STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Original Bill

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Subject: Home Mortgage Interest Deduction Reduction to Fund Homeless Housing

Summary

Under the Personal Income Tax Law, this bill would reduce the home mortgage interest paid deduction and require Franchise Tax Board (FTB) to annually estimate and report to the State Controller's Office (SCO), the expected or anticipated additional amounts of tax revenue. SCO would then be required to transfer such amounts from the General Fund to a new state fund created to address homelessness in California.

Recommendation – No position.

Summary of Suggested Amendments

Technical amendments are suggested below for accuracy of figures provided.

Reason for the Bill

The reason for this bill is to provide permanent funding to address homelessness in California by reducing mortgage interest paid deductions that benefit homeowners.

Effective/Operative Date

Effective Date

As an urgency matter, this bill would be effective immediately upon enactment.

Operative Dates

This bill is specifically operative for taxable years beginning on or after January 1, 2020, and with respect to acquisition indebtedness initially incurred on or after January 1, 2018.

Federal Law

As a general matter, personal interest is not deductible.[1] Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations.[2] Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

Acquisition Indebtedness

Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and which is secured by the residence. For taxable years beginning after December 31, 2017, and beginning before January 1, 2026, a taxpayer may treat no more than $750,000 as acquisition indebtedness ($375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred before December 15, 2017,[3] this limitation is $1,000,000 ($500,000 in the case of married taxpayers filing separately).[4] For taxable years beginning after December 31, 2025, a taxpayer may treat up to $1,000,000 ($500,000 in the case of married taxpayers filing separately) of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred.

Acquisition indebtedness also includes indebtedness from the refinancing of other acquisition indebtedness, but only to the extent of the amount (and term) of the refinanced indebtedness.

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[1]Internal Revenue Code (IRC) section 163(h)(1).
[2] IRC sections 163(h)(2)(D) and (h)(3).
[3] The provision specifies that a taxpayer who has entered into a binding written contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, shall be considered to have incurred acquisition indebtedness prior to December 15, 2017.
[4] Special rules apply in the case of indebtedness from refinancing existing acquisition indebtedness. Specifically, the $1,000,000 ($500,000 in the case of married taxpayers filing separately) limitation continues to apply to any indebtedness incurred on or after December 15, 2017, to refinance qualified residence indebtedness incurred before that date to the extent the amount of the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness. Thus, the maximum dollar amount that may be treated as principal residence acquisition indebtedness will not decrease by reason of a refinancing.

Interest on acquisition indebtedness is allowable in computing alternative minimum taxable income. However, in the case of a second residence, the acquisition indebtedness may only be incurred with respect to a house, apartment, condominium, or a mobile home that is not used on a transient basis.

State Law

Under state law, for acquisition indebtedness incurred on or after October 13, 1987, the aggregate amount of acquisition indebtedness may not exceed $1,000,000 (or $500,000 in the case of married persons filing separately).

This Bill

Mortgage Interest Deduction

For taxable years beginning on or after January 1, 2020, and for acquisition indebtedness initially incurred on or after January 1, 2018, this bill would:

- Reduce the limitation on the aggregate amount of acquisition indebtedness from $1,000,000 to $750,000, and from $500,000 to $375,000 for married individuals filing a separate return, and
- Disallow the mortgage interest deduction on acquisition indebtedness with respect to a qualified residence other than a principal residence.

FTB Reporting Requirements

This bill would require the FTB to estimate the amount of additional revenue, for taxable years beginning on or after January 1, 2019 and before January 1, 2020, that would have resulted from the modifications to the mortgage interest deduction if the bill's provisions were operative during such taxable years, and report such estimates to SCO no later than June 1, 2021.

This bill would also require the FTB to estimate the amount of additional revenue resulting from the modifications to the mortgage interest deduction and report such estimates to SCO no later than June 1, 2022, and annually thereafter.

Housing and Homeless Response (HHR) Fund

This bill would establish the HHR Fund in the State Treasury. Upon appropriation, amounts in the fund would be used for the purpose of financing immediate and long-term solutions to homelessness by moving homeless individuals and families into permanent housing. After notification by the FTB, SCO would be required to annually transfer the estimated additional revenue amounts from the General Fund to the HHR Fund.

