Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Chiu, et al.	Analyst:	Jessica Deitchman	Bill Number:	AB 71
Related Bills:	See Legislative History	Telephone:	845-6310	Introduced and Amended Dates:	December 16, 2016 and March 2, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Low-Income Housing Credit/Farmworker Housing and Disallow 2nd Home Mortgage Interest Deduction

SUMMARY

This bill would do the following:

Provision 1: Modify the existing Low-Income Housing Credit (LIHC) under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL).

Provision 2: Disallow the deduction of mortgage interest paid on a second home under the PITL.

This analysis only addresses the provisions of the bill that impact the department's programs and operations.

RECOMMENDATION – NO POSITION

Summary of Amendments

The March 2, 2017, amendments added co-authors, corrected a technical error, and modified the provisions related to farmworker housing.

This is the department's first analysis of the bill.

EFFECTIVE/OPERATIVE DATE

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

The increase in the low-income housing credit allocation authorization from $70 million to $370 million and the modifications made to the farmworker housing provisions would be operative for calendar years 2018 and later.

The disallowance of the mortgage interest deduction on second homes and the change in applicable percentage used in computing the LIHC would be operative for taxable years beginning on or after January 1, 2017.

ECONOMIC IMPACT – SUMMARY REVENUE TABLE ($ in Millions)

Fiscal Year	2017-18	2018-19	2019-20
Provision 1: Modify the LIHC	+ $.2	+ $.2	-$19
Provision 2: Eliminate the Mortgage Interest Deduction for a Second Home	+ $360	+ $240	+ $260
$ In Millions Total	+ $360.2	+ $240.2	+ $241

Provision 1: Modify the LIHC

REASON FOR THE PROVISION

The reason for the provision is to encourage additional investment in farmworker housing by allowing additional funds to be allocated to the LIHC farmworker housing.

FEDERAL/STATE LAW

Current federal tax law allows an LIHC for the costs of constructing, rehabilitating, or acquiring low-income housing. The LIHC amount varies depending on several factors including when the housing was placed in service and whether it was federally subsidized; and varies between 30 and 70 percent of the present value of the qualified low-income housing. The LIHC is claimed over ten years.

The California Tax Credit Allocation Committee (Allocation Committee)[1] allocates and administers the federal and state LIHC Programs.

Current state tax law generally conforms to federal law (Section 42 of the Internal Revenue Code (IRC)) with respect to the LIHC, except that the state LIHC is claimed over four taxable years (10 years for federal), is limited to projects located in California, must be allocated and authorized by the Allocation Committee, rents must be maintained at low-income levels for 30 years (15 years for federal), and the Allocation Committee must have authorized a federal credit to the taxpayer or the taxpayer must qualify for the federal credit. The LIHC is allocated in amounts equal to the sum of all the following:

- $100 million,[2]
- The unused housing credit ceiling, if any, for the preceding calendar years,
- The amount of housing credit ceiling returned in the calendar year, and
- $500,000 per calendar year for projects to provide farmworker housing.[3]

[1] Voting members of this committee are the State Controller, the State Treasurer, and the Director of Finance.
[2] The statutory $70 million allocation amount adjusted by the Consumer Price Index (CPI) through 2015.
[3] As defined in subdivision (h) of Section 50199.7 of the Health and Safety Code.

Current law requires allocation of the LIHC to partners based upon the partnership agreement, regardless of how the federal LIHC is allocated to the partners, or whether the allocation of the credit under the terms of the agreement has substantial economic effect, as specified.

The Allocation Committee certifies the amount of LIHC allocated. In the case of a partnership or an S Corporation, a copy of the certificate is provided to each taxpayer. The taxpayer is required, upon request, to provide a copy of the certificate to the Franchise Tax Board (FTB).

Any unused credit may continue to be carried forward until the credit is exhausted.

