Date of Hearing: March 8, 2017

ASSEMBLY COMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
David Chiu, Chair
AB 71 (Chiu) – As Amended March 2, 2017

SUBJECT: Taxes: credits: low-income housing: allocation increase

SUMMARY: Eliminates the mortgage interest deduction on second homes, increases the state Low-Income Housing Tax Credit (LIHTC) Program by $300 million, and makes changes to the LIHTC. Specifically, **this bill**:

1) Eliminates mortgage interest paid on a qualified second home as a deduction taxpayers can take against their state income tax.

2) Beginning in 2018, and each year thereafter, increases the allocation of state LIHTC by an additional $300 million and adjusts that amount for inflation beginning in 2019.

3) Beginning in 2018, increase the amount of low-income housing tax credits set-aside for farmworker housing from $500,000 to $25 million.

4) Provides that any low-income housing tax credits set-aside for farmworker housing developments that go unused of the $25 million will be available for qualified non-farmworker housing projects.

5) Provides that a sponsor that receives an award of 9% federal LIHTC cannot receive an allocation from the additional $300 million of state LIHTC but shall remain eligible for the $70 million allocation available prior to 2017.

6) Provides a newly constructed or the rehabilitated portion of an existing low-income housing project that is not located in a Difficult to Develop Area (DDA) or a Qualified Census Tract (QCT) and receives federal 4% LIHTC is eligible for cumulative state LIHTC over four years of 50% of the qualified basis of the building.

7) Provides the acquisition portion of an existing low-income housing project that is not located in a DDA or a QCT and receives federal 4% LIHTC is eligible for state LIHTC over four years of 13% of the qualified basis of the building.

8) Allows the Tax Credit Allocation Committee (TCAC) to replace federal LIHTC with state LIHTC for a new or existing low-income housing project that is a located in a DDA or QCT and receives federal 4% LIHTC of up to 50% of the qualified basis of the building, provided that the total amount of credits does not exceed 130%.

9) Provides that a low-income housing project is eligible for a cumulative state LIHTC of 95% of the qualified basis of the building over four years of the eligible basis if it meets all of the following requirements:

   a) It is at least 15 years old;

   b) It is a single room occupancy (SRO), special needs housing building, is in a rural area, or serves households with very-low income or extremely low-income residents;

c) It is serving households of very low or extremely low-income provided that the average income at the time of admission is no more than 45% of the median gross income adjusted for household size; and

d) It would have insufficient state credits to qualify to complete substantial rehabilitation due to a low appraised value.

10) Adds the following definitions:

a) "Extremely low-income" has the same meaning as Health and Safety Code Section 50053.

b) "Rural area" means a rural area as defined in Health and Safety Code Section 50199.21.

c) "Special needs housing" has the same meaning as paragraph (4) of Subdivision (g) of Section 10325 of Title 4 of the California Code of Regulations.

d) "SRO" means single room occupancy.

e) "Very low-income" has the same meaning as in Health and Safety Code Section 50053.

11) 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.

4) Allows TCAC to award state LIHTCs to developments in a QCT or a DDA if the project is also receiving federal LIHTC, under the following conditions:

a) Developments restrict at least 50% of the units to special needs households; and

b) The state credits do not exceed 130% of the eligible basis of the building.

5) Allows TCAC to replace federal LIHTC with state LIHTC of up to 130% of a project's eligible basis if the federal LIHTC is reduced in an equivalent amount.

6) Defines a QTC as any census tract designated by the Department of Housing and Urban Development (HUD) in which either 50% or more of the households have an income that is less than 60% of the area median gross income or that has a poverty rate of at least 25%.

7) Defines a DDA as an area designated by HUD on an annual basis that has high construction, land, and utility costs relative to area median gross income.

8) Provides that a low-income housing development that is a new building and is receiving 9% federal LIHTC credits is eligible to receive state LIHTC over four years of 30% of the qualified basis of the building.

9) Provides that a low-income housing development that is a new building that is receiving federal LIHTC, is "at risk of conversion" is eligible to receive state LIHTC over four years of 13% of the qualified basis of the building.

10) Defines "at risk of conversion" to mean a property that satisfies all of the following criteria:

    a) A multifamily rental housing development in which at least 50% of the units receive government assistance pursuant to any of the following:

    b) Project based Section 8 vouchers;

    c) Below-Market-Interest-Rate Program;

    d) Federal Rental Housing Assistance Program;

    e) Programs for rent supplement assistance pursuant to Section 101 of the Housing and Urban Development Act of 1965;

    f) Programs pursuant to Section 515 of the Housing Act of 1949; and

    g) Federal LIHTC.

