Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Moorlach, et al.	Analyst:	Jane Raboy	Bill Number:	SB 1437
Related Bills:	See Legislative History	Telephone:	845-5718	Introduced Date:	February 19, 2016
		Attorney:	Bruce Langston	Sponsor	

SUBJECT: Coverdell Education Savings Account Contributions & Education-Related Expenses Deduction

SUMMARY

This bill, under the Personal Income Tax Law, would do the following:

Provision No. 1: Allow an above-the-line tax deduction for contributions to a Coverdell education savings account.

Provision No. 2: Allow an above-the-line tax deduction for certain education-related expenses.

These provisions are discussed separately in this analysis.

Summary Table of Economic Impact

Estimated Revenue Impact of SB 1437 As Introduced February 19, 2016 Assumed Enactment After June 30, 2016			
Description	2016-17	2017-18	2018-19
Provision 1: Above-The-Line Tax Deduction For Contributions to a Coverdell Education Savings Account	- $400,000	- $450,000	- $450,000
Provision 2: Above-The-Line Tax Deduction For Certain Education-Related Expenses	- $20,000,000	- $20,000,000	- $21,000,000

RECOMMENDATION

No position.

EFFECTIVE/OPERATIVE DATE

As a tax levy, provisions 1 and 2 would be effective immediately upon enactment and specifically operative for each taxable year beginning on or after January 1, 2016, and before January 1, 2021.

REASON FOR THE BILL

The reason for this bill is to provide state education tax relief to empower and engage low and middle-income families in providing for their children’s primary and secondary school needs, as well as saving for college.

Provision 1: Above-The-Line Tax Deduction For Contributions to a Coverdell Education Savings Account

FEDERAL/STATE LAW

Existing federal and state laws allow for the deduction of certain expenses, from gross income, when calculating adjusted gross income (AGI), such as moving expenses and interest on education loans, certain ordinary and necessary trade and business expenses, losses from the sale or exchange of certain property, contributions for pension, profit-sharing and annuity plans of self employed individuals, retirement savings, and alimony. Thus, all taxpayers with these types of expenses receive the benefit of the deduction, regardless of whether the taxpayer itemizes deductions or uses the standard deduction. These are known as above-the-line deductions.

Coverdell Education Savings Accounts

A Coverdell education savings account, under Internal Revenue Code (IRC) section 530, is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary. Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and generally may not be made after the designated beneficiary reaches age 18. The contribution limit is phased out for taxpayers with modified 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 designated beneficiary, controls whether a contribution is permitted by the taxpayer.

Distributions from a Coverdell education savings 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 education savings account distribution not used to pay qualified education expenses is includible in the gross income of the student and generally subject to an additional 10-percent tax, for federal purposes.[1]

Tax-free transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as re-designations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary).

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

In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include “qualified higher education expenses” and “qualified elementary and secondary education expenses”.

“Qualified higher education expenses” means expenses for undergraduate or graduate-level courses, and includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible educational 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, certain room and board expenses for any period during which the beneficiary is at least a half-time student, and amounts paid or incurred to purchase tuition credits, or to make contributions to an account, under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.

“Qualified elementary and secondary education expenses” means expenses for enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12), and include tuition, fees, academic tutoring, special needs services, books, supplies, room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the designated beneficiary, and the purchase of any computer technology or equipment or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary’s family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary education expense unless the software is predominantly educational in nature.

Qualified education expenses generally include only out-of-pocket expenses, and do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income.

California law generally conforms to the federal for Coverdell education savings accounts rules, as of the “specified date” of January 1, 2015, modified to provide that the federal additional 10-percent tax on excess distributions is instead an additional tax of 2.5 percent for state purposes.

THIS PROVISION

For each taxable year beginning on or after January 1, 2016, and before January 1, 2021, this provision would allow an above-the-line deduction for an amount contributed by a taxpayer during the taxable year to a Coverdell education savings account, not to exceed $750 per taxable year.

This provision would define "Coverdell education savings account" to have the same meaning as defined by IRC section 530, as modified by Section 23712 of the Revenue and Taxation Code.

In applying IRC section 530, for California purposes, this provision would require that the basis of the Coverdell education savings account be reduced by any amount deducted.

This provision would be repealed on December 1, 2021.

IMPLEMENTATION CONSIDERATIONS

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

This provision is silent on whether rollover contributions from one Coverdell education savings account to another would qualify for the deduction. If this is contrary to the author's intent, this provision should be amended.

It is unclear how the department could verify that a contribution was made to a Coverdell education savings account. The lack of guidance could cause disputes between taxpayers and the department.

LEGISLATIVE HISTORY

AB 1041 (Baker, et al., 2015/2016), substantially similar to this provision, would have allowed an above-the-line deduction for contributions to a Coverdell education savings account.
AB 1041 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 2426 (Nestande, et al., 2013/2014), substantially similar to this provision, would have allowed an above-the-line deduction for contributions to a Coverdell education savings account.
AB 2426 failed to pass out of 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.

Florida does not impose a personal income tax, thus there is no above-the-line deduction comparable to the one proposed by this provision.

Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide an above-the-line deduction comparable to the one proposed by this provision.

FISCAL IMPACT

This provision would impact the department's programming, printing, and processing costs. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate:

This provision would result in the following revenue loss:

Estimated Revenue Impact Provision 1: Above-The-Line Tax Deduction For Contributions to a Coverdell Education Savings Account As Introduced February 19, 2016 Assumed Enactment After June 30, 2016		
2016-17	2017-18	2018-19
- $400,000	- $450,000	- $450,000

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

REVENUE DISCUSSION

Based on Section 529 College Savings Plan data from the College Savings Plan Network as well as Coverdell education savings account data from the Investment Company Institute, it is estimated there would be $14 million in Coverdell education savings account contributions in 2016 and $15 million in 2017.

Due to the passage of the provisions' timing and taxpayer behavior, it is estimated this provision would incentivize contributions to Coverdell education savings accounts resulting in a 5-percent increase in the 2016 contributions and a 20-percent increase in the contributions each year thereafter. This results in $15 million in total Coverdell education savings account contributions for 2016, and $17 million for 2017.

Based on the estimated average annual contributions, it is expected that 42 percent of annual contributions would be equal to or less than the $750 maximum deduction. This results in $6.2 million of 2016 contributions and $7.3 million of 2017 contributions qualifying for the deduction. An average tax rate of six percent was then applied to the qualifying contributions resulting in revenue losses of $400,000 in 2016 and $450,000 in 2017.

This provision would require reductions to the basis of the Coverdell education savings accounts by any amount deducted. In calculating the reduction to the basis of the Coverdell education savings accounts, it is assumed distributions from the accounts will be minimal in the first few years and only a small share of deductions would be related to distributions. The impact of the basis adjustment would increase over time as the share of deductions taken versus contributions grows. Therefore, in the first few years the revenue impact of the basis adjustment would be minimal.

The tax-year estimates are combined and converted to fiscal years, and 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 a deduction for contributions to a Coverdell education savings account could reduce the need for student loans and other educational borrowing by encouraging increased savings for educational expenses.

Opponents: Some may argue that less sophisticated taxpayers that are in greater need of educational assistance are unlikely to take advantage of a Coverdell education savings account.

POLICY CONCERNS

This provision would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation. Tax credits, unlike deductions, are claimed after taxable income has been calculated and, therefore, do not create differences between the taxable income amounts shown on the federal and state income tax returns.

Provision 2: Above-The-Line Tax Deduction For Certain Education-Related Expenses

FEDERAL/STATE LAW

Existing federal and state laws provide that gross income includes all income from whatever source derived, including compensation for services, business income, gains from property, interest, dividends, rents, and royalties, unless specifically excluded.

Existing federal and state laws allow for the deduction of certain expenses, from gross income, when calculating AGI, such as moving expenses and interest on education loans, certain ordinary and necessary trade and business expenses, losses from the sale or exchange of certain property, contributions for pension, profit-sharing and annuity plans of self employed individuals, retirement savings, and alimony. Thus, all taxpayers with these types of expenses receive the benefit of the deduction, regardless of whether the taxpayer itemizes deductions or uses the standard deduction. These are known as above-the-line deductions.

THIS PROVISION

For each taxable year beginning on or after January 1, 2016, and before January 1, 2021, this provision would allow an above-the line deduction, in an amount equal to the qualified amount that was paid or incurred for qualified education-related expenses for one or more dependent children by a qualified taxpayer during the taxable year, not to exceed $2,500 in a taxable year. If a deduction is allowed to more than one qualified taxpayer filing a joint return for a dependent child, the sum of all deduction amounts allowed under this provision would be limited to $2,500 in a taxable year.

This provision would define the following terms and phrases:

- “Dependent children” would mean one or more children, as defined under IRC section 152(f)(1)[2] relating to child defined, who meet all of the following requirements:
    - Attend kindergarten or any of grades 1 to 12, inclusive, in California at a public, charter, or private school that has a current private school affidavit on file with the State Department of Education in the taxable year.
    - Are deemed a full-time pupil in accordance with the compulsory education requirements of Sections 48200 or 48222 of the Education Code.
    - Are under 21 years of age at the end of the school year.
    - Meet the requirements of IRC section 152(c)(1)(D), and (E).[3]
    - Are claimed as the dependent children on the original, timely filed return of the qualified taxpayer.
- “Qualified amount” would mean the amount paid or incurred for qualified education-related expenses, not to exceed the amount specified.
- “Qualified education-related expenses” would mean the kindergarten or any of grades 1 to 12, inclusive, costs of any of the following:
    - The rental or purchase of educational equipment required for classes during the regular school day; computers, computer hardware, and educational computer software used to learn academic subjects;
    - Fees for college courses at public institutions or independent nonprofit colleges, or for summer school courses that satisfy high school graduation requirements;
    - Psychoeducational diagnostic evaluations to assess the cognitive and academic abilities of dependent children; special education and related services for dependent children who have an individualized education program or its equivalent;
    - Out-of-school enrichment programs, tutoring, and summer programs that are academic in nature; and
    - Public transportation or third-party transportation expenses for traveling directly to and from school.

