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Joint Committee on Finance

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First-Time Home Buyer Savings Accounts (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2019-21 Budget Summary: Page 141, #14]

CURRENT LAW

There are several steps required to calculate state income tax liability for tax year 2019. They include: (a) determining Wisconsin adjusted gross income (AGI); (b) subtracting the state standard deduction and personal exemptions to arrive at Wisconsin taxable income; (c) applying the state's tax rate and bracket schedule to determine gross tax amount; and (d) subtracting any applicable state tax credits. Under the first step, Wisconsin AGI is determined by making adjustments to federal AGI, which reflect differences between the state and federal tax codes. These adjustments can be expressed either as additions to or subtractions from federal AGI.

GOVERNOR

Create a program administered by the Department of Revenue (DOR) allowing an individual to become an account holder by creating an account, either individually or jointly with his or her spouse, to pay or reimburse the eligible costs of a first-time home buyer. Require the accounts to be created at any financial institution, defined as any bank, trust company, savings institution, savings bank, savings and loan association, industrial loan association, consumer finance company, credit union, or any benefit association, insurance company, safe deposit company, money market mutual fund, or similar entity authorized to do business in Wisconsin. Specify that eligible costs mean the down payment and allowable closing costs, defined as disbursements listed in a settlement statement for the purchase of a single-family residence in Wisconsin by an account owner or beneficiary. Limit the program to individuals who reside in Wisconsin and have not owned or purchased, either individually or jointly, a single-family residence, defined as a residence intended for the occupation by a single family unit that is owned and occupied by a beneficiary as

his or her principal residence, including a manufactured home, residential trailer, mobile home, condominium unit, or cooperative, during the 36 month period prior to the purchase of a single-family residence that is located in Wisconsin.

When an account is created, require the account holder to designate a single account beneficiary who is a first-time home buyer and who may be the account holder. Allow the account holder to change the beneficiary at any time. Allow individuals to jointly own accounts with their spouses. Provide that an individual may be the account holder of more than one account, but prohibit the account holder from having more than one account that designates the same beneficiary. Permit an individual to be the beneficiary of more than one account. Limit account contributions to cash and marketable securities and allow persons other than account holders to contribute to accounts.

Authorize account holders to withdraw funds from accounts to pay eligible costs for the benefit of the beneficiary or to reimburse the beneficiary for eligible costs that the beneficiary incurred and paid. Prohibit account holders from using account funds to pay any expenses incurred by the account holder in administering the account, but permit financial institutions to deduct service fees from accounts. Require account holders each year to submit the following information related to the account to DOR on forms prepared by the Department with the account holder's income tax return: (a) a list of account transactions during the tax year, including the account's beginning and ending balances; (b) the 1099 form issued by the financial institution relating to the account; and (c) a list of eligible costs, and other costs, for which account funds were withdrawn during the tax year. Authorize account holders to withdraw and transfer funds to a different financial institution without incurring a withdrawal penalty or affecting the account holder's Wisconsin AGI if the transfer occurs immediately and the funds are deposited in a first-time home buyer savings account at that institution. Require account holders to dissolve an account not later than 120 months (10 years) after its creation, and require financial institutions to distribute any proceeds in dissolved accounts to the account holder. Require proceeds be distributed to the account holder's estate if the account holder dies while funds remain in the account.

Create the following adjustments to federal AGI when calculating Wisconsin AGI under the state individual income tax. Require account holders to increase their AGI to include any distribution of proceeds from a dissolved account, and require account holders' estates to increase the AGI of the estate to include any distribution to an account holder's estate after the death of an account holder. In addition, require account holders to increase their AGI to reflect any amount withdrawn from an account for any reason other than payment or reimbursement of eligible costs, unless the withdrawal is the result of a transfer to an account at a different financial institution, as described above, or unless the disbursement is pursuant to a filing for bankruptcy protection. Impose a penalty of 10% on the amounts added to federal AGI under the preceding provisions. Authorize account holders to subtract from federal AGI the amount of any deposits into their accounts, as well as any interest, dividends, or other gain accruing in the account if the interest, dividends, or other gain is redeposited into the account. Limit the subtraction for each account holder to \$5,000 per year, or \$10,000 if the account holder is a married joint filer, for each account to which the account holder makes a deposit. Limit the total amount subtracted to \$50,000 of deposits per account for each beneficiary.

For federal tax purposes, no deduction for contributions would be allowed and the interest earnings accruing to accounts would be subject to tax. Since the accounts would be taxable on the "front end," no federal tax would be imposed at the time of withdrawal. Nor would withdrawals trigger a state tax, provided the proceeds would be used for eligible costs.