11) Includes an urgency clause.

FISCAL EFFECT: Unknown.

COMMENTS:

California has reduced its funding for the creation of affordable homes by 79%, from approximately $1.7 billion a year to nearly nothing. According to the California Housing Consortium, California has a shortfall of 1.5 million affordable units for extremely low and very-low income renter households. The Public Policy Institute of California reports that 32% of mortgaged homeowners and 47% of renters spend more than one-third of their total household income on housing and that while California has 12% of the nation's population, it has 20% of the nation's homeless.

Voter-approved bonds have been an important source of funding to support the creation of affordable housing. Proposition 46 of 2002 and Proposition 1C of 2006 together provided $4.95 billion for affordable housing. These funds financed the construction, rehabilitation, and preservation of 57,220 affordable apartments, including 2,500 supportive homes for people experiencing homelessness, and over 11,600 shelter spaces. In addition, these funds have helped 57,290 families become or remain homeowners. Nearly all of these funds have been awarded.

In 1945, the Legislature authorized local governments to create redevelopment agencies (RDAs) to address urban blight in local communities. RDAs were formed by a city or county that would declare an area blighted and in need of urban renewal. After this declaration, most of the growth in property tax revenue from the "project area" was distributed to the city or county's RDA as "tax increment revenues" instead of being distributed as general purpose revenues to other local agencies serving the area. By 2008, redevelopment was redirecting 12% of property taxes statewide away from schools and other local taxing entities and into community development and affordable housing. In fiscal year 2009-10, redevelopment agencies collectively deposited $1.075 billion of property tax increment revenues into their low and moderate-income housing funds.

In 2011, facing a severe budget shortfall, the Governor proposed eliminating RDAs in order to deliver more property taxes to other local agencies. Ultimately, the Legislature approved and the Governor signed two measures, AB 26 X1 (Blumenfield), Chapter 5, Statutes of 2011-12 First Extraordinary Session, and AB 27 X1 (Blumenfield), Chapter 6, Statutes of 2011-12 First Extraordinary Session, that together dissolved RDAs as they existed at the time and created a voluntary redevelopment program on a smaller scale. In response, the California Redevelopment Association (CRA) and the League of California Cities, along with other parties, filed suit challenging the two measures. The Supreme Court denied the petition for peremptory writ of mandate with respect to AB 26 X1. However, the Court did grant the petition with respect to AB 27 X1. As a result, all RDAs were required to dissolve as of February 1, 2012.

The Department of Housing and Community Development's *California's Housing Future: Challenges and Opportunities Draft Statewide Housing Assessment 2025* (Assessment) finds, "unstable funding for affordable home development is impeding our ability to meet California's housing needs, particularly for lower-income households." In the options to address the state's lack of affordable housing the Assessment proposes identifying "an ongoing source of funding for affordable housing that does not add new costs or cost pressures to the state' General Fund, but that does align with other State policy goals." The report further states "California needs both public and private investment, as well as land use solutions to address critical housing challenges. Funding programs cannot address California's housing need alone and land use policy changes…are critical. However, even with drastic changes in land use policy to increase supply, the needs of certain populations cannot be met by the private market alone. Funding programs allow the State to target resources to these populations."

Purpose of this bill: According to the author, "California is undergoing an unprecedented housing affordability crisis with a shortfall of over one million affordable homes. With the elimination of California's redevelopment agencies and the exhaustion of state housing bonds,

California has reduced its funding for the development and preservation of affordable homes by 79% -- from approximately $1.7 billion a year to nearly nothing. There is currently no permanent source of funding to compensate for this loss. The housing crisis has contributed to a growing homeless population, increased pressure on local public safety nets, and the outward migration of thousands of long-time California residents. The state's primary housing program is the mortgage interest deduction. We invest $5 billion a year in individuals who have already purchased homes while over half of our state is made up of renters. In addition, we invest approximately $300 million to subsidize owners with the means to purchase not one, but two homes. In the face of a severe housing crisis, it is necessary to reevaluate this investment and redirect the revenues subsidizing those with second homes to the LIHTC."

Mortgage interest deduction: In conformity with federal law, California law allows taxpayers to deduct the mortgage interest paid on up to $1 million in debt for a principal and second residence. A second residence is limited to a home that is either not rented out at any point in the year or one that the taxpayer can rent out but must also live in for part of the year. Taxpayers can deduct mortgage interest from both their federal and state tax liability. According to the Franchise Tax Board (FTB), the mortgage interest deduction resulted in approximately $5 billion in revenue loss for 2016-17 of which $360 million is a result of interest deducted on second homes. According to the FTB, on average about 4.2 million taxpayers claim a mortgage interest deduction each year on taxable returns over the last few years. Based on federal data from Fannie Mae, 4.76% of the mortgage market is made up of second homes, so approximately 195,000 of California taxpayers or .5% of the state's total population take a mortgage interest deduction on a second home. According to the FTB the average deduction for a second home in California is roughly $11,600, and at an average tax rate of 8% the average taxpayer would reduce their taxes by $928.

