Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Bonilla	Analyst:	Jane Raboy	Bill Number:	AB 17
Related Bills:	See Legislative History	Telephone:	845-5718	Introduced Date:	December 1, 2014
		Attorney:	Bruce Langston	Sponsor	

SUBJECT:	Contributions to Qualified Tuition Program Account Refundable Credit

SUMMARY

This bill would create a refundable credit for contributions to a qualified tuition program under the Personal Income Tax Law.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for the bill is to encourage taxpayers to invest for future higher education expenses and reduce student debt by providing tax relief for college savings.

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, and before January 1, 2021.

PROGRAM BACKGROUND

Internal Revenue Code (IRC) Section 529 provides specified income tax rules for the treatment of accounts and contracts established as qualified tuition programs. A qualified tuition program is a program established and maintained by a state (or agency or instrumentality of a state) and eligible educational institutions.

Qualified tuition programs are usually categorized as either a "prepaid tuition program" or "college savings plan." A prepaid tuition program allows a person to 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. An individual under the savings account program may contribute 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. Under both types of qualified tuition programs (prepaid tuition program and college savings plan), a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

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California conforms to IRC Section 529 (Section 529 Plan) 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. California modifies the additional 10 percent tax on excess distributions to instead be an additional tax of 2.5 percent for state purposes.

California has its own qualified tuition program, the Golden State ScholarShare College SavingsTrust, commonly referred to as “ScholarShare”. 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 qualified distributions from a qualified tuition program are excludable from tax if used for the beneficiary's qualified higher education expenses, 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 excess is subject to income tax and an additional 2.5 percent tax for state purposes.

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 as 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.

FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Under existing state law, credits are available to both full-time and part-time California residents, as well as to nonresidents with California-source income. California residents otherwise eligible for a credit are entitled to the full value of the credit. Generally, nonresidents and part-year residents of California that are otherwise eligible for a credit are required to prorate the amount of the credit allowed based on the ratio of “California taxable income to “total taxable income.”[1]

There are currently no federal or state credits comparable to the credit this bill would create.

[1] See Revenue and Taxation Code (R&TC) section 17055.

THIS BILL

For taxable years beginning on or after January 1, 2016, and before January 1, 2021, this bill would allow a credit equal to the lesser of 20 percent of the monetary contributions made by a qualified taxpayer to a qualified tuition program that the qualified taxpayer owns during the taxable year, or $500.

This bill would define the following phrases:

- “Qualified taxpayer” means an individual who, on behalf of a beneficiary, contributes money to a qualified tuition program for which the individual is the account owner and has one of the following annual adjusted gross incomes:
    - If the qualified taxpayer’s filing status is single, married filing separately, or domestic registered partner filing separately, $100,000 or less.
    - If the qualified taxpayer files as a head of household, surviving spouse, as defined in Section 17046, married filing jointly, or domestic partner filing jointly, $200,000 or less.
- “Qualified tuition program” means a qualified tuition program, as defined in IRC Section 529. (See the Program Background section of this analysis).

In the case of married taxpayers or registered domestic partners who file separate returns, the credit may be taken by either spouse or registered domestic partner or divided equally between the spouses or registered domestic partners.

An additional tax would be imposed on a qualified taxpayer who receives a nonqualified withdrawal in an amount that is the lesser of:

- 10 percent of that nonqualified withdrawal, or
- The total credit amount allowed for the current taxable year and all prior taxable years that the qualified taxpayer was allowed a credit.

“Nonqualified withdrawal” means any payment or distribution from a qualified tuition program that is subject to additional tax pursuant to Section 529(c)(6) of the Internal Revenue Code, relating to additional tax.[2]

Upon an appropriation by the Legislature, the portion of any credit allowed that is in excess of tax liability, would be required to be paid to the qualified taxpayer (refundable credit).

This bill would authorize the Franchise Tax Board (FTB) to prescribe rules, guidelines, or procedures necessary or appropriate to administer the credit.

[2] If a distribution is not used to pay qualified higher education expenses, the distribution is included in gross income. The income tax is increased by 10 percent of the amount of earnings which are so included, unless otherwise specified.

Any standard, criterion, procedure, determination, rule, notice, or guidelines established or issued by the FTB would be exempt from the Administrative Procedures Act.[3]

This credit would remain in effect only until December 1, 2021, and would be repealed as of that date.

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.

The bill language is unclear on (1) whether the $500 monetary contribution would apply to the total amount of the credit available for all years or a limit for each taxable year and (2) if an individual account owner would be allowed a tax credit for multiple beneficiaries, including a refundable credit for multiple accounts for the same beneficiary. Lack of clarity can result in disputes between taxpayers and the department. It is recommended that this bill be amended to clearly express the author's intent.

This bill would require regular annual appropriations by the Legislature to pay for the refundable portion of this credit. If insufficient funds are appropriated to cover all of the refunds due, the department would suspend payment of refunds until additional funds were appropriated. Interest would accrue during the suspension period. Suspension of refunds could result in additional contacts to the department that may increase departmental costs.

The FTB does not currently administer a refundable tax credit. Establishing a refundable tax credit program would have a significant impact on the department's forms, processes, and systems. Additionally, the department's experience administering refundable credits indicates that the cost to detect fraudulent refund claims would be significant.

