

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Niello Analyst: William Koch Bill Number: AB 757
Related Bills: See Legislative History Telephone: 845-4372 Introduced Date: February 26, 2009
Attorney: Patrick Kusiak Sponsor:

SUBJECT: Education Savings Accounts

SUMMARY

This bill would allow an amount deposited by a taxpayer during the taxable year in an education savings account to be excluded from the gross income of the beneficiary of the account and allow any interest earned by the education savings account to be exempt from taxation, except as otherwise provided.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to help offset the cost of education for parents of students in kindergarten and grades 1 to 12.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2009.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

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 benefit QTPs. No amount is included in the gross income of a contributor to, or a beneficiary of, a QTP with respect to any distribution from, or earnings under, such program, except to the extent such distributions exceed qualified higher education expenses.

Table with Board Position (S, NA, NP, SA, O, NAR, N, OUA, X, PENDING), Department Director (Selvi Stanislaus), and Date (05/01/09).

Any person may make contributions to a section 529 plan. Under federal law, contributions made to a section 529 plan are not deductible. Contributions in excess of those necessary to provide qualified higher education expenses of the beneficiary are prohibited.

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. The maximum amount that can be contributed to a Coverdell education savings account is \$2,000 per beneficiary, per year. Contributions are not deductible.

Qualified education expenses under Coverdell education savings accounts include expenses related to attending kindergarten and grades 1 to 12, as well as colleges and universities.

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.

California law also conforms to federal law relating 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, including expenses related to attending kindergarten and grades 1 to 12.

THIS BILL

This bill would allow any amount deposited by a taxpayer during the taxable year in an education savings account to be excluded from the gross income of the beneficiary of the account. This bill would also allow any interest earned by the education savings account to be exempt from taxation if the distributions are made for the purposes of paying qualified education expenses.

This bill would do the following:

1. Define "education savings account" as a trustee or custodial account that meets both of the following requirements:
 - Is established by an individual, or established jointly by an individual and his or her spouse, and designated as an education savings account by the trustee or custodian.
 - Is established for the exclusive benefit of any individual establishing the account or his or her spouse, or their dependents, if the written governing instrument creating the account provides both of the following:
 - A requirement for all contributions to the account to be in cash.
 - The account is established to pay the qualified education expenses of the individual establishing the account or his or her spouse, or their dependents.

2. Define "trustee or custodian" to mean a bank, as defined by section 408(n) of the IRC, or any person authorized to act as the trustee or custodian of an individual retirement account pursuant to section 409(a) of the IRC.
3. Define "Qualified education expense" as education expenses related to attending a school teaching kindergarten and grades 1 to 12 inclusive, in this state. Education expenses would include tuition, fees, books, supplies, equipment, room and board, academic tutoring, the purchase of computer technology equipment, or Internet access related services, uniforms, transportation, and supplementary items and services such as extended day programs as required or provided by the school.
4. Provide the term "dependent" would mean the same as the term is defined by section 152 of the IRC.
5. Require any amount withdrawn or distributed from an education savings account to be subject to a penalty equal to 10 percent of the payment or distribution unless it is used to pay for the qualified education expenses of an individual that established the account or his or her spouse or their dependents.
6. Allow the transfer of an individual's interest in an education savings account to his or her former spouse under a dissolution decree or under a written instrument incident to a dissolution decree to be considered a tax exempt transfer made by that individual as long as the transferred moneys are deposited into another education savings account established by the former spouse.
7. Require the trustee or custodian of an education saving account to make annual calendar year reports regarding the status of the account. The reports would include:
 - The amount of contributions.
 - The amount of distributions.
 - The name and address of the trustee or custodian.
 - Any other information as required by the Franchise Tax Board.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

It is unclear if the author's intent is to allow tax exemption for principal amounts contributed to and distributed from an education savings account. The bill language indicates any amount deposited by a taxpayer during the taxable year in an education savings account is excludable from the gross income of the beneficiary of the account. The bill defines, in part, an education savings account as an account that is established for the exclusive benefit of any individual establishing the account or his or her spouse, or their dependents. Based on these provisions, differing interpretations could occur. For example, a taxpayer could argue that he or she should be able to exclude amounts from gross income that he or she deposited into an education savings account claiming that he or she established the account for his or her own benefit. If this is not the author's intent, the bill should be amended to provide clarity on this issue.