According to the U.S. Center on Budget and Policy Priorities, the mortgage interest deduction is a regressive tax that benefits those at higher incomes that itemize deductions. In 2012, 77% of the benefits went to homeowners with incomes above $100,000. Meanwhile, close to half of homeowners with mortgages — most of them middle- and lower-income families — receive no benefit from the deduction. Approximately 35% of the benefits went to homeowners with incomes above $200,000 and taxpayers in this income group who claimed the deduction received an average subsidy of about $5,000. According to the California Budget and Policy Center, in California of the total $3.8 billion in reduced tax revenue from the mortgage interest deduction in 2012, $2.8 billion or 72% went to households with incomes of $100,000 or more. Those households represent 43% of the households claiming the deduction.

In regards to the mortgage interest deduction, the FTB states in *California Income Tax Expenditures: Compendium of Individual Provisions, Report for 2013 Tax Year Data*, "whether or not increasing homeownership is a valid goal, most economists believe that the value of the tax break is generally capitalized into the value of the home. 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 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 increasing prices of housing. Additionally if the goal is to encourage homeownership there is no reason to extend the benefit to second homes."

According to a 1990 report issued by the Legislative Analyst's Office (LAO) "the primary rationale for the current mortgage interest deduction is to provide a financial incentive for families to buy a home. However, the tax subsidy made available under this program undoubtedly accrues as a windfall benefit to taxpayers who would have purchased homes anyway, and it encourages the purchase of bigger and more expensive homes, as well as vacation homes rather than basic housing." The report goes on to make recommendations to reform the mortgage interest deduction "to reduce the incentives it currently provides to purchase luxury homes and vacation homes" including to limit the total amount of interest deducted each year or to disallow interest deductions on second homes. At the time the LAO estimated the revenue gain from eliminating the deduction for second homes would be $55 million to $65 million annually.

AB 71 proposes to eliminate the mortgage interest deduction on second homes which on average results in $300 million in lost revenue to the state each year and increase the LIHTC by $300 million. Taxpayers could continue to deduct mortgage interest from their federal tax liability.

Low-Income Housing Tax Credit Program: In 1986, the federal government authorized the LIHTC program to enable affordable housing developers to raise private capital through the sale of tax credits to investors. Two types of federal tax credits are available and are generally referred to as 9% and 4% credits. TCAC administers the program and awards credits to qualified developers who can then sell those credits to private investors who use the credits to reduce their federal tax liability. The developer in turn invests the capital into the affordable housing project.

Each state receives an annual ceiling of 9% federal tax credits. In 2015 it was $2.30 per capita, which worked out to $94 million in credits in California that can be taken by investors each year for 10 years. Federal LIHTCs are oversubscribed by a 3:1 ratio. Unlike 9% LIHTC, federal 4% tax credits are not capped, however they must be used in conjunction with tax-exempt private activity mortgage revenue bonds which are capped and are administered by the California Debt Limit Allocation Committee

In 1987, the legislature authorized a state LIHTC program to augment the federal tax credit program. State tax credits can only be awarded to projects that also receive federal LIHTCs, except for farmworker housing projects, which can receive state credits without federal credits. Investors can claim the state credit over four years. Projects that receive either state or federal tax credits are required to maintain the housing at affordable levels for 55 years.

Changes to the LIHTC: AB 71 would increase the state LIHTC allocation by an additional $300 million to fill the gap in funding that was created by the loss of redevelopment and the exhaustion of state voter-approved bonds. In addition to increasing the total amount of state LIHTC, AB 71 proposes to increase the amount of state tax credits awarded to a project that is also receiving 4% federal tax credits from 13% to 50% of the qualified basis. This would more than triple the amount of equity that an investor purchasing a state tax credit would receive which would bring the return on 4% credits in line with 9% credits and result in greater affordability for the project.

Federal LIHTC can be used anywhere in the state, but projects are given an additional 30% boost on their eligible basis if the project is located in a DDA or a QCT. Because these areas by

definition have a higher-poverty level and there is a higher concentration of extremely low-income or homeless individuals and families, housing needs deep subsidy to make it affordable. Existing state law does not allow state tax credits to be awarded in DDAs and QCTs with one exception: housing developments where 50% of the units are for special needs populations. The rationale for this prohibition is projects in these areas can qualify for more federal tax credits and therefore are already advantaged. AB 71 would also allow state tax credits to be awarded to projects without regard to DDA or QCT status with the main purpose of providing enough state tax credits to match the value of a 9% federal tax credit.

