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Housing-Related Tax Expenditure Programs

LEGISLATIVE ANALYST'S OFFICE

Presented to:
Assembly Revenue and Taxation Committee
Hon. Raul Bocanegra, Chair

Assembly Housing and Community Development Committee
Hon. Norma Torres, Chair

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What Are "Tax Expenditures?"

☑ ***Definition.*** Tax expenditure programs (TEPs) are special tax provisions—exemptions, deductions, and credits—that reduce the amount of revenues a "basic" tax system otherwise would generate in order to provide:

- *Benefits* to certain groups of taxpayers, and/or
- *Incentives* to encourage certain types of behavior and activities.

☑ ***Why Called a Tax* Expenditure*?*** Most TEPs could be rewritten as expenditure programs that would have similar results. As such, one way to evaluate a TEP is to try to determine how high a priority it would be if it were converted into an expenditure program with a similar practical effect and dollar value.

☑ ***What Governs Eligibility for TEPs?***

- ***Deductions (Expenses Deducted From Taxable Income).*** The TEPs that take the form of "below the line" deductions are available to taxpayers who itemize deductions on their state income tax returns.
- ***Exemptions (Income Not Taxed).*** Exemptions are typically available to anyone who files a return and who earned income in the exempted categories.
- ***Credits (Reduction of Tax Liability).*** Credits occasionally are capped at a statewide dollar amount and taxpayers sometimes have to apply for them from an oversight body, on a lottery basis, or by other means.

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California's TEPs

- ☑ ***State TEPs Valued at About $50 Billion Annually.*** The most recent Department of Finance (DOF) report estimates that California's state TEPs reduce state revenues by about $50 billion per year. As such, if all of them hypothetically were ended, rates of taxation and fees for the state's General Fund and special funds (now totaling about $135 billion per year) could be lowered substantially.

- ☑ ***Housing TEPs Make Up a Large Share of California's Total.*** Of the TEPs, DOF estimates that the largest portion—$33 billion—consists of TEPs that reduce personal income tax revenues. The housing-related TEPs discussed in this handout currently result in a total annual revenue loss of around $7 billion to $8 billion of the $50 billion statewide total.

  - Local property tax provisions in the State Constitution and statutes also affect housing decisions. These local taxes are not covered in this handout. (For more information, see our November 2012 publication, *Understanding California's Property Taxes*.)

How Should Housing TEPs Be Evaluated?

☑ ***Challenges in Evaluating TEPs.*** The effectiveness of TEPs often is very hard to evaluate. Data availability to evaluate their success is often limited. It also can be difficult to identify TEPs' effects, especially what taxpayers would do in the absence of those provisions (perhaps the most important evaluative issue). In some cases, legislative intent regarding a TEP's intended subsidies, benefits, or incentives may not be clear.

☑ ***Evaluating Housing-Related TEPs.*** In our office's 2007 TEP report to the Revenue and Taxation Committees, we discussed several questions that policymakers can consider when evaluating housing-related TEPs. These include:

- Is the TEP actually increasing homeownership, and if so, by how much?
- Is the TEP driving up prices by increasing housing demand?
- Is the TEP allowing people who would have owned homes anyway to buy more and/or bigger, more expensive homes or to spend tax savings on items other than housing?
- Should the TEP be modified or eliminated in order to make our collection of housing policies more coordinated, efficient, and effective?
- Does the TEP provide a housing subsidy that is at an appropriate level? Or, is it too large or small given the state's housing-related and competing policy objectives?
- Does California need its own set of housing TEPs and other policies, or are the state programs' effects so marginal that it should rely on federal programs to accomplish the policy objectives?

