and other reform proposals designed to limit nonbusiness interest deductions, the potential exists for the average homeowner to avoid the limitations to the extent that (a) the homeowner can finance purchases of consumer items (such as a car, vacations, college education, etc.) or investment property (such as a limited partnership interest) using his/her home as collateral and (b) the deduction for home mortgage interest is not further restricted. As noted below, many lending institutions currently provide homeowners the means to use their home equity to secure loans for purchases of nonbusiness property. Therefore, mortgage interest could include not only interest attributable to the purchase of, or improvements to, a residence, but also interest attributable to the purchase of any type of nonbusiness property. Thus, while the goals of reform proposals to limit nonbusiness interest deductions are clear, they are vulnerable to financial manipulation given, in part, the significant amount of equity homeowners have available to finance nonbusiness purchases.

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[4]For a more detailed description of the interest provisions in H.R. 3838, including an explanation of various technical terms such as "net investment income," see H. Report 99-426, 99th Cong. 1st Sess. 296-301 (1985).

[5]See Joint Committee on Taxation, Tax Reform Proposals: Rate Structure and Other Individual Income Tax Issues (JCS-36-85), August 12, 1985, p. 157-159.

The magnitude of this amount is illustrated by figure 5. It shows that in 1984 the total nominal dollar value of home equity (generally, the difference between the property's market value and mortgage debt) exceeded outstanding consumer credit by almost $1.6 trillion. Furthermore, figure 6 shows that in 1983, for each income class represented, the amount of home equity also greatly exceeded outstanding consumer credit.

The information we gathered indicates that lending institutions generally do not allow homeowners to borrow 100 percent of their home equity. They generally do, however, permit homeowners to use a percentage of their equity to finance nonbusiness purchases through second mortgages and equity lines-of-credit.

Second mortgage loans have provided homeowners a traditional source of funds for nonbusiness purchases. One lender recently advertised that by pledging a residence as security a homeowner could borrow up to $250,000 or more with no application fee or prepayment penalty. The advertisement stated that "you can use the money any way you like--for home remodeling, vacations, a car, college tuition, investment, any worthwhile purpose."

Similarly, some lenders also offer personal lines-of-credit secured by the borrower's home equity. An advertisement promoted the availability of such a line-of-credit of up to $100,000 for qualified homeowners. The advertisement stated:

> "So now you can write yourself a loan as easily as writing a check. And that can be as high as $100,000 depending upon the equity in your home. So whether it's time for a new addition, a college education, exploring new investment options or whatever else you want, now is the best time to borrow. . . ."

One recent equity line-of-credit we saw offered credit up to 75 percent of the home value, less the principal amount of mortgage debt. To get an idea of how much home equity may be available for use in securing loans for other purposes, we applied this formula to 1983 and 1984 data on nationwide home values and then we subtracted all outstanding consumer debt. Figure 7 shows that in 1984 over $700 million of home equity remained available for homeowners to use to secure loans. Figure 8 shows that in 1983 a substantial amount of home equity remained for that purpose in all income classes.

We do not believe that every homeowner would be able to or would find it economically advantageous to finance all non-business debt using his/her home as collateral or would qualify for such financing even if so inclined. However, disregarding transaction and other costs, figures 5, 6, 7, and 8 illustrate the potential for using additional home mortgage borrowings for consumer purchases and nonbusiness investments. Individuals could use these borrowings as a device to avoid provisions in H.R. 3838 and similar proposals that seek to limit nonbusiness interest deductions while, at the same time, generally retaining the deduction for interest on debt secured by home mortgages.

