SENATE COMMITTEE ON GOVERNANCE AND FINANCE

Senator Mike McGuire, Chair
2021 - 2022 Regular

Bill No:	SB 601	**Hearing Date:**	5/6/21
Author:	Ochoa Bogh	**Tax Levy:**	Yes
Version:	4/22/21 Amended	**Fiscal:**	Yes
Consultant:	Deitchman		

PERSONAL INCOME TAXES: EXCLUSIONS: CAPITAL GAINS: SALE OF RESIDENCE

Increases the Home Sale Gain Exclusion for sellers who sell to a first-time homeowner.

Background

Tax expenditures. California law allows various income tax credits, deductions, exemptions, and exclusions. The Legislature enacts such tax incentives either to compensate taxpayers for incurring certain expenses, such as child adoption, or to influence certain behavior, such as charitable giving. The Legislature uses tax incentives to encourage taxpayers to do something that but for the tax credit, they would otherwise not do. The Department of Finance is required annually to publish a list of state tax expenditures, currently totaling around $74.8 billion per year.

COVID-19 pandemic. The COVID-19 pandemic, also known as the coronavirus pandemic, is an ongoing, widespread outbreak of the disease caused by a strain of the coronavirus. This severe, acute respiratory syndrome was first identified in Wuhan, China in late December 2019. The first cases in the United States occurred in early 2020 and the first California case was confirmed in late January. To control the spread of the disease, California, and other states, issued mandatory “stay-at-home” orders. This pandemic left thousands out of work and struggling to pay for necessities, and businesses struggling to stay in business. California’s unemployment was 10.1 percent in 2020 and total nonfarm jobs decreased by 1,410,000 (an 8.0 percent decrease) from December 2019 to December 2020. Another impact from the COVID-19 pandemic is that there are less houses on the market, because less people want to move and sell their home in the middle of a pandemic. Because of this housing shortage, less first-time homebuyers are able to purchase their homes.

Home Sale Gain Exclusion. For tax purposes, gross income means all income regardless of source, unless specifically exempted. Federal and state laws grant a Home Sale Gain Exclusion, which allows taxpayers to exclude the capital gain from the sale of their primary residence. To qualify for the exclusion, taxpayers must have lived in their home for at least two of the last five years. The gain is limited to the following amounts:

- $250,000 for taxpayers who are single or married filing separately; and
- $500,000 for taxpayers who are married filing jointly or surviving spouses who sell their home within two years of their spouse’s death.

If taxpayers are selling their vacation home, rental property, or a home that they have only lived in for one year, they cannot claim the exclusion.

California real estate market. California is in the midst of a housing crisis. According to a report in 2019 from the Legislative Analyst's Office (LAO) *Considerations for the Governor's Housing Plan*, "California home costs 2.5 times the national average. California's average monthly rent is about 50 percent higher than the rest of the country. High housing costs drive California's official poverty rate from roughly 13 percent (slightly higher than average) to 19 percent (highest in the nation) under the Census Bureau's Supplemental Poverty Measure, which takes into account food, clothing, shelter, and utilities."

The Department of Finance announced, in April 2021, that the median price for a single family home reached $758,990 in California which represents a 24 percent increase from a year ago. This large increase makes it difficult for first time homebuyers to enter a very competitive market.

High home prices, high rents, limited housing, and increases in all-cash deals make it difficult — if not impossible — for Californians who want to buy their first home. The author would like to provide an incentive for taxpayers to sell their home to a first-time homeowner by increasing the Home Sale Gain Exclusion.

Proposed Law

Senate Bill 601 increases the Home Sale Gain Exclusion for taxpayers who sell their residence to a qualified first-time homeowner. The bill increases the exclusion to the following amounts:

- $300,000 for taxpayers who are single or married filing jointly; and
- $600,000 for taxpayers who are married filing separately, a head of household, or a surviving spouse.

A "qualified first-time homeowner" means any individual and, if married, that individual's spouse who had no ownership interest in a principal residence during the preceding three-year period ending on the closing date of the purchase of the qualified principal residence. Qualified first-time homeowner does not include any individual, their spouse, or both, if the individual and their spouse are treated as a "related party," as defined in the Internal Revenue Code.

A "qualified principal residence" means a single family residence, whether detached or attached, that is purchased to be the principal residence of a qualified first-time homeowner for a minimum of two years and is eligible for the homeowner's exemption for property tax purposes.

Senate Bill 601 requires that on or before the closing date of the sale or exchange of the qualified residence, the seller obtains a certification from the buyer, in writing and signed under penalty of perjury, that the buyer is a qualified first-time homeowner.

The certification shall include the following information in a form and manner as prescribed by the Franchise Tax Board:

- The buyer's name, taxpayer identification number, and address.

