

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Nestande and Allen Analyst: Jane Raboy Bill Number: AB 2426
Related Bills: See Legislative History Telephone: 845-5718 Amended Date: April 1, 2014
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Contribution Exclusion for the Coverdell Education Savings Accounts

SUMMARY

This bill would allow an exclusion for contributions to a Coverdell education savings account (Coverdell Account) under the Personal Income Tax Law.

RECOMMENDATION

No position.

Summary of Amendments

The April 1, 2014, amendments added a coauthor and replaced legislative intent language with the provisions discussed in this analysis. This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for this bill is to encourage families to invest and plan for qualified educational expenses.

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, 2014.

ANALYSIS

FEDERAL/STATE LAW

Under Section 530 of the Internal Revenue Code (IRC Section 530), a Coverdell Account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary. For 2013, the maximum annual contributions to a Coverdell Account may not exceed \$2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary).

Board Position:

_____ S _____ NA X NP
_____ SA _____ O _____ NAR
_____ N _____ OUA

Executive Officer

Date

Selvi Stanislaus

5/12/14

The contribution limit is phased out for taxpayers with modified adjusted gross income (AGI) between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Contributions to a Coverdell Account are not tax-deductible, but the earnings grow tax-free, and so do withdrawals, as long as the distributions are used for qualified education expenses. Earnings on contributions to a Coverdell Account generally are subject to tax when withdrawn.¹ However, distributions from a Coverdell Account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell Account distribution not used to pay qualified education expenses is includable in the gross income of the distributee and generally is subject to an additional 10-percent tax.²

As defined under IRC Section 530, qualified education expenses include “qualified higher education expenses” and “qualified elementary and secondary education expenses.” The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. The funds for “qualified elementary and secondary education expenses” can be used to cover the costs of attending elementary and secondary school, kindergarten through grade 12. In addition to tuition, these costs can include uniforms, tutoring, computers, software, and transportation.

California law does not allow a deduction for qualified higher education expenses.

California conforms to IRC section 530 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 education expenses. California modifies the additional 10-percent tax on excess distributions to instead be an additional tax of 2.5 percent for state purposes.

THIS BILL

This bill would allow an exclusion from gross income, up to a maximum of \$750, for contributions during the taxable year to a Coverdell Account.

This bill would define the following:

- "Coverdell Account" to have the same meaning as defined by Section 530 of the Internal Revenue Code.
- "Dependent"³ to have the same meaning as defined by Section 152 of the Internal Revenue Code.

¹ In addition, Coverdell Accounts are subject to the unrelated business income tax imposed by IRC section 511.

² This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

³ The term “dependent” means- (1) a qualifying child, as specified, or (2) a qualifying relative, as specified.

- "Qualified education expenses"⁴ to have the same meaning as defined by Section 530 of the Internal Revenue Code.

Any amounts withdrawn or distributed from a Coverdell Account would:

- Subject the taxpayer to a 2.5 percent penalty; unless the payment or distribution was made to pay for qualified education expenses of the taxpayer that established the account or his or her spouse or their dependents.
- Require the taxpayer to include in gross income for the taxable year any amount previously excluded, if the withdrawals or distributions from a Coverdell account were not used to pay for qualified education expenses. The taxpayer would be liable for any increase in tax attributable to such an inclusion.

The transfer of a taxpayer's interest in a Coverdell Account to his or her former spouse under a dissolution decree or a written instrument incident to a dissolution would be a non-taxable transfer, as long as the transferred moneys are deposited into another Coverdell education savings account established by the former spouse.

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.

Because the bill fails to specify otherwise, an individual other than the taxpayer that established the Coverdell account, their spouse, or the Coverdell account's beneficiary could make an excludable contribution. Additionally, such contributions would be taxable to the beneficiary upon distribution or withdrawal regardless of being used for qualifying expenses.

Because the bill fails to specify otherwise, the 2½ percent penalty on withdrawals or distributions would apply to all withdrawals or distributions made to an account beneficiary that formerly, but no longer, met the definition of dependent at the time of a withdrawal or distribution. If this is contrary to the author's intent, this bill must be amended.

Contributions that would be excluded under this bill could occur a number of years prior to a non-qualifying withdrawal or distribution and could result in the recapture of previously excluded contributions being barred by an expired statute of limitations. To better match the non-qualifying distribution with the recapture and prevent time barred recaptures, the author may wish to amend this bill to require recapture of the excluded amount in the taxable year of the nonqualified withdrawal or distribution.

⁴ "Coverdell education savings account" means 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), as specified.