Additionally, for a project that receives a preliminary reservation on or after January 1, 2016, and before January 1, 2020, a taxpayer may make an irrevocable election in its application to the Allocation Committee to sell all or any portion of any LIHC allowed to one or more unrelated parties for each taxable year in which the LIHC is allowed subject to the following conditions:

- An LIHC is sold for consideration that is not less than 80 percent of the amount of the credit.
- The unrelated party or parties purchasing any or all of the LIHC, is a taxpayer allowed the state or federal[4] LIHC for the taxable year of the purchase or any prior taxable year in connection with a project located in this state. “Taxpayer allowed the credit” would mean a taxpayer that is allowed the credit without regard to the purchase of a credit.

The taxpayer that originally receives the LIHC would report to the Allocation Committee within 10 days of the sale, in the form and manner specified by the Allocation Committee, all required information regarding the purchase and sale of the LIHC, including:

  - The social security or other taxpayer identification number of the unrelated party to whom the LIHC has been sold,
  - The face amount of the LIHC sold, and
  - The amount of consideration received by the taxpayer for the sale of the LIHC.

The Allocation Committee would provide an annual listing to the FTB, in the form and manner agreed upon by the Allocation Committee and the FTB, of the taxpayers that have sold or purchased an LIHC.

An LIHC can be sold to more than one unrelated party, but cannot be resold by the unrelated party to another taxpayer or other party. All or any portion of any LIHC allowed may be resold once by an original purchaser to one or more unrelated parties, subject to all the requirements of the LIHC.

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[4] Allowed under section 42 of the IRC.

The taxpayer that originally receives the LIHC that is sold remains solely liable for all obligations and liabilities imposed on the taxpayer with respect to the LIHC, none of which apply to any party to whom the LIHC has been sold or subsequently transferred. Parties purchasing an LIHC are entitled to utilize the purchased LIHC in the same manner as the taxpayer that originally received the LIHC.

A taxpayer cannot sell an LIHC if the taxpayer was allowed the credit on any tax return of the taxpayer.

The taxpayer, with the approval of the Executive Director of the Allocation Committee, may rescind the election to sell all or any portion of the LIHC allowed if the consideration falls below 80 percent of the amount of the LIHC after the Allocation Committee reservation.

The Allocation Committee is required to enter into an agreement with the FTB to pay any costs incurred by the FTB to administer this credit.

Existing federal and state laws provide that gross income includes all income from whatever source derived, including gains derived from dealings in property, unless specifically excluded.

The sale of a credit is treated for federal and state income tax purposes as a sale of property; therefore, the seller is required to report gain from the sale. The gain from the sale of the credit is the excess of the total consideration received over the seller's basis in the credit. The total amount of consideration received is the sum of any money received plus the fair market value of the property (other than money) received. Since the seller’s basis in the credit is $0 (zero), the seller will recognize and report gain on the full amount of consideration received.

THIS PROVISION

This provision would modify the allocation of the LIHC relating to the types of housing that qualifies and how it qualifies, administered by the Allocation Committee.

Additionally, this provision would, for allocations made during calendar year 2018 and for each calendar year thereafter:

- Increase the annual allocation amount by $300 million, subject to indexing for inflation, as specified.
- Preclude housing sponsors receiving an allocation under paragraph (1) of subdivision (c)[5] from receiving an allocation from the increased amount.
- Specify that $25 million of the additional $300 million annual allocation would be allocated for projects to provide farmworker housing, as defined in subdivision (h) of Section 50199.7 of the Health and Safety Code.
- Specify that the amount of any unallocated or returned credits for a calendar year would be added to the aggregate amounts of credits that could be allocated, as specified.

[5] Relating to any qualified low-income building that is a new building as defined in Section 42 of the IRC.

IMPLEMENTATION CONSIDERATIONS

Because the amendments made to this provision would be administered by the Allocation Committee, the department could make the corresponding changes during the normal annual update.

TECHNICAL CONSIDERATIONS

Please see the attached amendment page for our recommended technical amendments.

LEGISLATIVE HISTORY

AB 571 (Garcia, 2017/2018) would modify the provisions related to farmworker housing in the LIHC. AB 571 was introduced on February 14, 2017.

