Date of Hearing: April 22, 2024

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
Jacqui Irwin, Chair

AB 1932 (Ward) – As Amended April 3, 2024

2/3 vote. Fiscal committee.

SUBJECT: Personal income tax: mortgage interest deduction.

SUMMARY: Disallows the mortgage interest deduction (MID) on any property that is not a taxpayer's primary residence, as specified, and allocates new revenues from the disallowance to the Housing, Homeownership, and Homelessness Prevention Response Fund. Specifically, **this bill**:

1) Disallows, for taxable years beginning on or after January 1, 2025, the MID for any property that is not a taxpayer's primary residence.

2) Requires, no later than June 1, 2026, the Franchise Tax Board (FTB), in consultation with the Department of Finance (DOF), to estimate the amount of additional revenue that would have resulted if the disallowance had applied for taxable years beginning on or after January 1, 2024, and before January 1, 2025, and notify the State Controller of that amount.

3) Requires, no later than June 1, 2026, and annually thereafter, the FTB, in consultation with DOF, to estimate the amount of additional revenue resulting from the repeal of the MID on second homes for 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 notify the State Controller of that amount.

4) Requires the State Controller to transfer an amount from the General Fund (GF) to the Housing, Homeownership, and Homelessness Prevention Response Fund that is equal to the amount estimated by the FTB, and continuously appropriates money in the fund as follows:

   a) 50% to the Multifamily Housing Program;

   b) 25% to support homeownership opportunities for first-time homebuyers; and,

   c) 25% to local public housing authorities to provide housing navigation services and landlord incentives for housing voucher recipients.

EXISTING FEDERAL LAW:

1) Allows qualified residence interest as an itemized deduction, subject to limitations. (Internal Revenue Code (IRC) Section 163(h).)

2) Provides that 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. (IRC Section 163(h)(4).)

3) Provides, for taxable years beginning after December 31, 2017, and beginning before January 1, 2026, that a taxpayer may treat no more than $750,000 as acquisition indebtedness. In the case of acquisition indebtedness incurred before December 16, 2017, the limitation is $1 million. For taxable years beginning after December 31, 2025, a taxpayer may treat up to $1 million of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred. (IRC Section 163(h)(3)(B).)

4) 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 is used 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 for 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. (IRC 163(h)(4)(A)(i)(II).)

EXISTING STATE LAW:

1) Provides, for acquisition indebtedness incurred on or after October 13, 1987, the aggregate amount of acquisition indebtedness may not exceed $1 million ($500,000 in the case of married persons filing separately).

2) 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. (Revenue and Taxation Code (R&TC) Section 17201.)

FISCAL EFFECT: According to the FTB, this bill would result in a GF revenue gain of $110 million in fiscal year (FY) 2024-25, $190 million in FY 2025-26, and $190 million in FY 2026-27.

COMMENTS:

1) The author has provided the following statement in support of this bill:

    > California is undergoing an unprecedented housing affordability crisis with nearly 70% of low- and very low-income households spending more than half of their income on housing. The crisis has contributed to a growing population of people experiencing homelessness, increased pressure on local public safety nets, and the outward migration of thousands of long-time California residents. Despite this, the state's largest housing program is the mortgage interest deduction. We invest $3.5 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 $200 million to subsidize owners with the means to purchase not one, but two homes. In the face of our severe housing crisis and a budget shortfall which has led the Governor to propose eliminating $1.2 billion in housing programs, it is necessary to reevaluate this wasteful tax expenditure and redirect the

revenues currently subsidizing those with second homes to address this crisis. An additional $200 million per year for housing programs to build affordable housing, promote first-time homebuyer opportunities, and boost housing voucher utilization will allow us to make crucial investments for the long term. We should ensure those without a home in our state receive one before the state helps subsidize those well enough to purchase a second.

2) Supporters state that their reasons for support include: (a) the deduction disproportionately benefits those with higher incomes and larger mortgages as filers with mortgages who take the standard deduction get no benefit; (b) owning even one home is financially out of reach for millions of Californians; and, (c) the state is facing a multibillion-dollar deficit, which may continue in upcoming years and necessitate the cutting of affordable housing and homelessness prevention programs.

3) Opponents state that their reasons for opposition include: (a) the amount of the MID is already capped regardless of whether the taxpayer has one home or two homes; (b) families rely on second homes, such as accessory dwelling units, to reduce commute distances and maintain hybrid work arrangements; (c) reforms at the federal level bring much uncertainty to the current tax structure; and, (d) families have made significant financial decisions based on the access to this tax benefit.

4) Committee Staff Comments:

   a) *The MID*: In conformity with federal law as it read on January 1, 2015, 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. This limitation applies to the combined mortgages of the first and second home.

   b) *Historical background*: It is a common misconception that the MID was created as a subsidy to encourage homeownership. When the income tax laws were first enacted after the passage of the 16th Amendment, Congress viewed interest payments as an expense of earning business and investment income and therefore not part of a taxpayer's net income. Congress, however, did not differentiate between interest paid to generate income and non-income generating purchases. When the 1986 Tax Reform Act was passed, Congress eliminated the deductibility of all consumer interest except for the MID. As such, the provision is more of a "left over" from prior tax policies and less of an incentive that encourages the purchasing of homes.[1]

   c) *The MID leads to higher home prices*: In regards to the MID, the FTB stated the following in a 2011 report:

      Whether or not increasing home ownership is a valid goal, most economists believe