- The seller's name, taxpayer identification number, and address.
- The address and sales price of the qualified principal residence.
- An affirmative representation by the buyer that the buyer meets the requirements provided under this section and has not owned a qualified principal residence during the three-year period ending on the closing date of the purchase of the qualified principal residence.

SB 601 makes available the increased exclusion for taxable years beginning on or after January 1, 2021 and before January 1, 2026.

State Revenue Impact

Pending.

Comments

1. Purpose of the bill. According to the author, "SB 601 is a step in the right direction towards leveling the playing field for first-time homeowners. It would do so by allowing homeowners who sell their homes to a first-time homebuyer to exclude capital gains of $300,000 for single filers instead of the current $250,000 maximum and $600,000 for joint filers instead of the current $500,000 maximum from their gross income.

California is in the midst of a housing crisis. With the median price of a single family home being $693,690 in 2020 (more than twice the national average), an analysis done by the California Association of Realtors showed that only 28% of households could afford a home at this price. The cause of these high prices is mostly due to a severe lack of housing supply to meet increasing demand. One of the many consequences of this supply shortage is an extremely competitive market for potential home buyers, especially buyers looking to purchase their first home. In fact, California ranked as the toughest state in the nation for first-time home buyers according to a report done by bankrate.com. The report names a number of reasons for this ranking: the relatively high cost of housing, the tight market for available entry-level homes and the struggle that millennials face in saving for a down payment.

Homeownership is the bedrock of the American dream. Too many young people are seeing this dream move further and further out of their reach due to the high cost of housing in California. SB 601 is one small step we can take towards making that dream more attainable for these hard working Californians."

2. Windfall? Tax expenditures, such as an increased exclusion amount, accomplish two things. First, they reward behavior that would have occurred without the subsidy, providing a windfall benefit for taxpayers who would've sold their home to a first-time homeowner regardless. In this case, the state receives no marginal benefit and loses revenue. Second, the tax expenditure may lead to more sales to first-time homeowners that wouldn't have occurred without the extra incentive. In this case, first-time homeowners' benefit and the government accomplished its goal. Successful tax expenditures produce more benefits than costs. However, no tax expenditure has conclusively demonstrated that its aggregate gains exceed its fiscal losses. Moreover, California operates existing programs to help first-time homebuyers, including the Department of Housing and Community Development's CalHome program and the California Housing Finance Agency's program. Providing additional funding to these programs in lieu of

SB 601's tax may be a better option to allocate resources with the goal of advancing home ownership.

3. Revenue loss. Existing tax law provides various credits, deductions, exclusions, and exemptions for taxpayers. Since the Legislature enacts these items to accomplish some governmental purpose, which has a cost — in the form of foregone revenues — state law refers to them as "tax expenditures." This bill would create a new tax expenditure that may encourage current homeowners to sell their homes to first-time homebuyers, but as a result, will result in less revenue for the General Fund. Without General Fund moneys, the government has less funding to pay for important public services such as education and public safety. As a result, the state will have to reduce spending or increase taxes to match the foregone revenue. The Committee may wish to consider whether SB 601 is worth the spending cuts and/or tax increases.

4. Conformity issues. In general, state conformity with federal law promotes greater simplicity and eases the burden of administering complex tax law. However, SB 601 would create a difference between federal and state tax treatment of a taxpayer selling his or her principle place of residence to a first-time homeowner. While this specific type of expense would receive an increased deduction for state purposes, it would not receive an increased deduction for federal purposes. The Committee may wish to consider whether the burden on taxpayers created by a lack of conformity is worth the tax benefit provided.

5. The American Rescue Act of 2021. This federal act was signed into law by President Biden on March 11, 2021, which provided billions of dollars in aid to states and local governments. The Act requires funds to be used for specifically enumerated types of expenditures, and additionally contains language stating that funds cannot be used to cut state taxes either directly or indirectly:

> "*A State or territory shall not use the funds provided under this section or transferred pursuant to section 603(c)(4) to either directly or indirectly offset a reduction in the net tax revenue of such State or territory resulting from a change in law, regulation, or administrative interpretation during the covered period that reduces any tax (by providing for a reduction in a rate, a rebate, a deduction, a credit, or otherwise) or delays the imposition of any tax or tax increase."*

The Department of Treasury has yet to provide clear guidance regarding whether a state will lose funds allocated for aid if it enacts tax expenditures which result in a loss of revenue, like SB 601. The Committee may wish to consider the risk of losing federal aid funds resulting from enacting new tax expenditures.

Support and Opposition (5/3/21)

Support: California Association of Realtors; Howard Jarvis Taxpayers Association; Inland Valleys Association of Realtors; New Livable California Dba Livable California

Opposition: California School Boards Association

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