AB 2817 (Chiu, 2015/2016) would have, for allocations made during calendar year 2017 and thereafter, increased the LIHC allocation amount by an additional $300 million and would have modified the farmworker housing projects allocation amount. AB 2817 failed passage out of the Senate by the constitutional deadline.

SB 837 (Committee on Budget and Fiscal review, Chapter 32, Statutes of 2016), effective June 27, 2016, added provisions to the existing LIHC allowing the sale of LIHCs to unrelated parties and re-enacted the prior-law exception allowing an LIHC to be allocated among partners based upon the partnership agreement for taxable years beginning on or after January 1, 2016 and before January 1, 2020.

SB 16 (Lowenthal, 2009/2010), would have made the LIHC refundable and extended the partnership allocation rules for the preliminary reservation of the state LIHC during tax year 2008. SB 16 failed passage out of the Senate by the constitutional deadline.

SB 585 (Lowenthal, Chapter 382, Statutes of 2008), requires a project that is owned by a partnership that receives a preliminary LIHC reservation on or after January 1, 2009, and before January 1, 2016, to allocate the LIHC to the partners of a partnership owning a low-income housing project, in accordance with a partnership agreement, regardless of how the federal LIHC is allocated to the partners or whether the allocation of the credit under the terms of the agreement has substantial economic effect under IRC section 704(b). In addition, SB 585 requires a deferral of any loss or deduction attributable to the sale, transfer, exchange, abandonment, or any other disposition of a partnership interest where the credit was allocated without substantial economic effect. The loss would be deferred until the first taxable year immediately following the end of the ten-year credit period for which the federal credit is allowed.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide special rules for farmworker housing similar to those this bill would allow. 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 provision have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

This provision would result in the following revenue impact:

Estimated Revenue Impact of AB 71 Provision 1: Modify the LIHCAs Amended March 2, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $0.2	+ $0.2	-$19

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill. In addition, this estimate only reflects the revenue impact to income and franchise taxes. The estimated revenue loss would continue to increase reaching $170 million in fiscal year 2023-24.

Using LIHC allocation data from the Allocation Committee, it is assumed that the maximum credit allocation threshold would be reached each year. This bill would authorize an additional $300 million in LIHC allocations beginning for allocations made during calendar year 2018. It is assumed that five percent, or $15 million, of the allocation would ultimately be returned to the Allocation Committee due to unforeseen project issues. According to information provided by the Allocation Committee, the farmworkers housing credit is largely under allocated and there is over $5 million awaiting allocation. Due to the infrequent allocation of the farmworkers housing credit, the $25 million credit allocation was modeled as a one year allocation lag applied to each year. For example, the $25 million would be set aside in tax year 2018, and then added back in tax year 2019. Based on total current LIHC awards and usage, it is estimated that 75 percent of the remaining annual credits would be used to offset income and franchise taxes and the remainder would be used against insurance taxes. Based on current LIHC usage, it is assumed that 70 percent of the credit would be used over the four year credit period and the remaining 30 percent would be carried forward to future years. It is further assumed that 25 percent of the carry forward would be sold at 80 percent of its face value causing the seller to recognize capital gains in the year of the sale. It is assumed these amounts would be used over the four year credit period. Because allocated credits cannot be used until the building has been put into service, credit usage would not begin until 2020. Current usage indicates that 98 percent would be claimed by corporations and the remaining 2 percent would be claimed by personal income taxpayers.

The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the amounts reflected in the above table. The combined revenue impact from the sale and credit usage results in a revenue gain in the first two years and a revenue loss of approximately $19 million in fiscal year 2019-20, increasing to $170 million in fiscal year 2023-24.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some could argue that increasing the amount specifically allocated for farmworker housing projects would allow more developers to qualify for the LIHC and therefore expand the inventory of affordable housing in the state.

Opponents: Some could argue that this provision would increase economic disparity within the state by continuing to earmark funds for the habilitation of low-income farmworker housing while ignoring other areas of housing that may need additional incentives to encourage development.

Provision 2: Eliminate the Mortgage Interest Deduction for a Second Home

REASON FOR THE PROVISION

The reason for the provision is to help offset the cost of the bill's proposed changes to the LIHC by eliminating the deduction for mortgage interest associated with a second home.

