Date of Hearing: May 20, 2020

ASSEMBLY COMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
David Chiu, Chair
AB 1905 (Chiu) –Amended

SUBJECT: Housing and Homeless Response Fund: personal income taxation: mortgage interest deduction

SUMMARY: Creates the Housing and Homelessness Response (HHR) Fund to provide ongoing funding to address homelessness. Specifically, **this bill**:

1) Disallows the mortgage interest deduction on acquisition indebtedness with respect to a qualified residence other than a principal residence.

2) Requires the Franchise Tax Board (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 (MID) if the bill's provisions were operative during such taxable years, and report such estimates to State Controller's Office (SCO) no later than June 1, 2021.

3) Requires the FTB to estimate the amount of additional revenue resulting from the modifications to the MID and report such estimates to SCO no later than June 1, 2022, and annually thereafter.

4) Establishes the HHR Fund in State Treasury and requires, upon appropriation, amounts in the fund to be used to finance immediate and long-term solutions to homelessness by moving homeless individuals and families into permanent housing.

5) Requires, after notification by the FTB, SCO to annually transfer the estimated additional revenue amounts from the General Fund to the HHR Fund.

6) Includes an urgency clause.

EXISTING LAW:

1) Federal Internal Revenue Service (IRS) law allows a taxpayer to deduct the mortgage interest paid on up to $1 million in mortgage debt on a "qualified residence."

2) Federal IRS law defines a "qualified residence" for purposes of a mortgage interest deduction as a house, condominium, cooperative, mobile home, house trailer, boat, or similar property that has sleeping, cooking, and toilet facilities.

3) Federal IRS law defines a "qualified residence" as:

   a) A principal residence; or

   b) A second residence that is either not rented out for any portion of the year or a second home that you use for a portion of the year. If a second residence is rented out for a portion of the year a taxpayer must use this home more than 14 days or more than 10% of

the number of days during the year that the residence is rented at a fair rental, whichever is longer.

FISCAL EFFECT: Unknown. 2/3 vote.

COMMENTS:

Author's statement: According to the author, "California is facing a homelessness crisis. The COVID pandemic has served to not only intensify the homelessness crisis but jeopardize the limited, one- time funding the state has invested during good financial years in homelessness. We will not solve this problem without a plan and a sustained funding source. The largest investment the state makes in housing policy, on an ongoing basis, is the $3.5 billion in general fund revenues used to fund the mortgage interest deduction. Despite arguments to the contrary, the mortgage interest deduction does not increase homeownership and in part only rewards those fortunate enough to own a second, vacation home. It's time to prioritize our resources so that we can ensure that every Californian has one roof over their head before we subsidize those that have two."

Background: California is facing a homelessness and affordable housing crisis. In 2019, on a single night in January, 151,278 people experienced homelessness in California. California has 24 percent of the people in the nation experiencing homelessness. Nearly half of all unsheltered people in the country were in California. The number of people experiencing homelessness increased by 17 percent from 2018 to 2019.

The homeless crisis is driven by the lack of affordable rental housing for lower income people. In the current market, 2.2 million extremely low-income and very low-income renter households are competing for 664,000 affordable rental units. Of the six million renter households in the state, 1.7 million are paying more than 50% of their income toward rent. The National Low Income Housing Coalition estimates that the state needs an additional 1.5 million housing units affordable to very-low income Californians.

The 2018-19 and 2019-20 state budgets included one-time funding to local governments and Continuum of Care (CoC) to respond to homelessness. In 2018, the budget included $500 million for the Homeless Emergency Assistance Program (HEAP) to provide localities with flexible block grant funds to address their immediate homelessness challenges. In 2019, the budget included $650 million for the Homelessness Housing, Assistance, and Prevention Program (HHAP) to distribute to local governments – CoCs, counties, and large cities to respond to homelessness. HHAP is similar to HEAP but provides more specificity on how local governments must spending funding and moves away from a priority for emergency shelters and toward permanent housing solutions. In his January 2020 budget, the Governor proposed $750 million to the California Access to Housing Fund to provide rental assistance, funding for hotel and motel conversions, and to stabilize board and care facilities.

On March 16, 2020, the Legislature passed SB 89, which provided $500 million for COVID-19 response expenditures, with provisions to expand this amount to a total of $1 billion. This includes $100 million for prevention and containment of COVID-19 among the homelessness population and $50 million to secure hotel and motel beds for people experiencing homelessness.

