Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Blakeslee	Analyst:	Nicole Kwon	Bill Number:	AB 3
Related Bills:	See Legislative History	Telephone:	845-7800	Introduced Date:	12-6-2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Qualified Tuition Program Or Coverdell Education Savings Account Deduction

SUMMARY

This bill would allow a deduction for contributions made by a taxpayer to a qualified tuition program and to a Coverdell education savings account.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to allow an additional tax benefit for taxpayers that make contributions to a qualified tuition program and to a Coverdell education savings account, thus providing tax relief to the taxpayers.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately and apply to taxable years beginning on or after January 1, 2005.

POSITION

Pending.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Under federal law, Internal Revenue Code (IRC) Section 529 provides tax-exempt status to "qualified tuition programs" (QTPs). QTPs are programs established and maintained by a state, an agency, or an eligible educational institution to purchase tuition credits or make cash contributions on behalf of designated beneficiaries. Only states may establish cash account QTPs. No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified tuition program with respect to any distribution from, or earnings under, such program, except to the extent such distributions exceed qualified higher education expenses.

Any person may make contributions to a Section 529 plan. Contributions are not deductible. Under the Internal Revenue Service's established "safe harbor," contributions in excess of those necessary to provide qualified higher education expenses of the beneficiary are prohibited.

Board Position:			Department Director	Date
______ S	______ NA	______ NP		
______ SA	______ O	______ NAR	Gerald H. Goldberg	2/25/05
______ N	______ OUA	__X__ PENDING		

For 2001 through 2005, federal law allows eligible individuals an above-the-line deduction for qualified higher-education expenses paid during the taxable year. For 2003, the maximum deduction was $3,000 for taxpayers with modified adjusted gross income not in excess of $65,000 ($130,000 for a joint return). For 2004 and 2005, the maximum deduction for these taxpayers is $4,000 and, for taxpayers with modified adjusted gross income in excess of $65,000 ($130,000, joint) but not in excess of $80,000 ($160,000, joint), the maximum deduction is $2,000.

IRC Section 530 provides tax-exempt status to Coverdell education savings accounts. IRC Section 530 (b) explains the term "Coverdell education savings account" as a trust created or organized in the United States exclusively for the purpose of paying the qualified education expenses of an individual who is the designated beneficiary of the trust and designated as a Coverdell education savings account at the time created or organized.

California law conforms to federal law as it relates to tax-exempt QTPs. In addition, state law in the Education Code known as the Golden State Scholarshare Trust Act establishes authority for California's qualified state tuition plan. There is no limitation on who may make a contribution to a Golden State Scholarshare Trust Account or where a designated beneficiary must incur qualified higher education expenses. The trust is required to provide a copy of the report as specified under IRC Section 529 (d) to the Franchise Tax Board (FTB).

California law conforms to federal law, as amended by the federal Military Family Tax Relief Act of 2003, that relates to Coverdell education savings accounts. The Coverdell education savings account is exempt from income tax, and distributions are tax-free if used for qualified education expenses.

California law does not allow an above-the-line deduction for qualified higher-education expenses.

THIS BILL

This bill would allow a deduction, not to exceed $750 per taxable year per each designated beneficiary, as a deduction to taxpayers who make contributions to a QTP and to a Coverdell education savings account.

Since this bill does not specify otherwise, this deduction would be considered a miscellaneous itemized deduction and allowed only to the extent that all miscellaneous deductions exceed 2% of adjusted gross income.

IMPLEMENTATION CONSIDERATIONS

This bill is not clear if the deduction, not to exceed $750 per taxable year per each designated beneficiary, is limited to either a QTP *or* a Coverdell education savings account, or whether a taxpayer can take a deduction of $750 for both a QTP *and* a Coverdell education savings account.

LEGISLATIVE HISTORY

Federal law, P.L. 104-188 (1996), amended by P.L. 105-34 (1997), established an exemption from federal taxation and tax-deferred treatment for contributions to and earnings from qualified state tuition programs.

AB 530 (Stats. 1997, Ch. 851) established the California Golden State Scholarshare program in conformity with the federal qualified state tuition criteria. It provided an exemption from state taxation and tax deferred treatment for earnings from the Scholarshare program.

AB 2797 (Stats. 1998, Ch 322) allows, by direct conformity to the federal provisions, an exemption from state taxation and tax deferred treatment for contributions to and earnings from any state's qualified state tuition program.

SB 1262 (Stats. 1999, Ch. 664) made a number of technical changes to the California Golden State Scholarshare program under the Education Code, including making the Scholarshare Investment Board, which is chaired by the state Treasurer, responsible for administering the program instead of the Student Aid Commission.

SB 30 (Speier, 2005/2006) contains similar provisions as this bill. SB 30 also would allow FTB to require a trust to withhold an amount of the refund from nonresidents of California if any portion of the contribution made by a taxpayer to a trust is refunded back to the taxpayer.

OTHER STATES' INFORMATION

The states surveyed include *Illinois, Massachusetts,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Illinois has the College Savings Pool program named "Bright Start." A deduction is allowed from an individual's adjusted gross income for contributions made to the College Savings Pool.

Massachusetts is aligned with federal treatment of qualified tuition programs under IRC section 529, excluding distributions from the beneficiary's federal gross income to the extent the distribution is used to pay for qualified higher education expenses.

New York has the New York State College Savings Program in which an account owner may deduct contributions made to one or more family tuition plans from federal adjusted gross income in computing New York adjusted gross income.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 3 As Introduced December 6, 2004 [$ In Millions]		
2005-06	2006-07	2007-08
-$11	-$12	-$13

Tax Revenue Discussion

The revenue impact of the bill would be determined by the amount of contributions to qualified education-targeted savings programs deducted on tax returns each year and the marginal tax rate of qualified taxpayers reporting such deductions.

In 2005, total contributions by California taxpayers to qualified tuition programs and Coverdell education savings accounts are projected at approximately $2.7 billion. It is estimated that contributions of approximately $765 million would be under the proposed deduction limitation of $750 per designated beneficiary. Contributions of $765 million are reduced to eliminate taxpayers who would not itemize deductions or, if they itemized, would not have sufficient miscellaneous itemized deductions (with the proposed deduction in place) to exceed the 2% of adjusted gross income threshold. It is estimated that slightly less than one-quarter of the $765 million would be deducted on tax returns, or $175 million. Applying an average marginal tax rate of 6% to the amount of deductible contributions derives a revenue loss of $10.5 million for the 2005 taxable year [$175 million x 6% = $10.5 million]. Amounts of contributions deducted on tax returns are projected to increase each subsequent year due to growth in the number of qualified education-targeted savings accounts.

Taxable year estimates were converted to cash-flow estimates above. Cash-flow estimates reflect the ability of some taxpayers to accelerate tax benefits by adjusting their estimated tax payments.

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