AB 71 includes a set-aside from the $300 million increase to the LIHTC program of $25 million for farmworker housing. There is currently a $500,000 set-aside of low-income housing tax credits for farmworker housing developments serving farmworkers and their families. AB 71 would require any unused credits from the $25 million set-aside to go to qualified non-farmworker housing projects that don't receive funding under the main program.

Many low-income housing developments in the state are older and in need of rehabilitation. These projects need higher levels of equity investments because of their age, level of repairs needed, and the low rents. It is hard for these projects to compete for state tax credits because the assessed value is low and therefore the eligible basis upon which the amount of tax credits the project can qualify for is also low. To assist these older projects, AB 71 would allow them to receive state tax credits of 95% over four years. To qualify, projects would need to be at least 15 years old, serve low and extremely low-income households, be an SRO, in a rural area, and have insufficient state credits to complete substantial rehabilitation due to a low appraised value.

Arguments in support:

According to California Tax Reform Association, there is no valid public policy reason for the second home mortgage interest deduction. The major tax benefit from second homeownership is federal and will continue with this bill. Since there is no other budget or statutory policy of the state to encourage second homes, the only policy argument for this provision is conformity with federal law. While sometimes the state conforms to federal law because of complexity, there is little complexity to disallowing the mortgage interest deduction for a second home.

Arguments in opposition:

The California Association of Realtors (CAR) is opposed to AB 71 unless it is amended to remove the elimination of the mortgage interest deduction for second homes. CAR supports increasing the amount of tax credits available for low income housing however, they argue that the amount of the mortgage interest deduction is already capped regardless of whether the taxpayer has one home or two, that second homes may not necessarily be "vacation" homes but could be used by owners who commute to work during the week, and that the economic health of recreational areas in the state would be harmed by eliminating the mortgage interest deduction on second homes.

Related legislation: AB 35 (Chiu) (2015) increased the LIHTC by $300 million and did not include the elimination of the mortgage interest deduction. The bill was approved 79-0 on the Assembly Floor and was vetoed by the Governor.

Double referred: If AB 71 passes out of this committee, the bill will be referred to the Committee on Revenue and Taxation.

REGISTERED SUPPORT / OPPOSITION:

Support

California Housing Consortium (co-sponsor)
California Housing Partnership (co-sponsor)
Housing California (co-sponsor)
Abode Communities
ACCE
Affirmed Housing
Betty T. Yee, California State Controller
California Alternative Payment Program Association
California Apartment Association
California Bicycle Coalition
California Coalition for Rural Housing
California Community Economic Development Association
California Reinvestment Coalition
California Tax Reform Association
CCraig Consulting
Christian Church Homes
City of Oakland
Community Development Commission of Mendocino County
Community Housing Opportunities Corporation
Community Housing Partnership
Council of Community Housing Organizations, San Francisco
Downtown Women's Center
EAH Housing
East Bay Developmental Disabilities Legislative Coalition
East bay Housing Organizations
Eden Housing
Family Care Network, Inc.
First Place for Youth
Fred Finch Youth Center
Fresno Housing Authority
Friends Committee on Legislation of California
Greenbelt Alliance
Grounded Solutions Network
Highridge Costa Companies
House Farm Workers!
Housing Authority of the County of Santa Barbara
Housing Choices Coalition
Housing Consortium of the East Bay
Housing Trust Fund, San Luis Obispo County
Housing Trust Silicon Valley
Innovative Housing Opportunities

John Stewart Company
LeadingAge California
LifeSteps
LINC Housing
Little Tokyo Service Center
Manzanita Services
Mercy Housing
MidPen Housing Corporation
Move LA
Mutual Housing California
Napa Valley Community Housing
Non-Profit Housing Association of Northern California
Promise Energy
Public Advocates
Resources for Community Development
Rural Community Assistance Corporation
Sacramento Housing Alliance
San Diego Housing Federation
Satellite Affordable Housing Associates
Self-Help Enterprises
Skid Row Housing Trust
Small Business for Affordable Housing, Petaluma
Southern California Association of Nonprofit Housing
State Building and Construction Trades Council of California
SV@Home
Tenderloin Neighborhood Development Corporation
The Kennedy Commission
The Pacific Companies
Wakeland Housing and Development Corporation

Opposition

California Association of Realtors

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