Require DOR to prepare and distribute any forms that an account holder is required to submit and any other forms that the Department believes are necessary to administer the program and the program's adjustments to income, as described above. In addition, require DOR to prepare and distribute informational materials to financial institutions and potential home buyers. Finally, require DOR to impose a penalty on withdrawals from accounts that are additions to income, as described above, and direct the Department to administer the penalty as it assesses, levies, and collects income and franchise taxes.

The preceding provisions would apply beginning in tax year 2020. Reduce individual income tax collections by an estimated \$4,100,000 in 2020-21. The reduction is estimated at \$6,200,000 in 2021-22 and \$7,500,000 in 2022-23.

DISCUSSION POINTS

1. According to the Wisconsin Realtors Association, at least nine states have first-time home buyer savings accounts, including Iowa and Minnesota. While the programs differ from state to state, state tax benefits are a feature of each state's program. The Budget in Brief indicates that the Governor's proposal is intended to address concerns regarding housing affordability by providing "an incentive for prospective homeowners to build savings for a down payment and eligible closing costs" for the purchase of a first home.

2. Concerns about housing affordability have been prompted by a decline in the home ownership rate, defined as the number of owner-occupied housing units as a percentage of total occupied housing units. The U.S. home ownership rate peaked in 2004 at 69.0%, the same year that Wisconsin's rate peaked at 73.3%. After 2004, both rates declined over a multi-year period, with Wisconsin's home ownership rate reaching its nadir in 2015 at 66.6%, one year before the U.S. rate reached 63.4% in 2016. Since then, the U.S. home ownership rate has risen one percentage point to 64.4% in 2018, but has been outpaced by the Wisconsin rate, which improved to 67.9%, albeit over three years instead of two. Table 1 reports the change in the two rates since 1985.

TABLE 1

**Homeownership Rate, U.S. and Wisconsin:
1985 - 2018**

<u>Year</u>	<u>U.S.</u>	<u>Wisconsin</u>
1985	63.9%	63.8%
1990	63.9	68.3
1995	64.7	67.5
2000	67.4	71.8
2005	68.9	71.1
2010	66.9	71.0
2015	63.7	66.6
2018	64.4	67.9

Source: U.S. Census Bureau, Current Population Survey/Housing Vacancy Survey.

3. The 2004 peak in the homeownership rate was attributable, in part, to the housing bubble, and the bursting of the bubble precipitated the worst national economic downturn since the Great Depression. Although the housing market's recovery from the 2007-2009 recession has been slow, it could be argued that homeownership rates have returned to their natural levels. The 2018 home ownership rates for the U.S. and Wisconsin are comparable to the rates that occurred between 1985 and 1995, and a 2016 report in the housing Market Perspectives series of the Federal Reserve Bank of St. Louis notes, "Prior to the 1990s, the homeownership rate had fluctuated for three decades in a narrow band between 63 and 66 percent. This still might be the range to expect in the future."

4. To protect against a similar economic downturn in the future, a variety of safeguards have been implemented, including many affecting residential lending practices. These include more rigorous verification of borrowers' income and assets, oversight of credit rating agencies, lower loan to value ratios for home mortgages, regulations related to real estate appraisals, and fewer subprime mortgages. In addition, the Federal Reserve performs stress tests on banks and imposes capital reserve requirements based on a bank's loan portfolio. While intended to enhance the nation's economic security, the additional regulation has had some negative effects, such as hampering community banks' ability to be responsive to their community's needs and the inability of non-traditional borrowers to secure loans.

5. The safeguards implemented after the recession may disproportionately impact first-time home buyers. A proxy for this group could be individuals who are 35 years of age or younger because most individuals who become homeowners do so before they reach middle age. The homeownership data maintained by the U.S. Census Bureau includes data on homeownership rates by age category. Table 2 reports home ownership rates by age category for the nation as a whole between 1985 and 2018. During this period, the homeownership rate decreased for each of the age groups displayed, except for homeowners in the 65 years and over group. Between 2005 and 2018, the homeownership rate decreased for each of the age groups, as well as for the nation as a whole. The decrease for the under 35 age group (-15.8%) was greater than for any other age group and more

than twice the rate of decrease for the nation as a whole (-6.5%). Since 2015, the homeownership rate has increased for the under 35 and the 35 to 44 age groups, while remaining stable for the other age groups.