- “Qualified education-related expenses" would specifically exclude any expenses for items as provided in this provision that also are used in a trade or business.

[2] IRC section 152(f)(1) defines the term "child" to mean an individual who is a son, daughter, stepson, or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer and includes a legally adopted individual of the taxpayer, or eligible foster child.
[3] The term qualifying child under this section means, an individual, who hasn’t provided over one-half of his or her own support for the calendar year, and who must be younger than the claimant and be unmarried; qualifying child benefits restricted to child’s parents.

- "Qualified taxpayer" would mean a parent or legal guardian of one or more dependent children who meets all of the following requirements:
  - Both the dependent children and the parent or guardians reside in California when the qualified education-related expenses are paid or incurred.
  - The household income does not exceed 250 percent of the federal Income Eligibility Guidelines published by the Food and Nutrition Service of the United States Department of Agriculture for use in determining eligibility for reduced price meals.
- "Household income" would mean AGI as defined in IRC section 62.[4]

The Franchise Tax Board (FTB) would have the authority to prescribe rules, standards, criteria, guidelines, procedures, determinations, or notices necessary or appropriate to carry out this provision. These rules, standard, criterion, guideline, procedure, determination, or notice established or issued by the FTB would be exempt from the normal rulemaking requirements of the Administrative Procedures Act (APA).

This provision would be repealed on December 1, 2021.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations. 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 "household income", as defined in this provision, would include the AGI of each member of the household or only the AGI of the qualified taxpayer. To avoid confusion and for ease of administration, the author may wish to consider replacing "household income" with "AGI as defined in Section 62 of the Internal Revenue Code."

The phrase "necessary or appropriate to carry out the purposes of this section" is normally only used where the Legislature intends to provide a specific delegation of legislative rulemaking authority to the FTB, rather than as here, within the APA exemption. If this is contrary to the author's intent, the bill should be amended.

Because the definition of "Dependent children" would include the phrase "kindergarten or any of grades 1 to 12, inclusive", the author may wish to delete duplicative language found within this provision.

LEGISLATIVE HISTORY

AB 1371 (Lackey & Olsen, 2015/2016), substantially similar to this provision, would have allowed an above-the-line deduction from gross income for certain education-related expenses.
AB 1371 failed to pass by the constitutional deadline.

[4] IRC section 62 defines federal AGI as federal gross income minus specified deductions.

AB 1786 (Olsen, 2013/2014) would have allowed an above-the-line deduction from gross income for certain education-related expenses. AB 1786 failed to pass by the constitutional deadline.

AB 819 (Runner, 2007/2008) and SB 643 (Florez, 2007/2008) would have allowed an above-the-line deduction for contributions made by a qualified taxpayer to certain qualified tuition programs. AB 819 and SB 643 both failed to pass by the constitutional deadline.

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, thus there is no above-the-line deduction.

Illinois, *Massachusetts*, *Michigan*, and *New York* do not provide an above-the-line deduction comparable to the one proposed by this provision.

Minnesota allows a subtraction from taxable income for certain education-related expenses for a qualifying child in kindergarten through grade 12. The maximum subtraction that can be claimed is $1,625 per qualifying child in grades K through 6, and $2,500 for a qualifying child in grades 7 through 12.

FISCAL IMPACT

This provision would impact the department's programming, printing, and processing costs. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate:

This provision would result in the following revenue loss:

Estimated Revenue Impact Provision 2: Above-The-Line Tax Deduction For Certain Education-Related Expenses As Introduced February 19, 2016 Assumed Enactment After June 30, 2016		
2016-17	2017-18	2018-19
- $20,000,000	- $20,000,000	- $21,000,000

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

REVENUE DISCUSSION

Data from taxable year 2013 returns filed with the department shows that approximately 1.4 million taxpayers met the income eligibility provisions specified in this provision. Additionally, limiting this deduction to qualified taxpayers who claim dependent children on their originally filed returns is expected to reduce the qualified population by 290,000. It is assumed that 100 percent of all qualified taxpayers would take the deduction. Information from the Bureau of Labor and Statistics shows that qualified taxpayers spend nearly $700 annually on qualified education-related expenses for a total estimated deduction of approximately $780 million. Using an average tax rate of 2.5 percent, the annual tax loss would be approximately $20 million in tax year 2016.

The tax year estimates are converted to fiscal years, 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 this provision would provide needed financial assistance to parents who reach into their own pockets to fund vital education resources and services.

Opponents: Some may argue that providing a tax incentive for parents to assist with expenses associated with educating the state's children would result in revenue losses, which have to be paid for with higher taxes on others or reductions in services.

POLICY CONCERNS

This provision would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation. Tax credits, unlike deductions, are claimed after taxable income has been calculated and, therefore, do not create differences between the taxable income amounts shown on the federal and state income tax returns.

This provision would exclude a deduction for "qualified education-related expenses" for items used in a trade or business, but would allow a deduction for qualified education-related expenses that may be deductible under another provision. If the author's intent is to prohibit multiple tax benefits for the same item of expense, this provision should be amended.

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