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[1] Ventry, *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, Journal of Law and Contemporary Problems, Vol. 73, p. 233 (Winter 2010). https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1561&context=lcp.

that the value of the 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 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.[2]

According to a 1988 report issued by the Legislative Analyst's Office (LAO), "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 MID and "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.[3]

d) *Recent federal changes*: In 2017, the Tax Cuts and Jobs Act (TCJA) dramatically changed the way in which mortgage interest is deducted. Although still an itemized deduction, the TCJA lowered the value of mortgages on which homebuyers could deduct interest from $1 million to $750,000. Additionally, the TCJA increased the standard deduction from $6,500 to $12,550 for single filers and from $13,000 to $25,100 for joint filers. Prior to the TCJA, about 30% of filers itemized versus 10 to 15% of filers that itemized after the TCJA. These changes, of course, are only representative of federal tax filers since California did not conform to these provisions. According to *Debunking 3 Myths About the Mortgage Interest Deduction*, MID reform does not hurt the middle class because the MID is only available to those that itemize and those that do itemize tend to be wealthier individuals.

e) *Who benefits from itemized deductions?* In California, just over 15% of filers itemized deductions in 2020.[4] The U.S. Treasury Office of Tax Analysis, in a working paper analyzing the distribution of eight major tax expenditures across different income levels and racial and ethnic groups, found that itemized deductions disproportionately benefit

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[2] *California Income Tax Expenditures: Compendium of Individual Provisions, Updated December 2011,* FTB, Economic and Statistical Research Bureau (December, 2011). https://arev.assembly.ca.gov/sites/arev.assembly.ca.gov/files/hearings/Maitland%20FTB%20Tax_Expenditure_Report_2011_2-22-12.pdf.

[3] *Report on the 1988-89 Tax Expenditure Budget*, Office of the Legislative Analyst (December 1988). https://lao.ca.gov/reports/1988/12_88_report_on_the_1988_89_tax_expenditure_budget.pdf.

[4] Villanova, *Where Americans Write Off the Most in Taxes – 2023 Study*, SmartAsset (April 6, 2023). https://smartasset.com/data-studies/where-americans-write-off-the-most-in-taxes-2023.

White families: 84% of the benefits of the deductibility of mortgage interest were received by White families, which make up only 67% of the population studied. The average dollar benefit per family for the mortgage interest deduction was estimated to be $213 for White families, $77 for Hispanic families, and $63 for Black families.[5] Across all racial and ethnic categories, families in the upper middle-income ranges benefitted from the home mortgage deduction at higher rates than families in lower income deciles.

A deduction is generally more valuable to high-income taxpayers because the "value" of a deduction varies with the marginal tax rate (or tax bracket) of the taxpayer. For example, an individual taxpayer in a 10% tax bracket would receive a tax benefit of $10 on a $100 deduction. In contrast, a taxpayer in a 25% tax bracket would save $25 in taxes for every $100. Thus, assuming the same level of deductions, a high-income taxpayer, presumably with a greater ability to pay taxes, receive a greater tax benefit from the deduction than a lower income taxpayer.

f) *What does this bill do*? This bill would eliminate the MID that is available for second homes, and transfer the additional GF revenue that is generated from the elimination to the Housing, Homeownership, and Homelessness Prevention Response Fund. Additionally, this bill would require the FTB, in consultation with the DOF, to estimate the amount of additional revenue that would have resulted from the disallowance of the MID on second homes for the 2024 taxable year and notify the State Controller of that amount.

g) *Implementation consideration*: As described above, this bill requires the FTB to estimate the amount of additional revenue that would have resulted if this bill's provisions had been effective for the taxable year prior to the effective date of this bill. Currently, only the total amount of mortgage interest being claimed by the taxpayer is captured on the California income tax return; the amount of interest being claimed on each home is not specified. As such, the FTB currently 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.

h) *Double-referred*: In addition to this Committee, this bill was referred to the Assembly Committee on Housing and Community Development, which passed this bill on April 17th on a vote of 7-to-2. For additional discussion regarding issues that fall under that Committee's jurisdiction, including the allocation of revenues raised from the elimination of the MID, please refer to that Committee's analysis.

i) *Prior legislation*:

   i) AB 946 (Lee), of the 2021-22 Legislative Session, was substantially similar to this bill. AB 946 was not heard by this Committee.

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[5] Cronin, *Tax Expenditures by Race and Hispanic Ethnicity: An Application of the U.S. Treasury Department's Race and Hispanic Ethnicity Imputation*, U.S. Treasury Office of Tax Analysis (January 2023). https://home.treasury.gov/system/files/131/WP-122.pdf.

ii) AB 1905 (Chiu & Wicks), of the 2019-20 Legislative Session, was substantially similar to this bill. AB 1905 was not heard by this Committee.

iii) AB 71 (Chiu), of the 2017-18 Legislative Session, would have disallowed the deduction of mortgage interest paid on a second home and modified the existing Low-Income Housing Credit. AB 71 died on the Assembly Inactive File.

REGISTERED SUPPORT / OPPOSITION:

Support

All Home, a Project of Tides Center
Brilliant Corners
California Housing Partnership Corporation
Community Corporation of Santa Monica
Homes & Hope
Housing California
MidPen Housing Corporation
Nonprofit Housing Association of Northern California
Resources for Community Development
Sacramento Housing Alliance
Southern California Association of Non-profit Housing
United Way of Greater Los Angeles

Opposition

California Association of Realtors
California Mortgage Bankers Association
California Taxpayers Association

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