Mortgage interest deduction: State law allows a taxpayer to deduct interest on up to a $1 million in acquisition indebtedness on a "qualified interest." A qualified interest includes a primary residence and a second residence. To qualify, a second residence may be rented out for a portion of the year but a taxpayer must use the home more than 14 days or more than 10 percent of the number of days during the year that the residence is rented at a fair rental, whichever is longer. Under Federal law 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.

AB 1905 would eliminate the mortgage interest deduction on second homes and conform to federal law by reducing the amount of interest that can be deducted on a primary home to $750,000 for a married couple filing jointly and $350,000 for a married couple filing separately. FTB would be required to determine the general fund revenues generated from these changes each year, notify the SCO of the revenue figure, and SCO would deposit the amount in the HHR Fund to fund local efforts to address homelessness.

According to the FTB, AB 1905 would generate: $360 million in 2020-21; $230 million in 2021-22; and $230 million in 2022-23.

Who benefits from MID? According to the FTB, in tax year 2016, personal income taxpayers claimed $54 billion in mortgage interest deductions, lowering their taxes by about $3.5 billion. This deduction is only available to taxpayers who itemize their deductions. The majority of taxpayers who benefit from the mortgage interest deduction make more than $100,000 per year. According to FTB, approximately 175,000 taxpayers benefit from the mortgage interest deduction on second homes, for a total state cost of $250 million per year. According to FTB, under current law the estimated average second home deduction is approximately $11,500. Applying an average tax rate of 9% reduces the tax owed by the taxpayer by approximately $1,000. Should the second home mortgage interest deduction be disallowed, the taxpayer would owe about $1,000 more in tax per year.

Distribution: Mortgage Interest Deduction: 2016

Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	109.2	$1,319.6	$0.8
$10,000 to $19,999	114.5	$1,065.3	$0.7
$20,000 to $49,999	600.8	$5,521.4	$76.8
$50,000 to $99,999	1,269.4	$12,840.5	$659.4
$100,000 to $199,999	1,396.3	$18,061.2	$1,486.2
More than $199,999	798.7	$15,278.5	$1,311.7
Total	4,288.9	$54,086.5	$3,535.6

Source: 2016 PIT Tax Sample and Microsimulation Model Detail may not add to total due to rounding. *Includes part-year residents and nonresidents.

According to the Franchise Tax Board's *California Income Tax Expenditures: Compendium of Individual Provisions: Report for 2016 Tax Year Data:*

> "This program's [Mortgage Interest Deduction] goal is to provide an incentive for home ownership. Many people believe that increasing home ownership is desirable because it promotes neighborhood stability and civic responsibility. It is thought that home ownership can do this by giving individuals a financial stake (i.e., maintaining the value of real property owned) in the neighborhood's quality.
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> Whether or not increasing home ownership is a valid goal, most economists believe that the value of this tax break is generally capitalized into the value of housing. In other words, on average, housing prices should increase by the expected tax savings over the time period that the house will be owned. Therefore, this deduction does not actually make housing more affordable for homeowners. Instead, it results in a transfer from the state treasury to people who already owned homes at the time the deduction was granted or, in the case of new construction, to whomever owned the land at the time it becomes obvious that the land will likely be zoned for residential use. In fact, homeowners who do not itemize or whose income places them in low rate brackets are likely to find housing less affordable, because they will not receive a tax reduction large enough to offset the increased price of housing. Additionally, if the goal is to encourage home ownership, there is no reason to extend the benefit to second homes. Another aspect of this program is that many taxpayers have used the home equity provision to engage in tax-favored borrowing for purposes other than purchasing or remodeling homes. This is done by taking out unnecessarily large loans on houses instead of taking out nontax-favored loans for other purposes.
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> Policy alternatives that may bring this program more in line with its intended objectives include lower limits on the amount of deductible interest or limiting deductions to loans for first-time home purchases. The reduction or elimination of mortgage interest deductions could harm current homeowners in two ways. First, homeowners who itemize their deductions will lose the value of the tax deductions that they can no longer claim. This problem could be eliminated by "grandfathering" (i.e., allowing deductions for mortgages already existing when the policy changed). Grandfathering would enhance fairness by reducing the impact on taxpayers who took on mortgages under the assumption that the deduction would remain in place for the life of their loan. Of course, grandfathering would reduce the revenue gain to the state from this policy reform. Grandfathering would also create a "lock-in" effect that would reduce the efficiency of the housing market. There are two reasons for this. First, since only the current owner can claim the interest deduction, a grandfathered house is more valuable to its current owner than to a prospective buyer. Second, because the grandfathered owner can only claim the interest deduction on his current house, the grandfathered house is more valuable to its owner than another otherwise equally valuable house. Both of these effects will distort economic activity by discouraging home buying and selling (locking owners into their current homes). Our second alternative policy, limiting deductions to first-time home purchasers, would only lock homeowners into their first homes.
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> The second impact of the proposed policy alternatives on current homeowners is that this policy change will likely reduce home values. We argued above that the mortgage interest

