STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Lee

Sponsor:

Bill Number: AB 2616

Related Bills: See Legislative History

Introduced: February 14, 2024

SUBJECT

Secondary Residence Mortgage Interest Deduction Disallowance

SUMMARY

This bill would, under the Personal Income Tax Law (PITL), disallow the home mortgage interest deduction on a residence other than the taxpayers' principal residence and would require the Franchise Tax Board (FTB) to annually estimate and report to the State Controller's Office (SCO), the estimated additional amounts of tax revenue.

RECOMMENDATION

No position.

SUMMARY OF AMENDMENTS

Not applicable.

REASON FOR THE BILL

The reason for the bill is to eliminate the mortgage interest deduction on a second residence.

ANALYSIS

For taxable years beginning on or after January 1, 2025, this bill would disallow the mortgage interest deduction on indebtedness with respect to a qualified residence other than a principal residence.

This bill would require the FTB in consultation with the Department of Finance (DOF), to estimate the amount of additional revenue, for taxable years beginning on or after January 1, 2024, and before January 1, 2025, 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, 2025.

This bill would also, no later than June 1, 2026, and annually thereafter, require the FTB in consultation with DOF, to estimate the amount of additional revenue resulting from the modifications to the mortgage interest deduction and report such estimates to SCO. The estimate would be for the taxable years beginning on or after January 1 of the calendar year immediately preceding the year in which the estimate is made and before January 1 of the calendar year in which the estimate is made and require that SCO be notified of that amount.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2025.

Federal/State Law

Federal Law

As a general matter, personal interest is not deductible. Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations. 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, this limitation is $1,000,000 ($500,000 in the case of married taxpayers filing separately). 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.

Home Equity Indebtedness

Home equity indebtedness is any indebtedness protected by a qualified residence to the extent the combined amount of indebtedness does not exceed the fair market value of the qualified residence, reduced by the amount of acquisition indebtedness. The aggregate amount of home equity indebtedness may not exceed $100,000 (or $50,000 on a separate return by a married individual) for any period. For any indebtedness incurred before October 13, 1987, indebtedness shall be treated as acquisition indebtedness, and no limit shall apply.

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, as of January 1, 2015.

Implementation Considerations

The FTB has identified the following implementation considerations and is available to work with the author’s office to resolve these and other considerations that may be identified.

The bill requires FTB to notify SCO by June 1, 2026, 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 FTB 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 Considerations

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 interest on indebtedness with respect to a qualified residence other than a principal residence.

LEGISLATIVE HISTORY

AB 946 (Lee, 2021/2022) and AB 1905 (Chiu & Wicks, 2019/2020), similar to this bill, would have under the PITL, reduced the home mortgage interest paid deduction and required the FTB to annually estimate and report to the SCO, the expected or anticipated additional amounts of tax revenue. SCO would have been required to transfer such amounts from the General Fund to a new state fund created to address homelessness in California. AB 945 and AB1905 did not pass out of the Assembly by the constitutional deadline.

AB 71 (Chiu, 2017/2018) would have disallowed the deduction of mortgage interest paid on a second home and modified the existing Low-Income Housing Credit (LIHC). AB 71 did not pass out of the Assembly by the constitutional deadline.

PROGRAM BACKGROUND

None noted.

FISCAL IMPACT

The FTB's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be determined.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact of AB 2616 as Introduced February 14, 2024
Assumed Enactment after June 30, 2024

($ in Millions)

Fiscal Year	Revenue
2024-2025	$110
2025-2026	$190
2026-2027	$190

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

The home mortgage interest deduction is reported on the tax return as the total deductible interest from both primary and secondary homes. Using home mortgage interest deduction data, it is estimated that taxpayers would report $65 billion in total, primary and secondary, mortgage interest deductions in taxable year 2025. Using data from the U.S. Census Bureau, it is estimated that 3 percent, or $1.9 billion, in mortgage interest deductions would be from second homes. After applying an average tax rate of 9.4 percent, the estimated revenue gain from the elimination of second home mortgage interest deduction would be $180 million for taxable year 2025.

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

To be determined.

LEGISLATIVE CONTACT

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