Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Linder	Analyst:	Scott McFarlane	Bill Number:	AB 1796
Related Bills:	See Legislative History	Telephone:	845-6075	Introduced Date:	February 18, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Deduction for Contributions to Qualified Tuition Programs

SUMMARY

This bill would, under the Personal Income Tax Law, allow individuals to deduct certain contributions made to qualified tuition programs.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for the bill is to encourage more Californians to save for college.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 2014.

ANALYSIS

FEDERAL/STATE LAW

Federal Law

Internal Revenue Code (IRC) section 529 provides specified income tax rules for the treatment of accounts and contracts established as qualified tuition programs.[1] A qualified tuition program is a program established and maintained by a state or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a “prepaid tuition program”). In the case of a program established and maintained by

[1] For purposes of this description, the term “account” is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

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a state or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a “savings account program”). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary’s higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time.

Contributions to a qualified tuition program must be made in cash. IRC section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary’s qualified higher education expenses. Contributions are not tax deductible for federal income tax purposes, although they may be deductible for state income tax purposes. Amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan is not subject to current income tax).

Distributions from a qualified tuition program are excludable from the distributee’s gross income to the extent that the total distribution does not exceed the qualified higher education expenses incurred for the beneficiary. If a distribution from a qualified tuition program exceeds the qualified higher education expenses incurred for the beneficiary, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”) whom the program administrator (oftentimes a third-party administrator retained by the state or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who contribute to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.[2]

[2] IRC section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term account owner, which is a commonly-used term among qualified tuition programs.

State Law

Conformity to IRC section 529 in General

California conforms to IRC section 529 as of the “specified date” of January 1, 2009, with general state modifications, and thus generally conforms to the federal rules that apply to qualified tuition programs.[3] California modifies the additional 10-percent tax on excess distributions to instead be an additional tax of 2.5 percent for state purposes.[4]

California’s Qualified Tuition Program

California has its own IRC section 529 qualified tuition program, the Golden State Scholarshare Trust, commonly referred to as “ScholarShare.”[5] ScholarShare is a higher education expense prepayment program that allows purchasers to pay in advance for a designated beneficiary’s educational costs at a participating institution.

ScholarShare generally exempts from taxation the earnings from the trust at the time they are earned, provides that distributions in excess of amounts contributed (such as interest earnings) are included in the gross income of the designated beneficiary at the time the distributions are made, and provides that the furnishing of education to a designated beneficiary is considered a distribution. If a ScholarShare distribution exceeds the qualified higher education expenses incurred for the beneficiary, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 2.5-percent tax for state purposes.[6]

Parents, grandparents, relatives, and friends who are U.S. citizens or resident aliens and at least 18 years of age may open an account and contribute to ScholarShare on behalf of a beneficiary. ScholarShare funds can be used at eligible schools nationwide and many abroad, and funds can be used for tuition, mandatory fees, books, supplies, and equipment required for enrollment or attendance, certain room and board costs, and certain expenses for "special needs" students.

ScholarShare accounts have no income limitations, and contributors can contribute as much as $371,000 per beneficiary account as long the total balance of all accounts for that beneficiary does not exceed $371,000. Accounts that have reached the maximum account balance limit may continue to accrue earnings. ScholarShare contributions are not deductible.

THIS BILL

This bill would allow a deduction from California adjusted gross income for amounts contributed by a qualified taxpayer to a qualified tuition program. The deduction would be limited to $3,000 for each taxable year for a single individual or a married individual filing a separate return, and $6,000 for each taxable year for a married individual filing a joint return or an individual filing as a head of household.

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[3] Revenue and Taxation Code (R&TC) sections 17140.3 and 23711.

[4] R&TC section 17085(c)(1).

[5] R&TC sections 17140, 23711.5, and 24306. The Golden State Scholarshare Trust was designed to meet the requirements of IRC section 529 as a qualified tuition program, see Section 7 of Chapter 851 of the Statutes of 1997 (AB 530).

[6] The additional tax is 10 percent for federal purposes.

The deduction would be treated as a miscellaneous itemized deduction not subject to the two-percent floor, meaning the general rule that provides that miscellaneous itemized deductions are deductible only to the extent they exceed two percent of federal adjusted gross income would not apply; instead, contributions would be deductible as a miscellaneous itemized deductions up to the $3,000 and $6,000 limitations described above.

A qualified taxpayer would mean an individual who, on behalf of a beneficiary, contributes money to a qualified tuition program and meets all of the other applicable requirements of IRC section 529, as modified by R&TC section 17140.3.

IMPLEMENTATION CONSIDERATIONS

This bill would not significantly impact the department's programs or operations.

LEGISLATIVE HISTORY

AB 1956 (Bonilla, 2013/2014) would generally provide a refundable tax credit of up to $500 per taxable year for contributions to a ScholarShare account. AB 1956 is currently in the Assembly Revenue and Taxation Committee.

AB 2625 (Solorio, 2011/2012) would have allowed a taxpayer to designate on his or her personal income tax return an amount in excess of tax liability to be deposited into an ScholarShare account. AB 2625 was held in the Assembly Appropriations Committee.

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. A review of these states' laws found the following:

Florida does not impose an individual income tax, so a comparison to *Florida* is not relevant.

Illinois conforms to IRC section 529, and has three state-established IRC section 529 qualified tuition programs: the College Illinois Prepaid Tuition Plan, the Bright Start College Savings Plan, and the Bright Directions College Savings Program. *Illinois* allows a deduction of up to $10,000 per taxable year for single filers and up to $20,000 per year for joint filers for contributions to its qualified tuition programs.

Massachusetts is aligned with federal treatment of qualified tuition programs under IRC section 529, and has its own state-established IRC section 529 qualified tuition program, the U Plan Prepaid Tuition Program. *Massachusetts* does not allow a deduction for contributions to its qualified tuition program.

Michigan conforms to IRC section 529, and allows deductions of up to $5,000 per taxable year for single filers and $10,000 per taxable year for joint filers for contributions to its state-established IRC section 529 qualified tuition program, the Michigan Education Savings Program.

Minnesota conforms to IRC section 529, and has its own state-established IRC section 529 qualified tuition program, the Minnesota College Savings Plan. *Minnesota* does not allow a deduction for contributions to its qualified tuition program.

New York is aligned with federal treatment of qualified tuition programs under IRC section 529, and has its own state-established IRC section 529 qualified tuition program, the New York State College Choice Tuition Savings Program. *New York* allows a deduction of up to $10,000 per taxable year for single filers and up to $20,000 per year for joint filers for contributions to its qualified tuition program.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1796 As Introduced February 18, 2014 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)		
2014-15	2015-16	2016-17
- $340	- $230	- $240

SUPPORT/OPPOSITION

Support: Unknown.

Opposition: Unknown.

ARGUMENTS

Proponents: Those in support of this bill may argue that it would provide much-needed tax relief to families who do not meet the income threshold for financial aid but do not make enough money to comfortably pay for higher-education expenses.

Opponents: Those who oppose this bill may argue that its proposed contribution deduction should be expanded to be available to taxpayers who claim the standard deduction instead of limiting the proposed deduction to taxpayers who itemize deductions.

POLICY CONCERNS

This bill would create a difference between federal and California tax law, thereby increasing the complexity of California tax-return preparation.

LEGISLATIVE STAFF CONTACT

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