FEDERAL/STATE LAW

Under federal and state law, 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.

For acquisition indebtedness incurred on or after October 13, 1987, the aggregate amount of acquisition indebtedness may not exceed $1 million (or $500,000 in the case of married persons 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. Outstanding acquisition indebtedness incurred prior to October 13, 1987, (grandfathered debt), remains unlimited, thus interest attributable to grandfathered debt is fully deductible.

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 persons filing separately) maximum mortgage limits. Thus, interest attributable to the amount of grandfathered debt is fully deductible.

THIS PROVISION

This provision would disallow a deduction of mortgage interest paid on a second home as defined in the Internal Revenue Code.[6]

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

ABX 16 (Goldberg, 2003/2004) would have reduced the maximum amount of acquisition indebtedness used to determine the deductible qualified residence interest amount. ABX 16 failed to pass out of the house of origin by the constitutional deadline.

OTHER STATES' INFORMATION

The states surveyed include *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. *Illinois, Massachusetts,* and *Michigan* do not permit any itemized deductions including home mortgage interest. *Minnesota* and *New York* laws allow a deduction for home mortgage interest equal to the federal deduction (which allows mortgage interest on a 2nd home to be included).

[6] IRC sections 163(h)(4)(A)(i)(II) and 163(h)(4)(A)(ii)(II).

FISCAL IMPACT

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

ECONOMIC IMPACT

This provision would result in the following revenue impact:

Estimated Revenue Impact of AB 71 Provision 2: Disallow the Mortgage Interest Deduction for a Second Residence As Amended March 2, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $360	+ $240	+ $260

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Based on FTB data, it was determined that taxpayers claimed $50.9 billion in mortgage interest deductions on their tax year 2014 returns. This figure was grown to reflect changes in the economy over time. According to articles published by Fannie Mae, approximately 5 percent of total home mortgage originations are for second home mortgages. For purposes of this estimate, it is assumed that the existing mix of primary home mortgages versus second home mortgages would be similar. It is estimated the average tax rate for these taxpayers is eight percent, resulting in the estimated revenue gain of approximately $230 million in tax year 2017 for eliminating the mortgage interest deduction on a second home.

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some could argue that modifying the mortgage interest deduction to disallow the interest paid in connection with a second home would remove a tax benefit typically used by higher income individuals and allow the savings from the elimination of this deduction to be redirected to the state's poverty-reducing programs.

Opponents: Some could argue that eliminating a long-standing state tax benefit could encourage certain taxpayers to leave California thereby eroding the personal income tax base.

POLICY CONCERNS

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

LEGISLATIVE STAFF CONTACT

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PROPOSED AMENDMENTS TO AB 71

As Amended March 2, 2017

AMENDMENT 1

On page 5, line 24, after "Section 42" insert:

"(i)(4)

AMENDMENT 2

On page 5, line 36, after "Section 42" insert:

"(i)(4)

AMENDMENT 3

On page 9, line 8, strike "(6)(E)(I)(II)" and insert:

(6)(E)(i)(II)

AMENDMENT 4

On page 11, line 35, strike "The" and insert:

A provision that the

AMENDMENT 5

On page 14, line 15, strike "18"

AMENDMENT 6

On page 19, line 30, after “Section 42” insert:

“(i)(4)

AMENDMENT 7

On page 20, line 13, after “Section 42” insert:

“(i)(5)

AMENDMENT 8

On page 23, line 13, strike “(6)(E)(I)(II)” and insert:

(6)(E)(i)(II)

AMENDMENT 9

On page 25, line 36, strike “The” and insert:

A provision that the

AMENDMENT 10

On page 37, line 32, strike “later of the taxable years” and insert:

taxable year

AMENDMENT 11

On page 38, line 6, strike “(6)(E)(I)(II)” and insert:

(6)(E)(i)(II)

AMENDMENT 12

On page 40, line 31, strike “The” and insert:

A provision that the

AMENDMENT 13

On page 43, line 12, strike “18”