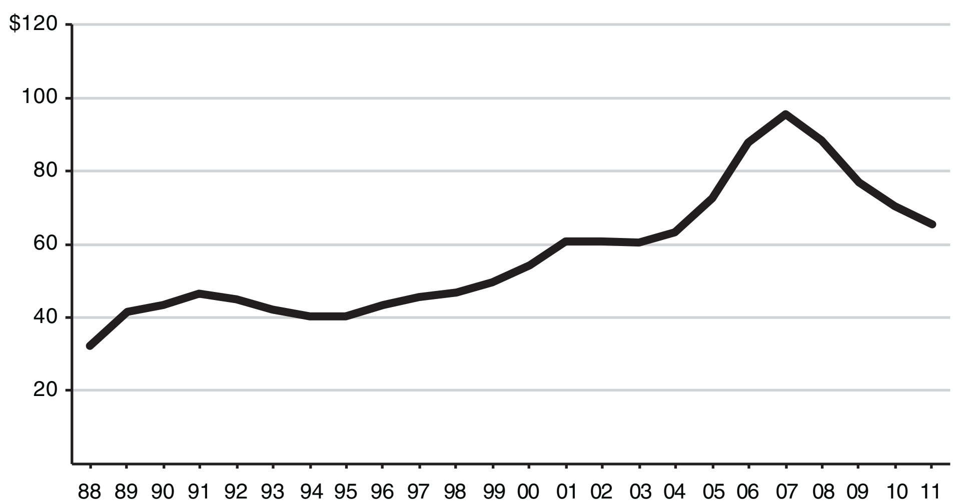
Mortgage Interest Deduction (MID)

☑ ***California Deduction Similar to Federal Law.*** All interest expenses, including home mortgage interest, were made deductible when the federal income tax was established in 1913. At the time, consumer borrowing was rare, and most such borrowing was for business expenses. Thus, this provision was not originally intended as a housing subsidy.

☑ ***Annual State Revenue Impact of Around $4.6 Billion.*** In 2010 (the most recent year with solid data), 4.5 million out of 15 million California tax filers claimed a total of $71 billion worth of deductions for mortgage interest. The revenue loss was approximately $4.6 billion. As shown below, the total amount of deductions is smaller now than in prior years due to declines in housing prices and mortgage interest rates since the housing bubble burst.

Californians' Mortgage Interest Deductions Have Dropped Recently

(In Billions)



MID *(Continued)*

☑ ***Critiques Offered by Some Concerning This TEP:***

- The deduction largely encourages people who were going to buy a house anyway to buy a more expensive house.
- As with other itemized deductions, benefits go disproportionately to higher-income taxpayers who pay higher marginal rates and are more likely to itemize.
- This deduction's value often is capitalized to some extent into housing prices. To the extent this occurs, it does not actually make housing more affordable.

☑ ***Eliminating or Modifying the MID.*** Our office—along with many economists—has suggested eliminating this deduction. In our office's 2007 TEP report (an excerpt from which is attached to this handout), we also discussed various options for modifying the deduction, as summarized in the table below.

- Some of these options could reduce the amount of deductions taken by Californians and attempt to focus its benefits on tax filers who need more assistance to become homeowners.
- Changing the deduction to a credit would increase the share of the benefits that go to taxpayers in lower tax brackets. In transitioning to a credit, policymakers could "grandfather in" the current deduction for existing mortgages or "phase in" the change over time.
- There would be winners and losers with any such changes.

Options for Modifying California's Mortgage Interest Deduction (MID)

✓ **Modify the Current MID**

- Restrict the MID to interest paid on a single principal residence, thereby eliminating eligibility of second homes.
- Eliminate the current MID for home equity loans.
- Reduce the current $1 million cap on the size of a mortgage loan for which interest can be deducted.
- Apply a means test under which the allowable deduction for mortgage interest phases out as income rises.
- Limit deductibility to a specific amount of interest (say $25,000) paid per year.
- Restrict the MID to first-time homebuyers.
- Restrict the MID to a limited number of years once a home is purchased and a mortgage loan is taken out.
- Make the MID an "above the line" deduction available even to taxpayers who do not itemize their deductions.
- Cap all deductions, including the MID, at a specific amount per year.

✓ **Replace the MID With a Credit**

- Replace the current deduction with a nonrefundable credit.
- Permit carry forwards into future years of mortgage credits not usable in a given year.
- Replace the current deduction with a refundable credit.
- Offer a flat dollar credit for homeownership.
- Base the tax benefit not on the size of the mortgage loan but rather on some other criteria.
- Cap the mortgage credit or all credits at a specific amount per year.

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Deduction for Real Property Taxes

- ☑ ***Similar to Federal Law.*** State tax law conforms to the federal law in this case.

- ☑ ***Annual State Revenue Impact of $1.5 Billion.*** In 2010, 4.8 million tax filers claimed a total of $23 billion worth of deductions for property taxes. The revenue loss was approximately $1.5 billion. This dollar value has declined only slightly as homes' taxable values are far less volatile than their market prices.

- ☑ ***Critiques Offered by Some Concerning This TEP:***

  - As with other itemized deductions, benefits go disproportionately to higher-income taxpayers who pay higher marginal rates and are more likely to itemize.