TECHNICAL CONSIDERATIONS

Because the author's intent is to create an above-the-line deduction and not establish an additional penalty imposed under current law, Amendments 1 through 6 would correct the language for this bill.

LEGISLATIVE HISTORY

AB 3 (Blakeslee, 2005/2006) would have allowed a deduction for contributions made by a taxpayer to a qualified tuition program. AB 3 failed passage in the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide a deduction comparable to the deduction allowed by this bill. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 2426 As Amended April 1, 2014 Assumed Enactment After June 30, 2014 (\$ in Millions)		
2014-15	2015-16	2016-17
- \$0.9	- \$0.6	- \$0.7

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

SUPPORT/OPPOSITION⁵

Support: CA Catholic Conference and Palm Desert Area Chamber of Commerce.

Opposition: None provided.

⁵ As provided by the Assembly Member Brian Nestande's Assembly Bill 2426, Fact Sheet as of April 3, 2014.

ARGUMENTS

Proponents: Supporters may argue that this bill may encourage additional savings in Coverdell Accounts.

Opponents: Some may argue that this bill may have a minimal impact and would fail to encourage additional savings in Coverdell Accounts.

LEGISLATIVE STAFF CONTACT

Jane Raboy

Legislative Analyst, FTB

(916) 845-5718

jane.raboy@ftb.ca.gov

Mandy Hayes

Revenue Manager, FTB

(916) 845-5125

mandy.hayes@ftb.ca.gov

Jahna Carlson

Asst. Legislative Director, FTB

(916) 845-5683

jahna.carlson@ftb.ca.gov

Analyst	Jane Raboy
Telephone #	(916) 845-5718
Attorney	Bruce Langston

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2426
AS AMENDED APRIL 1, 2014

AMENDMENT 1

On page 2, before line 1, insert:

SECTION 1. Section 17072 of the Revenue and Taxation Code is amended to read:

17072. (a) Section 62 of the Internal Revenue Code, relating to adjusted gross income defined, shall apply, except as otherwise provided.

(b) Section 62(a)(2)(D) of the Internal Revenue Code, relating to certain expenses of elementary and secondary school teachers, shall not apply.

(c) Section 62(a)(21) of the Internal Revenue Code, relating to attorneys fees relating to awards to whistleblowers, shall not apply.

(d) Section 62 (a) of the Internal Revenue Code is modified to provide that the deduction allowed under Section 17141.1, shall be allowed in determining the adjusted gross income.

AMENDMENT 2

On page 2, line 1, ~~strikeout~~ the term "SECTION 1" and insert:

"SEC. 2"

AMENDMENT 3

On page 2, line 4, after the term "contrary," ~~strikeout~~ "any" and insert:

"a deduction shall be allowed for an"

AMENDMENT 4

On page 2, lines 7 through 8, ~~strikeout~~ "shall not be includable in the gross income of the taxpayer,".

AMENDMENT 5

On page 2, ~~strikeout~~ lines 10 through 38, inclusive and insert:

(b) For purposes of this section, ~~:-~~

~~(1) "Coverdell education savings account" shall have the same meaning as that term is defined by Section 530 of the Internal Revenue Code, as modified by Section 23712.~~

~~(2) "Dependent" shall have the same meaning as that term is defined by Section 152 of the Internal Revenue Code.~~

~~(3) "Qualified education expenses" shall have the same meaning as that term is defined by Section 530 of the Internal Revenue Code.~~

~~(c) For purposes of applying Section 530 of the Internal Revenue Code, the basis of the Coverdell education savings account shall be reduced by any amount deducted pursuant to this section.~~

~~(1) Any amount withdrawn or distributed from a Coverdell education savings account shall subject the taxpayer to a penalty in an amount equal to 2.5 percent of the payment or distribution, unless the payment or distribution is made to pay for the qualified education expenses of the taxpayer that established the account or his or her spouse or their dependents.~~

~~(2) If the withdrawal or distribution from a Coverdell education savings account is not used to pay for qualified education expenses then any amount previously excluded from gross income pursuant to this section shall be included in a taxpayer's gross income for the taxable year in which the amount was excluded and the taxpayer shall be liable for any increase in tax attributable to that inclusion.~~

~~(d) Notwithstanding any other provision of this part, the transfer of a taxpayer's interest in a Coverdell education savings account to his or her former spouse under a dissolution decree or under a written instrument incident to a dissolution is not to be considered a taxable transfer made by that taxpayer, as long as the transferred moneys are deposited into another Coverdell education savings account established by the former spouse.~~

AMENDMENT 6

On page 3, line 1, ~~strikeout~~ the term "Sec. 2" and insert:

"SEC. 3"