This bill would also require any non-qualifying distribution from an education savings account to be subject to a state penalty equal to 10 percent of the distribution. If it is the author's intent to allow exclusion of contributions from gross income, the bill is silent as to the treatment of the amounts previously excluded from gross income if the payment or distribution is not used to pay education expenses. If the author's intent is to require previously excluded amounts to be included in gross income, the bill should be amended to explicitly require payments or distributions to be included in gross income if the amounts are not used to pay qualified education expenses.

TECHNICAL CONSIDERATIONS

On page 2, line 26, the language states "the purchase of computer technology, equipment, or." It appears the "," after technology was inserted in error and should be struck.

LEGISLATIVE HISTORY

AB 529 (Blumenfield, 2009/2010) would allow a deduction for amounts contributed to a Golden State Scholarshare Savings Trust. This bill is currently referred to the Assembly Revenue and Taxation Committee.

AB 819 (Runner, 2007/2008) would have allowed a deduction for contributions made by a qualified taxpayer to certain qualified tuition programs. This bill failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

SB 643 (Florez, 2007/2008) would have allowed a deduction for contributions made by a qualified taxpayer to a qualified tuition program and required the Scholarshare Investment Board to make a one-time contribution to certain qualified tuition programs. This bill failed to pass out of the Senate Revenue and Taxation Committee by the constitutional deadline.

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.

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.

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

OTHER STATES' INFORMATION

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

None of these states offer an education savings account that is stand-alone, or decoupled from federal law, similar to this bill.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, this bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on the data and assumptions discussed below, this bill would result in the following revenue losses beginning in fiscal year 2010-11.

Estimated Revenue Impact of AB 757 Effective for Taxable Years BOA January 1, 2009 Assumed Enacted after June 30, 2009		
2009-10	2010-11	2011-12
No impact	-\$2,000	-\$13,000

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue loss generated by this bill is a result of excluding interest earnings from current taxation. The revenue loss is calculated by estimating the number of education saving accounts opened each year, annual cash contributions, interest income earned on such deposits and the average marginal tax rate of qualified beneficiaries or parents.

The number of accounts that would be opened each year as a result of this bill is unknown. In California, for the 2007/08 school year, approximately 6.2 million children were enrolled in public schools and approximately 500,000 children in private schools (kindergarten and grades 1 to 12). In response to the creation of a new education savings program, it is assumed that mainly students enrolled in private schools would potentially have an account created for them as a result of this bill. In addition to students currently enrolled in kindergarten and grades 1 to 12, this new education savings program could also attract participation of children currently at the pre-kindergarten stage (0 to 4 years old). California's pre-k population is approximately 2.5 million children. Because the proposed education savings account would provide only a state income tax benefit and because other education savings programs exist that provide both federal and state income tax benefits, participation is projected at one in every one hundred students/children, or approximately 92,000 accounts [(6.2 million public school students + 500,000 private school students + 2.5 million pre-k children) x 1%].

Because it will take time for banks to offer these new education savings accounts and allowing time for taxpayers to learn of the program, participation is anticipated to gradually increase over a six-year period to a total of 92,000 accounts; with 10 percent or 9,200 accounts opened during 2010.

For accounts opened during 2010, contributions are estimated at \$11 million. This assumes cash contributions of \$200 per month for six months (9,200 accounts x \$2,400 annual contribution x 6/12 months ≈ \$11 million). Using an annual rate of interest of 1.5%, interest income earned during 2010 would total \$82,500 (\$11 million x 1.5% x 6/12 months = \$82,500). It is assumed that half, or \$41,250 of interest earned, absent this bill, would have been taxed. Of the remaining \$41,250, it is assumed that half would have been taxed at a child's average marginal tax rate of 1.25 percent and the remaining at the parent's average marginal tax rate of 8 percent, this bill would generate a revenue loss of approximately \$2,000 [(\$20,625 x 1.25%) + (\$20,625 x 8%) ≈ \$2,000]. The offering of education savings accounts is anticipated to be delayed by banks until 2010; under current law, this income is assumed to have been reported at the time of filing the income tax return. Therefore, the total revenue loss of \$2,000 is attributable to fiscal year 2010/11. The revenue impact for fiscal year 2011/12 includes an increase in the value of accounts (and interest income) opened during 2010 and newly created accounts.

POLICY CONCERNS

This bill would allow interest earned by a qualifying education savings account to be exempt from California income tax. This would result in differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

This bill would also require any non-qualifying distribution from an education savings account to be subject to a state penalty equal to 10 percent of the distribution. Non-qualifying distributions from QTPs are generally subject to a 10 percent federal penalty and a 2.5 percent state penalty.

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