With the exception of contributions to the California ScholarShare program, it is unclear how the department could verify that the contributions were made to an out-of-state qualified tuition program.

The bill's language regarding the payment of this credit in excess of tax liability lacks the usual language of refundable credits that would allow the department to apply the refundable portion of the credit for a tax year against other amounts due from a taxpayer. Absent this language, monies may be refunded even though the taxpayer owes a liability.

TECHNICAL CONSIDERATIONS

On page 2, lines 6 and 7, the phrase "to a qualified tuition program that the qualified taxpayer owns" is grammatically inaccurate and unnecessarily duplicates the definition of "qualified taxpayer" and should be deleted.

[3] Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code.

Subdivision (c) regarding the use of credit by married taxpayers or registered domestic partners filing separately is unnecessary and should be deleted because existing state[4] law provides this general rule.

LEGISLATIVE HISTORY

AB 1956 (Bonilla, et al., 2013/2014), substantially similar to this bill, would have created a refundable credit for contributions to a qualified tuition program account. AB 1956 failed to pass out of the Assembly Appropriations Committee.

AB 26 (Nation, 2001/2002), would have established a refundable tax credit of up to $500 for contributions to ScholarShare accounts. AB 26 failed to pass the Assembly Committee on Revenue and Taxation.

SB 44 (Alpert, 2001/2002), similar to this bill, would have established a refundable tax credit of up to $500 for each beneficiary on whose behalf an individual makes a contribution to a ScholarShare trust. SB 44 failed to pass the Senate Revenue and Taxation Committee.

SB 782 (Brulte, et al., 2001/2002), a substantially similar bill, would have established a refundable tax credit of up to $500 for contributions to ScholarShare accounts. SB 782 failed to pass the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

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

FISCAL IMPACT

The FTB does not currently administer a refundable tax credit. Establishing a refundable tax credit program would have a significant impact on the department's programs and operations and require extensive changes to forms and systems.

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved, but anticipate the costs to be significant.

[4] See R&TC section 17021.7.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 17 As Introduced on December 1, 2014 Assumed Enactment After June 30, 2015 ($ in Millions)		
2015-16	2016-17	2017-18
- $44	- $90	- $100

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

Revenue Discussion

This bill would allow a qualified taxpayer to file for a refundable tax credit based on contributions to a Section 529 Plan. Once fully implemented, the revenue loss is estimated at $100 million per year.

The Investment Company Institute, reports there were 11.9 million open Section 529 Plan accounts nationwide as of June 2014 (and ScholarShare data reports approximately 1.65 accounts per account owner). Californian's hold 12 percent of the open Section 529 plans. As a result, California residents have an estimated 1.4 million accounts. California nonresidents have an additional 85,000 accounts, bringing the total accounts to approximately 1.5 million or 920,000 taxpayers.

Using 2012 federal adjusted gross income (AGI) data, approximately 70 percent or 611,000 of the accounts held by California resident owners meet the income requirements specified in the bill. After applying the 4.5 percent average annual historical growth rate to the 2014 and 2015 account volumes, there would be an estimated 667,000 accounts in 2016.

Based on available data, approximately 50 percent of account holders make regular annual contributions. This percentage was increased to 70 percent, or 467,000, for 2016, to account for existing taxpayers with qualified educational expenses that would funnel funds through a Section 529 Plan to obtain this tax credit.

It was assumed single taxpayers with AGI less than $25,000 and married filing joint taxpayers with AGI less than $40,000 would not contribute to a Section 529 Plan. For taxpayers with AGI higher than $25,000 or $40,000, depending on the filing status, it was assumed contribution amounts would increase relative to the increase in AGI. After multiplying the assumed contribution amount by the number of taxpayers in each assumed contribution tier, it is estimated that qualified contributions would be $478 million in taxable year 2016.

The total estimated contribution per taxable year, based on the lesser of 20 percent of qualified contributions or $500, was multiplied by 20 percent, arriving at an estimated potential tax credit of $96 million in taxable year 2016.

The estimate assumes 80 percent of eligible taxpayers would take advantage of the credit in the first year and 100 percent thereafter. The taxable year estimates were reduced by one percent for taxpayers taking nonqualified withdrawals for taxable year 2016. The total credit for resident taxpayers was offset by the additional tax amount to calculate the total credit per taxable year, or $77 million for taxable year 2016.

The revenue impact for nonresident taxpayers was estimated using the same methodology as for resident taxpayers. Additionally, because R&TC section 17055 requires the credit for nonresidents and part-year residents to be limited to the “credit percentage” (the ratio of California taxable income to total taxable income), an 81.6 percent reduction was made (based on analysis of taxable year 2012 data), arriving at an estimated credit of $678 thousand in taxable year 2016.

The combined results for the resident and nonresident taxpayers were then converted to fiscal years and rounded.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Supporters may argue that this bill would bolster economic activity within the state by decreasing the educational debt carried by post-secondary school students and their families.

Opponents: Some may argue that this bill would be too costly for the state to administer and would have an undesirable consequence on students who would otherwise be eligible to receive financial aid.

POLICY CONCERNS

This refundable credit would be available to a qualified taxpayer with California source income regardless of the location of the qualified taxpayer, the qualified tuition program, the beneficiary, or where the beneficiary’s qualified higher education expenses were paid or incurred. If this eligibility is broader than the author intends, this bill should be amended.

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