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To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Thursday, February 23, 2017

Time: 12:00 P.M.

Place: Conference Room 308, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.B. 486, H.D. 1, Relating to the Mortgage Interest Deduction

The Department of Taxation (Department) appreciates the intent of H.B. 486, H.D. 1, and provides the following comments for your consideration.

H.B. 486, H.D. 1, limits the mortgage interest deduction to interest attributable to primary residences only. The bill also requires that the amount of tax revenue gained due to the limitation be deposited into the rental housing revolving fund. The measure has a defective effective date and applies to taxable years beginning after December 31, 2016.

First, the Department notes that the mortgage interest deduction is an itemized deduction. Section 68 of the Internal Revenue Code limits itemized deductions for taxpayers who exceed certain adjusted gross income (AGI) thresholds. The section 68 rules are operative for Hawaii income tax purposes. Section 68 reductions are equal to 80% of the otherwise allowable itemized deductions or 3% of the excess of the taxpayer's AGI over the threshold, whichever is smaller.

Due to the existing Section 68 limits, the proposed limitation of the mortgage interest deduction may not return a revenue gain at all. This is because taxpayers with second homes are likely to exceed the Section 68 AGI thresholds, and thus, be subject to the itemized deduction limits already in place. For these taxpayers, the proposed limitation may only reduce the already disallowed amount of itemized deductions.

Next, the Department notes that the previous committee adopted the Department's recommended language regarding the calculation and deposit of revenue gain attributable to this proposal. This language will allow flexibility as to the timing of the deposit, but the required deposit will still require an estimate of any revenue gain attributable to this proposal. As written, the Department is not able to calculate the amount of revenue gain attributable to this proposal.

Itemized deductions are not reported in enough detail to isolate the deduction for mortgage interest or the amounts attributable to mortgage interest for a second home. To measure this accurately, the Department will need to require taxpayers to report the amounts of mortgage interest deductions on second homes, otherwise allowable, that this bill disallows. Given the complexity of the limitations discussed above, even this may not provide an accurate measure.

Thank you for the opportunity to provide comments.

DAVID Y. IGE
GOVERNOR



CRAIG K. HIRAI
EXECUTIVE DIRECTOR

STATE OF HAWAII

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HAWAII HOUSING FINANCE AND DEVELOPMENT CORPORATION
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IN REPLY REFER TO:

Statement of
Craig K. Hirai
Hawaii Housing Finance and Development Corporation
Before the

HOUSE COMMITTEE ON FINANCE

February 23, 2017 at 12:00 p.m.
State Capitol, Room 308

In consideration of
H.B. 486, H.D. 1
RELATING TO THE MORTGAGE INTEREST DEDUCTION.

The HHFDC *offers the following comments* on H.B. 486, H.D. 1. HHFDC defers to the Department of Taxation on the overall merits and feasibility of the amendments to the mortgage interest deduction proposed in this bill.

We support increased funding for the Rental Housing Revolving (RHRF) as long as they do not replace priorities requested in the Executive Budget. The Executive Budget does include a request of \$50 million in General Obligation bond funding in Fiscal Year 2017-2018 for infusion into the RHRF, for which we respectfully request the Committee's support.

Thank you for the opportunity to testify.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Eliminate Mortgage Interest Deduction for Second Homes

BILL NUMBER: HB 486, HD-1

INTRODUCED BY: House Committee on Housing

SYNOPSIS: Amends HRS section 235-2.4(h) to make the mortgage interest deduction for second homes (section 163(h)(4)(A)(i)(II) and section 163(h)(4)(A)(ii)(II), Internal Revenue Code) inoperable in Hawaii.

Requires the department of taxation to calculate the revenue from this provision annually and deposit that amount in the rental housing revolving fund (HRS section 201H-202).

EFFECTIVE DATE: Upon approval, applies to taxable years beginning after December 31, 2016.

STAFF COMMENTS: Under Hawaii's general conformity to the Internal Revenue Code, individuals may be allowed an itemized deduction for "qualified residence interest," which is interest on debt incurred to buy a qualified residence (acquisition indebtedness) or is otherwise secured by the qualified residence (home equity indebtedness). A qualified residence is defined as the principal residence of the taxpayer, or one other residence selected by the taxpayer that is used by the taxpayer as a residence. The bill works by decoupling from the "one other residence" provision in the Internal Revenue Code and from the similar provision that applies to married taxpayers filing separately.



