Franchise Tax Board **ANALYSIS OF ORIGINAL BILL**

Author:	Steinorth	Analyst:	Funmi Obatolu	Bill Number:	AB 53
Related Bills:	See Legislative History	Telephone:	845-5845	Introduced Date:	December 5, 2016
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Homeownership Savings Account/Deduction/Exclusion

SUMMARY

Under the Personal Income Tax Law, this bill would create a "homeownership savings account" that would provide certain income tax benefits similar to an individual retirement account (IRA).

RECOMMENDATION – NO POSITION

REASON FOR THE BILL

The reason for this bill is to encourage and promote individual homeownership.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for each taxable year beginning on or after January 1, 2017.

FEDERAL/STATE LAW

IRAs

Federal law provides for two types of IRAs: traditional IRAs and Roth IRAs. In general, contributions (other than a rollover contribution) to a traditional IRA may be deductible, and distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions. In contrast, contributions to a Roth IRA are not deductible, and qualified distributions from a Roth IRA are excludable from gross income. Contributions to a traditional IRA are limited; for 2016, contributions are limited to the lesser of $5,500 ($6,500 if age 50 or older), or the taxpayer's taxable compensation for the year.

A taxpayer that receives a distribution from a traditional IRA prior to age 59 1/2, death, or disability, is generally subject to a 10-percent additional tax on the amount includable in income for federal purposes, unless an exception to that additional tax applies. Among other exceptions, the 10-percent additional tax does not apply to a onetime distribution of up to $10,000 made to first-time homebuyers for the qualified acquisition cost of a residence.

California law automatically conforms to the federal rules that apply to IRAs, except that the additional tax on nonqualified distributions is modified to be 2.5 percent for California purposes instead of the federal 10-percent rate.

Neither federal nor state law allows a deduction or an exclusion similar to the one this bill would allow.

Itemized Deductions

Under federal law, an individual may elect to claim his or her itemized deductions for a taxable year in lieu of the standard deduction. Itemized deductions generally are those deductions which are not allowed in computing Adjusted Gross Income (AGI). Itemized deductions include unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, state and local income taxes (or in lieu of income, sales taxes), property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses that are only deductible to the extent that they exceed 2 percent of AGI. Additional limitations apply to high-income taxpayers.

California generally conforms to the federal rules that apply to itemized deductions.

THIS BILL

For each taxable year beginning on or after January 1, 2017, this bill would allow qualified taxpayers to create a homeownership savings account. The income earned and the requirements and limitations on the homeownership savings account, except as provided in this bill, would receive the same treatment as a traditional IRA. Gross income would not include any income accruing during the taxable year to a homeownership savings account, and the qualified taxpayer’s annual contribution to the Homeownership savings account would be deductible, as specified.

A deduction would be allowed for contributions to a homeownership savings account as a miscellaneous itemized deduction subject to the 2 percent of AGI floor limitation, not to exceed the following amounts:

- Twenty thousand dollars ($20,000) for qualified taxpayers filing a joint, head of household, or surviving spouse(as defined in Section 17046) return.
- Ten thousand dollars ($10,000) in the case of a qualified taxpayer filing a return other than as described above.

Any amount withdrawn from a homeownership savings account would be included in the income of the payee or distributee for the taxable year in which the payment or distribution is made, unless the payment or distribution is used to pay for the qualified homeownership savings expenses of a qualified taxpayer who established the account.

The bill would define a homeownership savings account as a trust that meets all of the following requirements:

- Is designated as a homeownership savings account by the trustee.
- Is established for the exclusive benefit of any qualified taxpayer establishing the account where the written governing instrument creating the account provides that: 1) all contributions to the account be in cash; and 2) the account is established to pay for the qualified homeownership savings expenses of a qualified taxpayer establishing the account.

- Is, except as otherwise specified, subject to the same requirements and limitations as an IRA established under Internal Revenue Code (IRC) Section 408.[1]
- Is the only homeownership savings account established by the qualified taxpayer.

