



## Bill Analysis

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Sponsor:

Bill Number: AB 1905

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Amended: May 14, 2020

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Related Bills: See Legislative  
History

## 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 AMENDMENTS

The May 14, 2020, amendments removed the bill provisions that would have limited the amount a taxpayer may currently treat as acquisition indebtedness from \$1,000,000 (\$500,000 in the case of married taxpayers filing separately) to \$750,000 (\$375,000 in the case of married taxpayers filing separately).

## 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.

## ANALYSIS

Mortgage Interest Deduction

For taxable years beginning on or after January 1, 2020, this bill would 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.

## *Effective/Operative Date*

As an urgency matter, this bill would be effective immediately upon enactment. This bill is specifically operative for taxable years beginning on or after January 1, 2020.

## *Federal/State Law*

### *Federal Law*

As a general matter, personal interest is not deductible.<sup>1</sup> Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations.<sup>2</sup> 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.

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<sup>1</sup>Internal Revenue Code (IRC) section 163(h)(1).

<sup>2</sup>IRC sections 163(h)(2)(D) and (h)(3).

## 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,<sup>3</sup> this limitation is \$1,000,000 (\$500,000 in the case of married taxpayers filing separately).<sup>4</sup> 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.

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).

California conforms to the federal law that defines a qualified residence as the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence.

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<sup>3</sup> 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.

<sup>4</sup> 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.

### *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 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*

None noted.

### *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 eliminate a California deduction for taxpayers that have already made the decision to incur mortgage obligations for property purchased before this bill is effective, taxpayers could face unexpected increased California tax liability due to the elimination of the deduction for acquisition indebtedness with respect to a qualified residence other than a principal residence.

## **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.

## **PROGRAM BACKGROUND**

None noted.

## 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*

This bill would result in the following revenue gain:

Estimated Revenue Impact of AB 1905 as Amended on May 14, 2020  
Assumed Enactment after June 30, 2020

(\$ in Millions)

<b>Fiscal Year</b>	<b>Revenue</b>
2020-2021	\$310
2021-2022	\$200
2022-2023	\$210

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.

Because the impact of current economic circumstances is unknown, this estimate is subject to change.

### *Revenue Discussion*

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 \$60 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 \$2.2 billion, of the mortgage interest deductions are from second homes (taxpayers currently report primary and second mortgage data together when filing their tax return). After applying an average tax rate of 9 percent the revenue

impact of disallowing second homes is estimated to be \$200 million for 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.

**LEGAL IMPACT**

None noted.

**APPOINTMENTS**

None noted.

**SUPPORT/OPPOSITION**

To be determined.

**ARGUMENTS**

None noted.

**LEGISLATIVE STAFF CONTACT**

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