The apparent intent of the bill is to raise taxes and earmark the money for the rental housing revolving fund. However, as the Department of Taxation previously stated, it may be difficult or impossible to measure the revenue gain from this provision (which determines the amount of the earmark) because itemized deductions are already limited for higher-income taxpayers, which is the group this bill apparently targets.


As with any earmarking of revenues, the legislature will be preapproving each of the programs fed by the fund into which the tax monies are diverted, expenses from the funds largely avoid legislative scrutiny, and the effectiveness of the programs funded becomes harder to ascertain. It is also difficult to determine whether the fund has too little or too much revenue.

If the legislature deems the programs and purposes funded by this special fund to be a high priority, then it should maintain the accountability for these funds by appropriating the funds as it does with other programs. Earmarking revenues merely absolves elected officials from setting priorities. If the money were appropriated, lawmakers could then evaluate the real or actual needs of each program.

Digested 2/21/2017



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February 23, 2017

The Honorable Sylvia Luke, Chair

House Committee on Finance
State Capitol, Room 308
Honolulu, Hawaii 96813

RE: H.B. 486, H.D.1, Relating to the Mortgage Interest Deduction

HEARING: AGENDA #2: Thursday, February 23, 2017, at 12:00 p.m.

Aloha Chair Luke, Vice Chair Cullen, and Members of the Committee.

I am Myoung Oh, Director of Government Affairs, here to testify on behalf of the Hawai'i Association of REALTORS® ("HAR"), the voice of real estate in Hawai'i, and its 9,000 members. HAR **opposes** H.B. 486, H.D.1 which proposes to eliminate the Mortgage Interest Deduction (MID) for second homes under Hawai'i income tax law. This measure also transfers an equivalent amount to the Rental Housing Revolving Fund.

The ability to take a Mortgage Interest Deduction (MID) on state and federal income taxes can make home ownership affordable, or at least offer a financial incentive toward homeownership. Introduced along with the Income Tax itself in 1913, the federal MID allows homeowners who itemize deductions on their taxes to deduct mortgage interest attributable to primary residence and second-home debt, and interest paid on home equity debt.

The Mortgage Interest Deduction encourages the American Dream of homeownership and gives people great financial security through homeownership. The deduction helps middle-income purchasers make their mortgage payments more affordable and is vital to the health and stability of housing markets.

In today's real estate environment, more homeowners are purchasing a second home for their elderly parents or their adult children who cannot otherwise afford to pay for a home. The same would apply for existing mortgages that is passed down to immediate families and siblings.

HAR believes that the MID for second homes is an important opportunity for individuals to use to invest for retirement or to support their families with Hawaii's high cost of living and housing.

Mahalo for the opportunity to testify in opposition to this measure.



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Testimony to the House Committee on Finance**Thursday, February 23, 2017****12:00 pm****Conference Room 225****RE: H.B. 486 HD1 – Relating to Mortgage Interest Deduction**

Chairs Luke, Vice-Chair Cullen, and members of the committee:

My name is Gladys Quinto Marrone, CEO of the Building Industry Association of Hawaii (BIA-Hawaii). Chartered in 1955, the Building Industry Association of Hawaii is a professional trade organization affiliated with the National Association of Home Builders, representing the building industry and its associates. BIA-Hawaii takes a leadership role in unifying and promoting the interests of the industry to enhance the quality of life for the people of Hawaii.

BIA-HAWAII has concerns on H.B. 486 HD 1, which proposes to eliminate the mortgage interest deduction for second homes under the Hawaii Income Tax Law. The bill specifies that the revenue gain attributable to this measure be deposited into the Rental Housing Revolving Fund, and requires the Department of Budget and Finance, in consultation with the Department of Taxation, to submit a report on the administration of this measure to the Legislature prior to the 2018, 2019, 2020, 2021, and 2022 Regular Sessions.

The NAHB has been tracking similar legislation across the country, looking for alternative ways to provide more funding to increase the supply of rental housing. They provide the following comments on the subject bill:

NAHB's research on 2nd homes is focused on federal tax law, but it looks seems Hawaii's income tax system links to the federal rules, as far as the Mortgage Interest Deduction (MID) goes.

First, we have broad concerns with the notion of taking from homeowners to support renters. We are facing similar pressures on the federal level, and it would be unfortunate to see the housing industry forming this circular firing squad by attacking homeownership in favor of rental subsidies. It should not be an either/or debate; housing policy should support both populations.