Implementation Considerations

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The bill requires the FTB to notify SCO by June 1, 2022, and annually thereafter of an estimate of additional revenue that results from the bill's provisions, but lacks a specification of the taxable years to be annually estimated. For clarity and ease of administration, it is recommended that the bill be amended.

The department lacks the ability to determine mortgage interest deduction amounts that would be limited by the acquisition indebtedness thresholds or disallowed from a second home, and would need to develop a new form or worksheet, with related processing and system updates, to determine the estimated annual amounts of additional revenue that are required by the bill.

Technical Considerations

Subdivision (s) of Section 1 needs to be amended to change the amount of lowered taxes from "$4,200,000,000" to "$3,500,000,000", based on the Department of Finance, California Income Tax Expenditures, Compendium of Individual Provisions, Report for 2016 Tax Year Data, pages 58-60 relating to the Mortgage Interest Deduction.

Legislative History

AB 71 (Chiu, 2017/2018) would disallow the deduction of mortgage interest paid on a second home and modify the existing Low-Income Housing Credit (LIHC). AB 71 failed passage out of the Assembly by the constitutional deadline.

Fiscal Impact

The department would need to create a new tax form or worksheet to obtain the data necessary to calculate and report the estimated annual amount of reduction in mortgage interest deductions. As a result, this bill would impact the department's programming, printing, and processing costs. As the bill continues to move through the legislative process, costs will be identified, and a budget change proposal will be requested, if necessary.

Economic Impact

Revenue Estimate

Estimated Revenue Impact of AB 1905 as Introduced on January 8, 2020

For Taxable Years Beginning On or After January 1, 2020 for Acquisition Indebtedness Initially Incurred by a Taxpayer On or After January 1, 2018
Assumed Enactment After June 30, 2020

($ in Millions)

Fiscal Year	Revenue*
2020-2021	$500
2021-2022	$360
2022-2023	$400

*The revenue gain would peak at approximately $1 billion in fiscal year 2046-2047.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

This estimate includes both the impact from the disallowance of second home mortgage, of $200 million, and the limitation on home acquisition indebtedness, of $100 million, which results in a combined revenue gain of $300 million in taxable year 2020.

The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the amounts reflected in the above table.

<u>Second Home Disallowance</u>

The home mortgage interest deduction is reported on the tax return as the total deductible interest from both primary and secondary homes. Using available home mortgage interest deduction data, it is estimated that taxpayers would report $64 billion in total, primary and secondary, mortgage interest deductions in taxable year 2020. Data from the U.S. Census Bureau indicates that approximately 3.6 percent, or $2.3 billion, of the mortgage interest deductions are from second homes (taxpayers currently report primary and second mortgage data together when filing their tax return). The taxpayers impacted by this provision of the bill have an average tax rate of 9 percent. After applying this, the revenue impact of disallowing second homes is estimated to be $200 million for taxable year 2020.

Home Acquisition Indebtedness Limitation Amount

This bill would limit the amount of interest taxpayers can claim as a mortgage interest deduction. Any interest in excess of the limitation which is no longer deductible (non-deductible interest) would result in a revenue gain.

Using home loan data from the Finance Protection Bureau and home sales projections, the estimated non-deductible interest was calculated for taxable years 2018, 2019, and 2020. Although the taxable year impact begins with 2020, the mortgages impacted by this proposal begin with calendar year 2018. For each year of home purchases, the amount of non-deductible interest is estimated to be $350 million. Therefore, the estimated three year accumulation (2018, 2019, and 2020) of non-deductible mortgage interest paid is projected to be $1 billion for taxable year 2020. The taxpayers impacted by this provision of the bill have an average tax rate of 10 percent. Applying this results in an estimated revenue gain of $100 million for taxable year 2020. An estimated average growth of $36 million is expected each year thereafter.

Because the average mortgage is paid over 30 years, the full impact of the limitation would not be realized until 2047. The accumulation of home mortgages over the 30 year period increases the revenue gain annually, peaking at $1 billion in taxable year 2047. This estimate assumes economic conditions related to the housing market will remain constant.

Policy Concerns

The provision in this bill that disallows a deduction for interest on second homes would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

Because this bill would reduce a California deduction for taxpayers that have already made the decision to incur mortgage obligations for property purchased after January 1, 2018, rather than for property purchased after this bill is operative, taxpayers who incurred mortgage obligations during this period could face unexpected increased California tax liability due to the new deduction limitations in this bill.

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