This bill also would define the following terms and phrases:

- "Qualified homeownership savings expenses" means expenses, including a down payment or closing costs paid or incurred, in connection with the purchase of a qualified taxpayer's principal residence within the meaning of IRC section 121, relating to exclusion of gain from the sale of principal residence, in this state for use by that qualified taxpayer who established the homeownership savings account.
- "Qualified taxpayer" means any individual, or individual's spouse, who had no present ownership interest in a principal residence within the meaning of IRC section 121, relating to exclusion of gain from the sale of principal residence, during the preceding three-year period ending either on the date of the individual's, or individual's spouse's, contribution to a homeownership savings account or on the date of the individual's, or individual's spouse's, purchase of the principal residence for which any amount is withdrawn from the individual's, or individual's spouse's, homeownership savings account.
- "Trustee" shall have the same meaning as that term under IRC section 408, relating to individual retirement accounts.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns for purposes of a high-level discussion. Additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The definition of homeownership savings accounts as a trust generally subject to the requirements and limitations applicable to an individual retirement account (IRA) established under IRC section 408 may be overly broad. For example, such accounts would be able to invest cash contributions in any investment vehicle an IRA may invest in, including foreign or domestic real estate, precious metals, stock, pass-through entities, as well as more traditional interest-bearing investments such as government bonds and certificates of deposit. The income accruing on these investments could be significant and if used for the specified purpose would be excluded from taxable income. Additionally, the early distribution penalty and contribution limits applicable to IRAs would apply to homeownership savings accounts. For consistency with the author's intent and to avoid conflicting requirements, this bill should be amended to specify the IRC's IRA provisions applicable to homeownership savings accounts.

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[1] Section 408 of the IRC, relating to individual retirement accounts.

Although the bill limits the contribution amount subject to deduction, unlike the rules governing excess contributions to IRAs, the bill lacks a clear and unambiguous limit on the total amount that may be contributed.

The definition of “qualified taxpayer” lacks an income limitation, thus allowing all individuals, regardless of income levels, to establish a homeownership savings account. This may be a broader population than the author intends.

A principal residence could be interpreted to include property other than real property such as houseboat and house trailer. If this is contrary to the author’s intent the bill should be amended.

Because the term “qualified taxpayer” would mean an individual or the individual’s spouse, it appears that both individuals would be eligible for the tax benefits this bill would allow. If this is contrary to the author’s intent, this bill should be amended.

The bill fails to specify which of the trigger dates, is intended to be the controlling date for determining whether an individual is a “qualified taxpayer” for purposes of this bill, the date of the contribution to the homeownership savings account or the date of the purchase of the principal residence?. Additionally, in the event of multiple contributions to a homeownership savings account, it is unclear which contribution (the initial contribution, the most recent contribution) would trigger the three-year look back period.

The definition of “qualified homeownership savings expenses” is overly broad. For example, it could be argued that closing costs, as well as expenses for repairs, renovations, the purchase of new appliances and soft goods (furniture and drapes), and moving expenses could be “paid or incurred in connection with the purchase of a qualified taxpayer’s principal residence. Additionally, it could be argued that on-going mortgage payments would be qualified homeownership expenses because the bill fails to specify a cut-off date for expense paid or incurred in connection with a purchase. If this is contrary to the author’s intent, the bill should be amended.

Because the bill fails to specify otherwise, if any amount of withdrawal from a homeownership savings account is used for non-qualified expenses, the entire amount withdrawn would be included in the income of the distributee or payee. If the author intends that only the amount used to pay for non-qualified expenses be included in income, this bill should be amended to clarify that a withdrawal is only taxable to the extent not used for qualified expenses. Additionally, if the author intends that non-qualified expenses be included in the qualified taxpayer’s income regardless of whether the withdrawal was paid directly to the qualified taxpayer or paid to a third party on behalf of the qualified taxpayer, this bill should be amended.