deduction is generally capitalized into the value of housing. Removing or reducing the deduction should lower home prices by approximately the value of the eliminated tax benefit. Since most current homeowners purchased their homes after the implementation of the mortgage interest deduction raised housing values, most current homeowners will be unfairly harmed by this reduction in housing values.

However, it should be pointed out that, in the long run, removing the mortgage interest deduction would decrease the inequities arising from tax-driven fluctuations in housing prices. Under the current system, the tax value of the interest deduction changes every time tax rates are changed. Through the capitalization process, any increase/decrease in statutory tax rates will increase/decrease housing values, producing windfall gains/losses to homeowners. Removing the deduction will eliminate these unintended changes to wealth that results whenever tax rates change.

Impact of the mortgage interest deduction on homeownership: One of the main arguments against eliminating or even simply modifying the mortgage interest deduction is that it will suppress homeownership. Recent research by leading economists Kamila Sommer with the Federal Reserve Board and Paul Sullivan with the American University challenges that assertion. Below is an excerpt from their study, "Implications of US Tax Policy for House Prices, Rents, and Homeownership," American Economic Review, 2018:

Each year, the mortgage interest deduction reduces U.S. Federal tax revenue by over $ 90 billion. This lost revenue amounts to approximately 7 percent of total personal income tax payments. In the ongoing debate over budget deficits and fiscal reform, eliminating the mortgage interest deduction has been a frequently discussed policy change. Proponents of reform point out that the mortgage interest deduction reduces government revenue, is a regressive tax policy, and subsidizes household mortgage debt. However, there are many unanswered questions about the effects of eliminating the mortgage interest deduction on the housing market. In this paper, we build a model that focuses on understanding, and quantifying, the effects of tax reform on equilibrium house prices, rents, homeownership, and welfare. Although opponents of tax reform claim that repealing the deduction would reduce homeownership, whether this is true is ultimately a quantitative question about the magnitude of the resulting equilibrium change in the after-tax cost of homeownership. Ceteris paribus, repealing the mortgage interest deduction increases the cost of financing housing, thereby reducing homeownership. However, our model shows that in equilibrium, house prices fall, allowing credit-constrained renters to become homeowners. Moreover, the price-to-rent ratio falls, shifting relative prices in favor of owning. Given the progressive nature of the US income tax code, the results also show that in addition to increasing homeownership, eliminating the mortgage interest deduction shifts housing consumption from high-income to lower-income households, thereby increasing expected lifetime welfare. The impact of unanticipated tax reform on the welfare of households who are alive at the time of the reform (and therefore made decisions about homeownership and mortgage debt under the original tax code) is another significant policy concern. We study this issue by examining the transitional dynamics of the housing market after the sudden repeal of the mortgage interest deduction. As far as social welfare, 58 percent of households alive at the time of the reform are better off under the reformed tax code. However, welfare effects vary widely across the population depending on a household's state at the time of the reform. In particular, homeowners with large mortgages and high incomes frequently incur large welfare losses over their lifetimes.

Arguments in support: According to the California Tax Reform Association, "in a state of 40 million people, an estimated 150,000 Californians face homelessness. At this same time, 175,000 Californians utilize the MID tax break on their vacation homes saving an average of $1,000 a year each. 224,000 other Californians claim the tax break on their primary home mortgages acquired in 2018 or later, which are valued at over $750,000 and see an average savings of $750 a year. According to the California Franchise Tax Board, there is no evidence to indicate that the MID increases homeownership, or makes homeownership more affordable. Instead, eligible individuals simply factor the expected tax saving in to the overall cost of their home.

Arguments in opposition: The California Association of Realtors is oppose to AB 1905 for several reasons. They argue that the bill would apply to all second homes regardless of when the loan was originated, people should not pay more in taxes, some second homes are not vacation homes but are used by commuters, and that the value of homes will be reduced and make resale harder.

