Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Goldberg	Analyst:	John Pavalasky	Bill Number:	ABX 16
Related Bills:	See Legislative History	Telephone:	845-4335	Introduced Date:	February 20, 2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Mortgage Interest Deduction/Decrease Amount to $500,000 and $250,000

SUMMARY

This bill would reduce the home mortgage interest deduction by lowering the maximum acquisition home mortgage by 50%.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to increase state revenue.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under federal and state law, only a limited amount of interest paid or accrued on acquisition indebtedness incurred on or after October 13, 1987, is deductible as qualified residence interest. Qualified residence interest is interest that is paid or accrued during the taxable year on acquisition or home equity indebtedness with respect to the principal residence of the taxpayer and one other residence (i.e., vacation home). If the residence is rented out during the taxable year, special rules require that to retain its qualified status, it must be used by the taxpayer for at least a specified minimum amount of time and it must be rented out at a fair rental value.

The aggregate amount of acquisition indebtedness may not exceed $1 million (or $500,000 in the case of married person filing separately). Acquisition indebtedness is debt incurred in acquiring, constructing, or substantially improving a qualified residence and secured by that residence. Refinanced debt remains acquisition debt to the extent that it does not exceed the principal amount of acquisition debt immediately before refinancing.

Board Position:			Department Director	Date
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The aggregate amount of home equity indebtedness may not exceed $100,000 (or $50,000 in the case of married person filing separately). Home equity indebtedness is all non-acquisition indebtedness that is secured by a qualified residence to the extent it does not exceed the fair market value of the residence reduced by any acquisition indebtedness. Interest on home equity indebtedness is deductible even if the proceeds are used for personal expenditures.

Interest attributable to the amount of debt equal to or less than these maximum mortgage amounts is fully deductible, while interest attributable to debt over the maximum mortgage amounts is nondeductible personal interest.

In addition, special rules apply to pre-October 13, 1987, acquisition indebtedness (commonly called grandfathered debt). Under those rules, interest attributable to the amount of that debt is not subject to the $1 million (or $500,000 in the case of married person filing separately) maximum mortgage limits. Thus, interest attributable to the amount of grandfathered debt is fully deductible.

THIS BILL

This bill would reduce the maximum amount of acquisition indebtedness used in 2003 and later years to determine the deductible qualified residence interest amount for that year from $1 million (or $500,000 in the case of married person filing separately) to a maximum of $500,000 (or $250,000 in the case of married person filing separately).

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

This is the first bill that is proposing to restrict the amount of the mortgage interest deduction that is allowed as a deduction on the California return.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* only has a corporation income tax and therefore the personal income tax deduction for home mortgage interest is not applicable. *Illinois, Massachusetts,* and *Michigan* do not permit any itemized deductions including home mortgage interest. *Minnesota* and *New York* laws do not require a reduction in the amount of the federal deduction for home mortgage interest comparable to the reduced deduction being proposed by this bill.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Revenue Gain ($ Millions)			
Fiscal Year	2003-04	2004-05	2005-06
Revenue Gain	+380	+290	+300

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The results for this analysis were estimated using the updated 2000 PIT microsimulation tax model for taxpayers reporting home mortgage/equity interest deductions. The results indicated that the proposed lower home mortgage ceiling would impact, at most, 250,000 taxpayers. An average mortgage length of 22.5 years was assumed, with a 6.5% average interest rate.

The first fiscal year 2003-04 is higher than subsequent fiscal years because it contains the impact for all of tax year 2003 and a portion of 2004 due to changes in withholding or estimated tax payments beginning in 2004.

ARGUMENTS/POLICY CONCERNS

When the maximum acquisition indebtedness of $1 million (or $500,000 in the case of married persons filing separately) was enacted under federal law (and conformed to by California), specific statutory rules that applied to pre-October 13, 1987 acquisition indebtedness rules were enacted. These "grandfathered debt" rules allow taxpayers who had acquired a mortgage before October 13, 1987, to continue to deduct that interest in full, even though the mortgage exceeded the newly imposed limits. This bill would not change the "grandfathered debt" rules and, thus, the interest on those old mortgages would still be deductible in full even though those mortgages exceed the newly reduced maximum amounts.

This bill may be viewed as inequitable because it does not contain any "grandfathered debt" rules for mortgages acquired after October 13, 1987, and before this law is enacted in 2003.

LEGISLATIVE STAFF CONTACT

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