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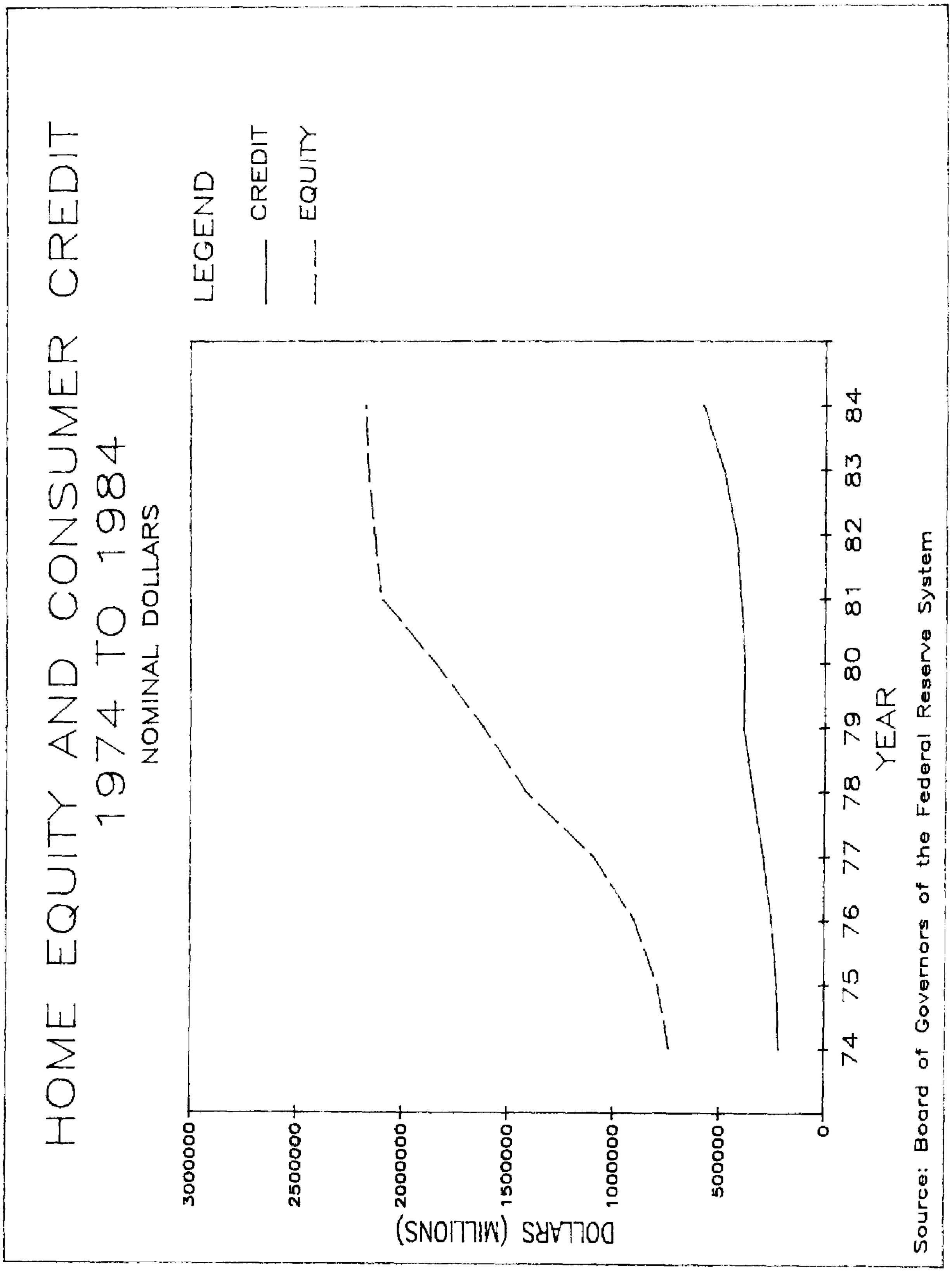
Explanation of Figure 5

Time series data on the level of home equity and consumer credit are from Table 702, Balance Sheets for the U.S. Economy 1945-1985, published in October 1985 by the Flow of Funds Section of the Board of Governors of the Federal Reserve System. We calculated home equity values by adding the value of owner-occupied housing structures to owner-occupied land and then subtracting the amount of home mortgages outstanding. The Flow of Funds Section receives its data on housing from the U.S. Department of Commerce, Bureau of Economic Analysis (BEA). A BEA staff person told us that (1) the total value of the housing stock (structures plus land) included all owner-occupied housing, whether single units or condominiums and (2) the data included both first and second homes. We calculated consumer credit by adding installment consumer credit to other consumer credit. A Federal Reserve staff person told us that installment consumer credit included credit obtained from time payment plans and revolving account credit cards, and "other consumer credit" means credit that is extended for only a short period of time before the entire bill is due--American Express cards, for example.