REGISTERED SUPPORT / OPPOSITION:

Support

ACCE Action
AIDS Healthcare Foundation
Bend the Arc: Jewish Action
California Housing Partnership Corporation
California Rural Legal Assistance Foundation
California State Council of Service Employees International Union (SEIU)
California Tax Reform Association
California YIMBY
Central Valley Empowerment Alliance
Congregations Organized for Prophetic Engagement (COPE)
Corporation for Supportive Housing
Courage California
Disability Rights California
Downtown Women's Center
EAH Housing
East Bay Asian Local Development Corporation
East Bay for Everyone
Eviction Defense Network
Faith in The Valley
Family Care Network
Foothills Kitchen
Housing California
Housing Equality & Advocacy Resource Team (HEART)
Housing Now! CA
KIWA
LA Forward
Latinos United for A New America
Leadership Counsel for Justice and Accountability
Legal Services for Prisoners With Children
Life Skills Training and Educational Programs, INC. (LIFESTEPS)

Linc Housing
MHAction
Non-Profit Housing Association of Northern California
One Redwood City
Pacifica Housing 4 All
Peninsula for Everyone
Peoples' Self-help Housing Corporation
Pico California
Power
Public Advocates
Shelter Partnership
Social Justice Learning Institute
Sonoma Intersections Coalition
Sonoma Valley Housing Group
Southern California Association of Nonprofit Housing
Stonewall Democratic Club
TechEquity Collaborative
Tenderloin Neighborhood Development Corporation
The People Concern
TODCO
Transform
UAW Local 2865
United Way Bay Area
United Way of Greater Los Angeles
Venice Community Housing Corporation
Wakeland Housing and Development Corporation
Western Center on Law & Poverty
YIMBY Action
23 Individuals

Opposition

Amador County Association of Realtors
Arcadia Association of Realtors
Bakersfield Association of Realtors
Bay East Association of Realtors
Burbank Association of Realtors
Calaveras County Association of Realtors
California Association of Realtors
California Desert Association of Realtors
Central Valley Association of Realtors
Coastal Mendocino Association of Realtors
Conejo Simi Moorpark Association of Realtors
Contra Costa Association of Realtors
Del Norte Association of Realtors
East Valley Association of Realtors
El Dorado County Association of Realtors
Fresno Association of Realtors
Greater Antelope Valley Assn. of Realtors

Greater Los Angeles Realtors
Humboldt Association of Realtors
Imperial County Association of Realtors
Inglewood Board of Realtors
Inland Gateway Association of Realtors
Inland Valleys Association of Realtors
Joshua Tree Gateway Association of Realtors
Kings County Board of Realtors
Lake County Association of Realtors
Lodi Association of Realtors
Lompoc Valley Association of Realtors
Malibu Association of Realtors
Mammoth Lakes Board of Realtors
Marin Association of Realtors
Merced County Association of Realtors
Nevada County Association of Realtors
North San Diego Association of Realtors
North San Luis Obispo County Association of Realtors
Northern Solano County Association of Realtors
Orange Coast/Newport Beach Association of Realtors
Orange County Realtors
Oroville Association of Realtors
Pacific Southwest Association of Realtors
Pacific West Association of Realtors
Palm Springs Regional Association of Realtors
Palos Verdes Peninsula Association of Realtors
Paradise Association of Realtors
Pasadena-foothills Association of Realtors
Pismo Coast Association of Realtors
Placer County Association of Realtors
Rancho Southeast Association of Realtors
Rim O' the World Association of Realtors
Sacramento Association of Realtors
San Benito County Association of Realtors
San Luis Obispo Association of Realtors
San Mateo County Association of Realtors
Santa Barbara Association of Realtors
Santa Ynez Valley Association of Realtors
Sierra North Valley Realtors
Silicon Valley Association of Realtors
Siskiyou Association of Realtors
Solano Association of Realtors
South Bay Association of Realtors
Southland Regional Association of Realtors
Southwest California Legislative Council
Southwest Los Angeles Association of Realtors
Tahoe Sierra Board of Realtors
Tehachapi Area Association of Realtors
Tehama County Association of Realtors

Tri-counties Association of Realtors
Tulare County Association of Realtors
Tuolumne County Association of Realtors
Valley Industry & Commerce Association
Ventura County Coastal Association of Realtors
West San Gabriel Valley Realtors
Yolo County Association of Realtors
14 Individuals

Analysis Prepared by: Lisa Engel / H. & C.D. / (916) 319-2085