TABLE 2

**Homeownership Rates by Age of Homeowner, United States:
1985 to 2018**

<u>Year</u>	<u>Under 35</u>	<u>35 to 44</u>	<u>45 to 54</u>	<u>55 to 64</u>	<u>65 and Over</u>
1985	39.9%	68.1%	75.9%	79.5%	74.8%
1990	38.5	66.3	75.2	79.3	76.3
1995	38.6	65.2	75.2	79.5	78.1
2000	40.8	67.9	76.5	80.3	80.4
2005	43.0	69.3	76.6	81.2	80.6
2010	39.1	65.0	73.5	79.0	80.5
2015	35.0	58.5	70.0	75.4	78.9
2018	36.2	60.1	70.1	75.4	78.5
<u>Change</u>					
2005 to 2018	-15.8%	-13.3%	-8.5%	-7.1%	-2.6%
2010 to 2018	-7.4	-7.5	-4.6	-4.6	-2.5
2015 to 2018	3.4	2.7	0.1	0.0	-0.5

6. Some of the decrease in homeownership rates may relate to housing affordability, which can be gauged by comparing the change in per capita income, as determined by the U.S. Department of Commerce, Bureau of Economic Analysis (BEA), to the house price index, as determined by the Federal Housing Finance Authority (FHFA). The index measures average price changes in repeat sales or refinancings on the same properties, based on properties whose mortgages have been purchased or secured by Fannie Mae (Federal National Mortgage Association) or Freddie Mac (Federal Home Loan Mortgage Corporation). Both the BEA and FHFA maintain data specific to Wisconsin. For the 23-year period between 1995 and 2018, the average per capita income in Wisconsin has grown slightly faster than Wisconsin housing values, and the two rates of change between 2010 and 2018 are almost identical. However since 2015 when Wisconsin's homeownership rate reached its post-recession low point, the average rate of growth in Wisconsin's house price index (6.3%) is more than double the rate of growth in Wisconsin's per capita personal income (2.9%), indicating that Wisconsin housing has become less affordable over this period. These data are displayed in Table 3.

TABLE 3

Average Rate of Change in Wisconsin Per Capita Personal Income and Wisconsin House Price Index for Select Periods Ending in 2018

<u>Period Beginning</u>	<u>Per Capita Personal Income</u>	<u>House Price Index</u>
1995 (23-yr. avg.)	3.5%	3.0%
2000 (18-yr. avg.)	3.0	2.6
2005 (13-yr. avg.)	3.0	1.3
2010 (8-yr. avg.)	3.4	3.3
2015 (3-yr. avg.)	2.9	6.3

7. One reason to provide assistance to first-time homebuyers is due to their importance to the residential real estate market. Without buyers for entry-level homes, owners of those homes are unable to "move up" in the market. The National Association of Realtors has conducted a survey of homebuyers since 1981 and reports that first-time homebuyers have historically comprised nearly 40% of the purchases of homes to be used as the buyer's primary residence. In 2015, sales to first-time homebuyers equaled 32% of sales, the second lowest percentage in the survey's history. The percentage of sales to first-time buyers climbed to 35% in 2016, but has declined in each of the two subsequent years, totaling only 33% in 2018.

8. Recent increases in home appreciation rates and higher loan-to-value requirements since the recession have combined to make the down payment a constraint for many first-time homebuyers. Other contributing factors, such as "burdensome student loans and rising rents," as noted in a 2015 Urban Institute report, "A Closer Look at the Data on First-Time Homebuyers," also make saving for a down payment more difficult. Based on an examination of debt levels of young adults between the ages of 24 and 32 from 2005 to 2014, a U.S. Federal Reserve System report concludes that 20% of the decrease in the young adult homeownership rate is due to student loan debt. The report indicates that the average real per capita student loan debt doubled between 2005 and 2014.

9. The proposed first-time homebuyer accounts would help prospective buyers overcome these obstacles and accumulate a down payment. It would allow individuals seeking to enter the housing market to establish a first-time home buyer account at a financial institution and make contributions to the account which would be deductible for state tax purposes. Also, account earnings would not be subject to state tax. Contributions would be limited to no more than \$5,000 per year for each account holder, or \$10,000 if the account holder is a married joint filer. Under these adjustments, account holders would be prohibited from subtracting more than \$50,000 per account. Accounts would be permitted to exist for up to ten years after their creation.

10. Because contributions would not be deductible for federal tax purposes and account earnings would be subject to federal tax, the two state tax treatments would occur as subtractions to federal AGI on state tax forms. Also, disbursements from dissolved accounts and amounts withdrawn from accounts for any reason other than for the payment or reimbursement of eligible costs would be

reported on state tax forms as additions to federal AGI. The proposed state tax treatments are estimated to decrease individual income tax collections by \$4.1 million in 2020-21. This assumes that over 8,000 tax filers would claim deductions averaging \$7,850 and totaling \$66.0 million in tax year 2020. The tax benefit per file would average \$492. As more prospective buyers open accounts and make deductible contributions, the statewide tax decrease is estimated to increase to \$6.2 million in 2021-22 and \$7.5 million in 2022-23.