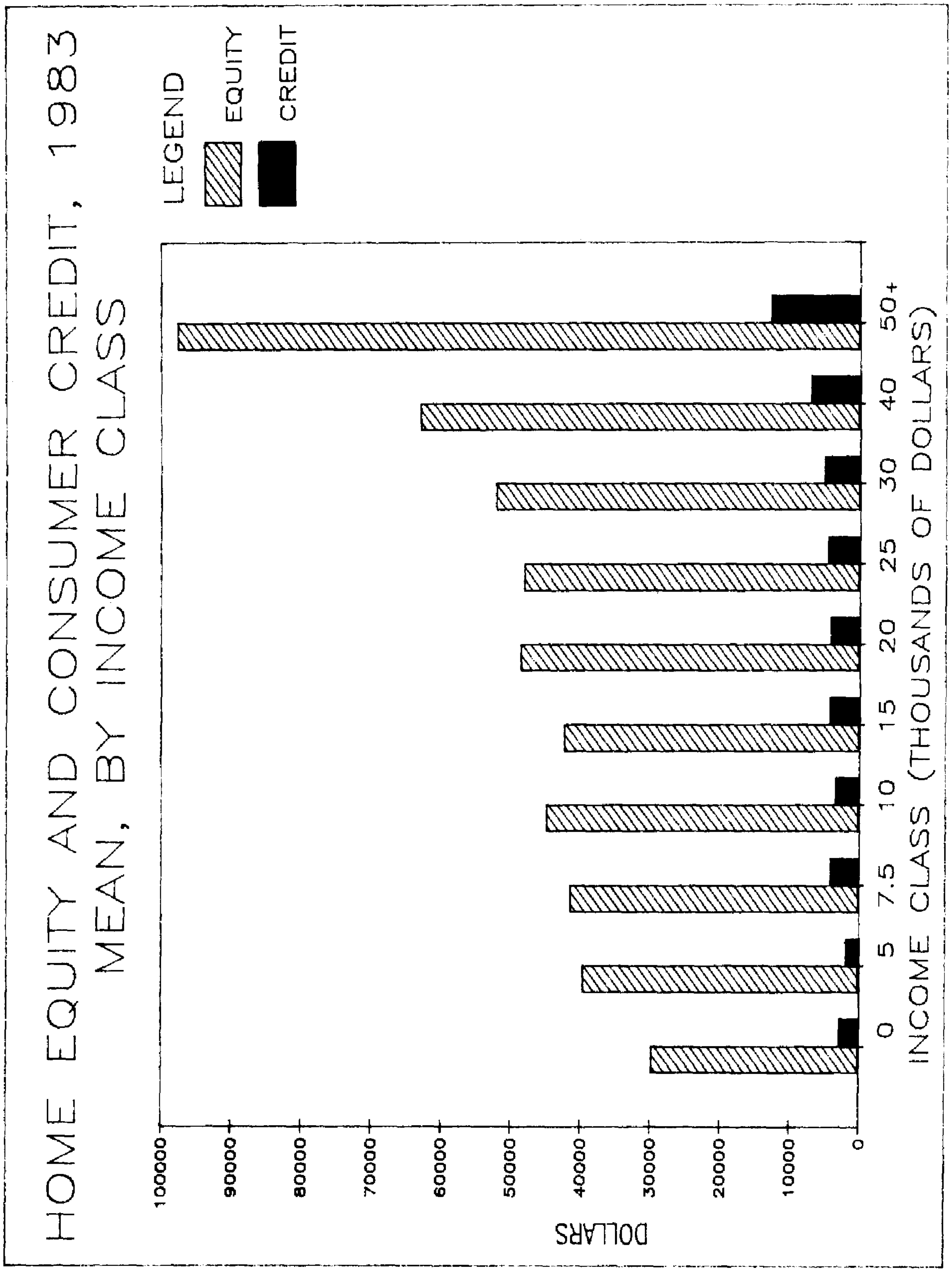
FIGURE 5


HOME EQUITY AND CONSUMER CREDIT
1974 TO 1984
NOMINAL DOLLARS
LEGEND
CREDIT
EQUITY
DOLLARS (MILLIONS)
3000000
2500000
2000000
1500000
1000000
500000
0
74
75
76
77
78
79
80
81
82
83
84
YEAR
Source: Board of Governors of the Federal Reserve System

Explanation of
Figure 6

Mean values for home equity and consumer credit are from published and unpublished results of the 1983 Survey of Consumer Finances. The 1983 Survey of Consumer Finances was jointly sponsored by the Board of Governors of the Federal Reserve System, the U.S. Department of Health and Human Services, and five other federal agencies. Data on housing is from an unpublished table that was developed as part of the 1983 Survey. It was obtained from staff of the Federal Reserve. Data on consumer credit is from the "Survey of Consumer Finances, 1983: A Second Report," published in the Federal Reserve Bulletin for December 1984. According to this article (1) data in the survey are weighted so that results represent estimates for all families and for each of the various groups shown and (2) income means total family income in 1982 from all sources, before taxes and deductions. Home equity is defined in the Survey as the market value of the home minus the amount of the home mortgage. The 1983 Survey of Consumer Finances excludes mobile homes in calculating the total value of homes, and home mortgages include first and second mortgages for those homeowners with such debt. For purposes of the Survey consumer debt consists of credit card and other open-end debt, installment debt, and noninstallment consumer debt from all sources for all families owing such debt.