Because the bill fails to specify otherwise, a homeownership savings account may remain open indefinitely, allowing the qualified taxpayer to continue making tax deductible contributions to and receiving tax deferred, and possibly excluded, earnings on investments made by the account’s trustee.

TECHNICAL CONSIDERATIONS

On page 2, strikeout lines 19 and 20 and insert "filing a joint, head of household, or surviving spouse (as defined in Section 17046) return."

On page 2, line 24, strikeout "payee or distributee" and insert "qualified taxpayer."

LEGISLATIVE HISTORY

AB 1736 (Steinorth, et al., 2015/2016), similar to this bill, would have created an individual homeownership savings account that would have included income tax benefits similar to an IRA. AB 1736 failed to pass by the constitutional deadline.

AB 1164 (Bogh, 2005/2006) and AB 1573 (Garcia, 2005/2006) would have created an individual homeownership development account that would have included income tax benefits similar to an IRA. AB 1164 and AB 1573 failed to pass by the constitutional deadline.

SB 553 (Dutton, 2005/2006) would have created an individual homeownership development account that would have included income tax benefits similar to an IRA. SB 553 failed to pass out of the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a tax benefits comparable to the tax benefits allowed by this bill. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process and the implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 53 As Introduced December 5, 2016 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
- $0	- $300	- $650

The revenue loss is expected to grow at a rate of $250 million per year indefinitely. This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill. The analysis also assumes that once an account has been opened taxpayers could continue contributing to the account after a home is purchased and use the money in the account to pay their mortgage.

Revenue Discussion

Although the bill is operative for taxable years beginning on or after January 1, 2017, financial institutions are not expected to be able to have the infrastructure ready until 2019. Based on reports from the California and National Association of Realtors and Federal Reserve Economic Data, an average of 520,000 housing units are sold in California every year. Research indicates that nearly 50 percent, or 260,000 housing units, are sold to individuals who are either first-time buyers or buyers who have not owned a home in the previous three years.

It is assumed that 80 percent of prospective home buyers would open a homeownership savings account. Because purchasing a home requires several years of savings, it is assumed that taxpayers would quickly learn about the benefits of homeownership savings account contributions and would begin contributing to the accounts several years before purchasing a principal residence. Taking into account the timing of home purchase plans, it is estimated that 780,000 accounts would be open by the end of 2019 and taxpayers would contribute an average of $14,000. The deduction is subject to the 2-percent miscellaneous itemized deduction floor and it is assumed that 80 percent of taxpayers would qualify for the deduction.

It is estimated that qualified taxpayers would make $8.7 billion in qualified contributions to their homeownership savings account in 2019 and contributions plus interest would grow at an average of $3.9 billion annually. Applying the average tax rate of 6 percent, the estimated revenue loss would be $550 million in 2019 and $1 billion in 2021. It is assumed that taxpayer would continue to maintain the homeownership savings account for their lifetime. As a result, the revenue loss is expected to grow by an estimated $250 million per year in perpetuity. The tax year estimate is converted to fiscal years and rounded to arrive at the amounts reflected in the above table.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that this bill would encourage homeownership by allowing new homeowners to more easily plan to and save money.

Opponents: Some may argue that California has several state and federal programs designed to assist homebuyers, as such the additional incentive provided under this bill would not increase or encourage homeownership.

POLICY CONCERNS

This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same item of expense. For example, the purchase of a new roof could be paid with income this bill would exclude from taxable income and the purchase price could be added to the home's basis.

This bill would allow qualified taxpayers to purchase personal property with income excluded from tax.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

This bill would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

LEGISLATIVE STAFF CONTACT

Funmi Obatolu
Legislative Analyst, FTB
(916) 845-5845
funmi.obatolu@ftb.ca.gov

Jame Eiserman
Revenue Manager, FTB
(916) 845-7484
jame.eiserman@ftb.ca.gov

Diane Deatherage
Legislative Director, FTB
(916) 845-4783
diane.deatherage@ftb.ca.gov