H.B. 486 H.D.1 partially disconnects from the federal rules on the MID. Specifically, Hawaii would no longer recognize this section of the federal tax code:

(II) 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)).

When is a Second Home not a Second Home

So what does this mean? It means that for the purposes of claiming the MID, if H.B. 486 H.D.1 passes, homeowners will only be able to deduct mortgage interest on their "principal residence." The IRS has a complicated test for what qualifies as a taxpayer's "principal" residence but, ultimately, only one home per year may be classified as a "principal residence." This has grave consequences for any homeowner thinking of moving.

In practice, the second home deduction is important for many households who in fact do not think of themselves as owning two homes. For example, the second home deduction facilitates claiming the mortgage interest deduction during a period of homeownership transition, such as when a family relocates and will own two separate principal residences in a given tax year—even if both homes are not owned concurrently. Without the second home MID, this family would only be able to claim an interest deduction on a portion of their total mortgage interest payment.

For example, family X owns a condo, sells it on June 30, and on July 1 buys a new home. Although they never owned the homes at the same time, only one home can be considered the "principal residence" for that year. Under the current rules, the family can fully deduct their mortgage interest on both homes, because the other home qualifies as their second home.

If this bill passes, they will only be able to deduct their mortgage interest on one of the two homes. This would not only act as a tax on moving, but it could distort consumer behavior by discouraging relocation or leading to homeowners moving only at the start or end of a tax year in order to minimize the tax implications.

This issue can be solved, but the bill's sponsors would lose a substantial amount of the "savings" they are directing into the revolving fund.

New Home Construction and 2nd Home Rules

There is also another issue related to new home construction. The second home rules allow up to 24 months of construction loan interest on a newly-constructed home to be claimed while the family resides in their existing principal residence. Basically, a family owns their current home, but wants to move to a new home and chooses to have that home built. If the owner takes out a construction loan (often called a construction to permanent loan, as it converts to a mortgage), the homeowner can deduct the interest, for up to 24 months, as their new home is constructed. For those 24 months, the home under construction is recognized as their "second home."

Who is the "true" second homeowner?

The final issue is, who is actually claiming the second home deduction? To claim it, you need to own a second home, and have a mortgage on it. That will tell us who is affected by this change in law.

First, rental homes do not use the mortgage interest deduction, so they are not affected.

Second, multi-million dollar homes are not typically using the mortgage interest deduction—why? These lucky folks pay cash and don't need a mortgage. Third, there is a \$1.1 million cap on the amount of acquisition debt that a homeowner can deduct. That is not a per-house limit, but rather a total limit of both homes. In Hawaii, with the high housing costs, that doesn't get you far even on your principal residence. But the point is, homeowners are not deducting millions of dollars on mortgages for second homes. There's a cap.

Lastly, second homeowners with a mortgage nationwide are fairly regular Americans. NAHB analysis shows they have an average household income of \$71,344.

It's hard to use that in Hawaii with high housing costs, but the point is, rich people don't need a mortgage, rental housing doesn't use the mortgage interest deduction, so lawmakers should ask themselves who actually owns a second home in Hawaii with a mortgage on it—and doesn't rent it out?

It would appear that the only taxpayers affected by this will be homeowners who are moving or using a construction loan to finance building a new house. And that would be terrible for the housing industry.

We appreciate the opportunity to provide you with our comments and concerns on H.B. 486 HD 1.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304

Honolulu, Hawaii 96813 Tel. 536-4587

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Digested 2/21/2017

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WRITTEN ONLY
TESTIMONY BY WESLEY K. MACHIDA
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
TO THE HOUSE COMMITTEE ON FINANCE
ON
HOUSE BILL NO. 486, H.D. 1

LATE

February 23, 2017
12:00 p.m.
Room 308

RELATING TO THE MORTGAGE INTEREST DEDUCTION

House Bill No. 486, H.D. 1, eliminates the mortgage interest deduction for second homes under the Hawaii Income Tax Law and specifies that the revenue gain attributable to this measure be deposited into the Rental Housing Revolving Fund.

The Department of Budget and Finance has serious concerns with the tweaking of the tax code in order to provide a revenue source to fund a particular objective. Furthermore, it would be difficult to obtain information from taxpayers as they will no longer report interest deductions on their second or other residences. Without this information, the Department of Taxation will not be able to provide an accurate amount of savings (revenue gain to the State). We believe that the funding of projects or programs should be through the normal budget process.

Thank you for your consideration of our comments.