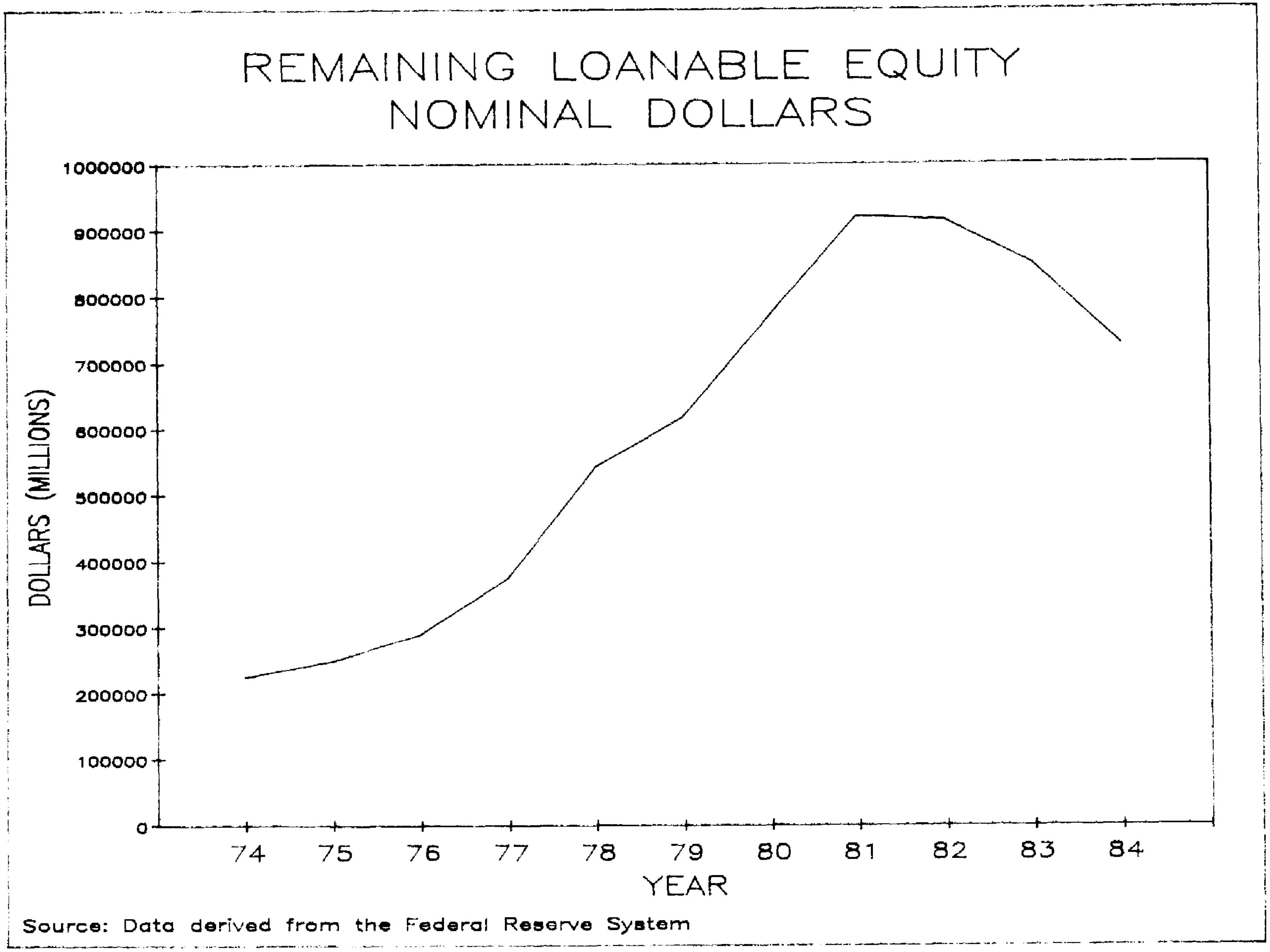
FIGURE 6


HOME EQUITY AND CONSUMER CREDIT, 1983
MEAN, BY INCOME CLASS
LEGEND
EQUITY
CREDIT
DOLLARS
100000
90000
80000
70000
60000
50000
40000
30000
20000
10000
0
0
5
7.5
10
15
20
25
30
40
50+
INCOME CLASS (THOUSANDS OF DOLLARS)

Explanation of
Figure 7

We obtained the data for this figure from Table 702, Balance Sheets for the U.S. Economy 1945-1985, as published by the Flow of Funds Section of the Board of Governors of the Federal Reserve System. The definitions of home equity and consumer credit are the same as those used for figure 5. We calculated remaining loanable equity by taking 75 percent of the nationwide value of homes and subtracting from it the amount of home mortgages and consumer credit. The level of remaining loanable equity may be biased downward when calculated in this fashion since total consumer credit is for all families with such debt and not just for homeowners.