  - Its value is also likely capitalized into housing prices to some extent.

Exclusion of Capital Gains on Sale of Primary Residence

- ☑ ***Similar to Federal Law.*** State law also follows federal law in its treatment of capital gains from the sale of the owner's primary residence. The first $250,000 of the capital gain is excluded from taxable income if the owner files a single return (or $500,000 if the owner files a joint return).

- ☑ ***Annual State Revenue Impact of Around $1 Billion.*** The Franchise Tax Board (FTB) estimates that the General Fund revenue loss was about $1.1 billion in tax year 2009.

- ☑ ***Critiques Offered by Some Concerning This TEP:***

  - It produces what some may view as substantial "windfall gains" not subject to taxation. With the top marginal state tax rate for filers usually being around 10 percent, most eligible households would see substantial, untaxed gains even if the exclusion were lowered considerably (below the $250,000 or $500,000 in current law).

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"Step-Up" of Basis on Inherited Property

☑ ***Similar to Federal Law.*** State law also follows federal law in its treatment of assets inherited after the owner dies. If the heir sells the asset, the capital gain is calculated based on the asset's "stepped-up" value when the owner died, not its value when the owner bought it.

☑ ***Affects Housing, but Not Specifically a Housing Subsidy.*** This is not specifically a housing subsidy, as it applies to other assets too. Income taxes apply to capital gains on homes in excess of $250,000 or $500,000, depending on the taxpayer's filing status. Accordingly, step-up treatment of capital gains affects some housing transactions.

☑ ***Annual State Revenue Impact.*** The FTB estimates that the state's *total* General Fund revenue loss from step-up (both housing and nonhousing) was about $2.2 billion in tax year 2009. We suspect this estimate is somewhat high. Nevertheless, the portion of step-up revenue losses related to housing likely totals up to hundreds of millions of dollars per year.

☑ ***Critiques Offered by Some Concerning This TEP:***

- It was originally justified as a way to avoid double taxation of capital gains on inherited property, but California removed its taxes on inherited property in 1982. In addition, the applicability of the federal estate tax has been limited recently.
- In general, it is unclear how applying this provision to inherited housing property helps encourage homeownership.

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Renter's Credit

- ☑ ***No Comparable Federal Credit.*** The state allows renters with taxable income below a certain level to take a credit of $60 (or $120 for joint returns or widows/widowers) against their income tax liability. The credit is nonrefundable, meaning that it cannot be used to reduce the taxpayer's liability below zero. There is no comparable federal credit.

- ☑ ***Current Income Thresholds.*** For tax year 2012, the income threshold was $36,337 for a single filer or $72,674 for a joint filer.

- ☑ ***Annual State Revenue Impact of About $150 Million.*** The estimated General Fund revenue loss from this provision in 2009 was $155 million.

- ☑ ***Critiques Offered by Some Concerning This TEP:***

  - Eligibility for this credit cuts off abruptly at the income threshold, creating a situation where a taxpayer will end up with a higher after-tax income if their pretax income is just below the threshold than if it is just above it. This means that over this narrow range of income, the marginal tax rate is over 100 percent. This could be corrected by phasing the credit out over the next few thousand dollars of income.

  - In some market conditions, landlords may be able to increase rents to credit recipients and others, thereby reducing the net value of the credit.

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Other Housing TEPs of Less Than $100 Million Per Year

- ☑ ***Tax-Exempt Bonds for Certain Housing Agencies.*** State housing agencies are allowed to issue tax-exempt bonds and use the proceeds to issue loans at below-market interest rates to low- and moderate-income home buyers in certain instances. The FTB estimated that tax exemption for all California state and local government debt (both housing and nonhousing) reduced state revenues by $975 million in 2009. Housing-related debt is likely responsible for a small portion of this $975 million total.

- ☑ ***Low-Income Housing Expenses Credit.*** The state allows a credit for investments in qualified rental housing. The total amount available under this credit is capped, and the California Tax Credit Allocation Committee allocates specific credits to applicants. The credit's General Fund cost was $54 million in 2009. There is a comparable, although not identical, federal credit.

- ☑ ***Exclusion of Gains on Like-Kind Exchanges.*** Like federal law, state law allows filers not to book capital gains until eligible property is sold or exchanged for what is determined to be a dissimilar property. This applies to nonhousing and housing exchanges, with the estimated revenue loss for all like-kind exchanges (both housing and nonhousing) estimated at $118 million as of 2009.