Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Stone	Analyst:	Diane Deatherage	Bill Number:	SB 1148
Related Bills:	None	Telephone:	845-4783	Introduced Date:	February 18, 2016
		Attorney:	Bruce Langston	Sponsor	

SUBJECT: College Education Expenses Deduction

SUMMARY

This bill would allow a deduction for qualified educational expenses to be taken by a qualified taxpayer as an "above-the-line" deduction when calculating adjusted gross income (AGI), under the Personal Income Tax Law.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for this bill is to help students and their parents with rising education costs by allowing a state deduction for qualified educational expenses to be used in determining an individual or married couple's AGI.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2016.

FEDERAL LAW

Existing federal law allows for the deduction of certain expenses when calculating AGI, such as moving expenses, qualified tuition and related expenses, and interest on education loans. Thus, all taxpayers with this type of expense receive the benefit of the deduction. These are known as "above-the-line" deductions.

Through tax year 2016, an individual is allowed a deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year. The deduction is allowed in computing AGI. The term "qualified tuition and related expenses" is defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution. The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is $4,000 for an individual whose AGI for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose AGI does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose AGI exceeds the relevant AGI limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual, and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.

Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion from income under Internal Revenue Code (IRC) section 529 is claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

In addition, the deduction is subject to phase-out ratably for individual taxpayers with modified AGI of $65,000-$80,000 ($130,000 - $160,000 for joint returns).

The deduction is not allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Qualified higher education expenses are defined as the student's cost of attendance (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income for redemption of U.S. savings bonds, (2) any amount distributed from an education Individual Retirement Account and excluded from gross income, and (3) the amount of any scholarship or fellowship grants excludable from gross income, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that is excludable from the employee's gross income.

STATE LAW

California specifically does not conform to the federal qualified tuition deduction. As a result, California does not allow a deduction for qualified tuition and related expenses, and taxpayers who deduct such expenses on their federal tax returns report the amount deducted for federal purposes as a California adjustment on Schedule CA (540/540NR).

THIS BILL

For taxable years beginning on or after January 1, 2016, this bill would allow as a deduction, when determining AGI, the amount paid or incurred by a qualified taxpayer during the taxable year for qualified education expenses at a public four-year university or community college.

"Qualified education expenses" would mean both of the following:

- Costs of attendance that include, but are not limited to, payments for books, supplies, equipment, tuition, and fees, and similar payments.
- Payments of principal of a qualified education loan, as defined by the IRC.[1]

"Qualified taxpayer" would mean an individual who pays or incurs qualified education expenses during the taxable year for any natural person including, but not limited to, the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer and who has a federal AGI of $250,000 or less during the taxable year in which those expenses are paid or incurred.

Under this bill, for each taxable year beginning on or after January 1, 2017, the Franchise Tax Board would recompute the federal AGI limitation using the California Consumer Price Index as specified in Section 17041.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill's definitions contain phrases that make the definition too broad, i.e., the definition of "qualified education expenses" includes "but are not limited to," "fees and similar payments," and the definition of "qualified taxpayer" includes the phrase "but not limited to." These broad phrases would arguably allow expenses that may be weakly connected with higher education to be eligible for the deduction and the taxpayer could choose to pay for an unrelated person's education and be eligible for the deduction.

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[1] IRC section 221, relating to interest and education loans.

This could lead to disputes and would complicate the administration of this bill. The bill should be amended to more specifically define "qualified education expenses" and "qualified taxpayer".

In addition, several terms are undefined, i.e., “public four-year university,” and “community college.” The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this bill. The author may want to amend the bill to clearly define the terms.

This bill fails to limit the amount of the deduction that may be taken. Deductions that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis. The author may wish to consider amending the language to provide a limitation on a yearly basis or on an aggregate amount.

TECHNICAL CONSIDERATIONS

Department staff has identified the following technical consideration. Department staff is available to work with the author’s office to resolve this and other concerns that may be identified.

The bill uses “natural person” where the appropriate word is “individual” as "natural person" includes more than individuals.

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.

Florida does not impose a personal income tax.

Massachusetts allows a deduction for tuition payments paid to qualifying two or four year colleges leading to undergraduate or associate degrees, diplomas, or certificates. The deduction is equal to the amount by which the tuition payments, less any scholarships, grants or financial aid received, exceed 25 percent of the taxpayer's *Massachusetts* AGI. No deduction is allowed for any amount paid for room and board, books, supplies, equipment, personal living expenses, meals, lodging, travel or research, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

New York provides for a college tuition credit (up to $400 per student) or itemized deduction (up to $10,000 for each student).

Illinois, Michigan, and *Minnesota* have no deduction comparable to the one proposed by this bill.

FISCAL IMPACT

The department’s costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 1148 As Introduced on February 18, 2016 Assumed Enactment After June 30, 2016 ($ in Millions)		
2016-17	2017-18	2018-19
- $1,100	- $800	- $850

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

Revenue Discussion

Based on data from California Colleges and College Boards, the estimated average expenses associated with attending a 2-year and 4-year public college for undergraduate and graduate students' in–and-out of state is estimated to be $17,000 per year. Using data from the California Community Colleges Chancellor's Office, the California State University, the University of California, and other available data, the estimated number of students enrolled in a public college is estimated to be 2.8 million. This results in total estimated qualified education expenses of $46 billion in 2016. Using data from the College Board, this amount was grown for future years using an average annual growth rate of 3 percent.

In addition to qualified education expenses, this bill would allow qualified taxpayers to deduct principal payments from qualified education loans. It is assumed that the average student would have accumulated $26,000 in student loans and approximately 700,000 students would be making payments on qualified education loans. Using a 10-year repayment plan, it is estimated that $1.8 billion in principal payments are made each year, bringing the total qualified education expenses to $48 billion in 2016.

The estimate of total qualified education expenses is then reduced by 45 percent to account for taxable returns and the Federal AGI of $250,000. An additional 20 percent reduction is added to account for taxpayers with qualified expenses that exceed their AGI, resulting in a total estimated deduction amount of $21 billion. It is assumed 80 percent of taxpayers would know to take the deduction in the first year and 100 percent each year thereafter. This results in an estimated $17 billion adjustment to gross income in the first year available. Applying the average tax rate of 4 percent and a 1 percent increase to account for non-residents, the result is an estimated revenue loss of $700 million in 2016.

The tax year estimates are converted to fiscal years estimates, and then rounded to arrive at the amounts reflected in the above table.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that by allowing a larger deduction, a taxpayer may have more disposable income to reinvest in the economy.

Opponents: Some may argue that a larger educational expense deduction should be replaced with reducing the cost for an education.

POLICY CONCERNS

This bill would increase differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

This bill would allow a taxpayer to claim a deduction for the amount of qualified education expenses in one taxable year for which student loans were taken and then claim a deduction for the amount of principal of a qualified education loan paid in a later year. In effect, the taxpayer would receive a deduction for the same education expense twice. Example: An individual attends college in 2016, incurred the tuition expense for which they took a student loan out and then paid off the student loan in a later year. It appears that they would receive a double deduction (for 2016 and in the later year) for the same item.

The amount of the qualified education expense deduction is not reduced by the amount of scholarships, grants, etc. and not restricted for those expenses where a federal qualified tuition and related expenses deduction or a federal educational credit was taken for the same qualified education expenses. Therefore, under these situations, a taxpayer may receive a deduction for expenses where there was no net economic outlay.

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