11. If the Committee prefers a smaller state tax reduction, lower contribution limits could be specified. For example, if the annual contribution limits were set at \$3,750 and \$7,500 for married joint filers, a 2020-21 decrease in individual income tax collections estimated at \$3.1 million would result, \$1.0 million less than under the Governor's proposal. If the contribution limits were set at \$2,500 and \$5,000, a 2020-21 decrease in individual income tax collections estimated at \$2.1 million would result, \$2.0 less than under the Governor's proposal. The estimated average tax benefit would decrease from \$492 under the Governor to \$369 and \$246, respectively under these alternatives. These alternatives are presented as Alternatives 2.a. and 2.b.

12. Another option would be to remove the deduction for account contributions and limit the state tax benefit to the exclusion for account earnings. Under this option, accounts would operate similarly to Roth IRA and 401k plans, but without the federal tax benefits. An argument against this approach is that one of the barriers that first-time homebuyers face is difficulty saving for a down payment. Consequently, the deduction for contributions under the Governor's proposal address this issue. Nonetheless, if the Committee prefers a Roth-styled approach for first-time homebuyer accounts, the deduction for contributions could be removed, increasing individual income tax collections by an estimated \$4.1 million relative to the bill. This is presented as Alternative 3.

13. The proposal's fiscal effect indicates that a larger decrease in state tax collections in the 2021-23 biennium than in the 2019-21 biennium. The program is not likely to be fully phased-in for five to ten years, when the number of newly created accounts is offset by the number of dissolved accounts. If the Committee is concerned about the potential long-term impact of the proposal, the \$50,000 limitation on tax-preferred deposits could be reduced. An account with a \$50,000 balance could provide a 20% down payment on a home with a \$250,000 selling price. This is considerably higher than the 2018 median sales price of \$184,000 reported by the Wisconsin Realtors Association (WRA). However, home prices vary considerably based on location, and WRA reports that 2018 median sale prices ranged from \$155,000 for 18 counties in northern Wisconsin to \$226,500 for the 12 counties in south central Wisconsin.

14. A 20% down payment is a goal for many buyers because a down payment at that level eliminates the requirement for private mortgage insurance (PMI), which protects the lender against foreclosure. PMI premiums typically increase a homeowner's mortgage payment by \$30 to \$70 per month for every \$100,000 borrowed. If a buyer is willing to incur that cost, conventional mortgages are available in the private sector with down payments of less than 20%. In addition, a 3.5% down payment is available to an eligible buyer under the Federal Housing Authority (FHA) mortgage program. Alternative 4 would lower the proposed limitation on tax-preferred deposits from \$50,000 to \$30,000, although the Committee could set the limit at another level. Adopting this alternative would not immediately affect the proposal's fiscal estimate, but would reduce the proposal's fiscal

effect in future years.

ALTERNATIVES

1. Approve the Governor's proposal to create a first-time homebuyer savings account program, beginning in tax year 2020. Reduce individual income tax collections by an estimated \$4,100,000 in 2020-21.

ALT 1	Change to	
	Base	Bill
GPR-Tax	- \$4,100,000	\$0

2. Modify the Governor's proposal to create a first-time home buyer savings account program. Based on the amount deposited in an account, reduce the limit on the annual amount that an account holder may subtract from federal AGI from \$5,000, or \$10,000 in the case of a joint filer, to either: (a) \$3,750, or \$7,500 in the case of a joint filer; or (b) \$2,500, or \$5,000 in the case of a joint filer. Relative to current law, reduce individual income tax collections in 2020-21 by an estimated \$3,100,000 under (a) or \$2,100,000 under (b). Relative to the bill, increase individual income tax collections by an estimated \$1,000,000 under (a) or \$2,000,000 under (b).

ALT 2	Change to	
	Base	Bill
a. GPR-Tax	- \$3,100,000	\$1,000,000
b. GPR-Tax	- 2,100,000	2,000,000

3. Modify the Governor's proposal to create a first-time home buyer savings account program by eliminating the proposed individual income tax subtraction from federal AGI based on the amount that an account holder deposits in a first-time home buyer savings account. The proposed subtraction for interest, dividends, or other gain that accrues and is redeposited to an account would be retained. Modify the proposed addition to federal AGI to apply only to the withdrawal of amounts subject to the remaining subtraction. Increase individual income tax collections in 2020-21 by an estimated \$4,100,000, relative to the bill.

ALT 3	Change to	
	Base	Bill
GPR-Tax	\$0	\$4,100,000

4. Modify the Governor's proposal to create a first-time home buyer savings account program by reducing the limitation on the total amount that may be subtracted from federal AGI from not more than a total of \$50,000 of deposits to a total of not more than \$30,000 of deposits. This

alternative could be adopted with any of the preceding alternatives, without changing the reported fiscal effect.

5. Take no action. Relative to the bill, increase individual income tax collections in 2020-21 by an estimated \$4,100,000.

ALT 5	Change to	
	Base	Bill
GPR-Tax	\$0	\$4,100,000

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