FIGURE 7

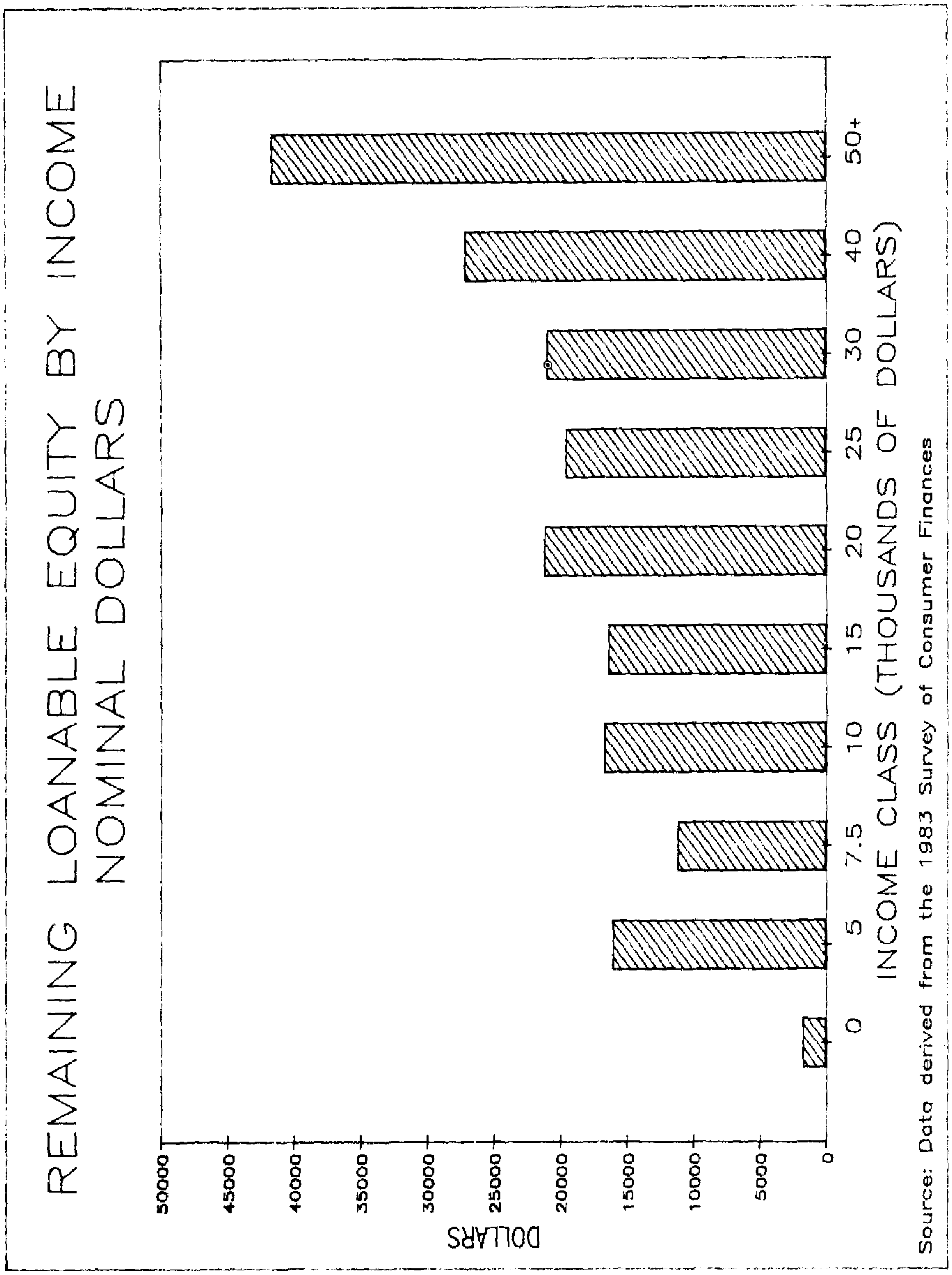


REMAINING LOANABLE EQUITY
NOMINAL DOLLARS
DOLLARS (MILLIONS)
1000000
900000
800000
700000
600000
500000
400000
300000
200000
100000
0
74
75
76
77
78
79
80
81
82
83
84
YEAR
Source: Data derived from the Federal Reserve System

Explanation of Figure 8

As noted in the explanation of figure 7, we calculated remaining loanable equity by taking 75 percent of the nationwide value of homes and subtracting from it the amount of home mortgages and consumer credit. Data for this figure were obtained from the 1983 Survey of Consumer Finances. See the explanation of figure 6 for more detail on how this survey defined income, home equity, and consumer credit. Similar data by income class were not available for 1984.

FIGURE 8


REMAINING LOANABLE EQUITY BY INCOME
NOMINAL DOLLARS
DOLLARS
50000
45000
40000
35000
30000
25000
20000
15000
10000
5000
0
0
5
7.5
10
15
20
25
30
40
50+
INCOME CLASS (THOUSANDS OF DOLLARS)
Source: Data derived from the 1983 Survey of Consumer Finances

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