Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	McCarty	Analyst:	Jane Raboy	Bill Number:	AB 2726
Related Bills:	See Legislative History	Telephone:	845-5718	Introduced Date:	February 19, 2016
		Attorney:	Bruce Langston	Sponsor	

SUBJECT: Contributions to Qualified Tuition Program Credit

SUMMARY

This bill would create a 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, which allow states to establish and maintain programs that taxpayers to either prepay or contribute to an account for paying a student's qualified education expenses at a postsecondary institution.

California has its own qualified tuition program, the Golden State ScholarShare Trust, 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.

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.

The maximum account balance per beneficiary for Scholarshare is $475,000. Accounts that have reached the maximum account balance limit may continue to accrue earnings, though further contributions would be returned unapplied.

FEDERAL/STATE LAW

Tax Credits

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 Revenue and Taxation Code (R&TC) section 41, legislation that would create a new tax credit is required to include specific goals, purposes, objectives, and performance measures to allow the Legislature to evaluate the credit's effectiveness.

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

Qualified Tuition Programs

Under federal law, an IRC section 529 qualified tuition program is either (1) 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”), or (2) a program with similar establishment and maintenance requirements 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.

Contributions to a qualified tuition program must be made in cash. Contributions are not tax deductible for federal 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). 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.

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the IRC, 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.

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 amount includible in gross income is determined, first, by applying the annuity rules of IRC section 72 to determine the amount that would be includible in gross income if none of the amount distributed was for qualified higher education expenses and, then, reducing that amount by an amount which bears the same ratio to that amount as the qualified higher education expenses bear to the amount of the distribution.[1]

California generally conforms to federal rules that apply to IRC section 529 qualified tuition programs as of the "specified date" of January 1, 2015, with modifications. California conforms to the federal contribution rules, income in an account accumulates on a tax-free basis, and similar to federal law, contributions are not deductible for state income tax purposes. However, while California generally conforms to the federal distribution rules, 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

For each taxable year 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 one or more accounts established pursuant to a qualified tuition program during the taxable year, or $500.

This bill would define the following phrases:

- "Qualified higher education expenses" means qualified higher education expenses, as defined under IRC section 529(e)(3).
- "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 California adjusted gross incomes (AGI):
    - ➢ If the qualified taxpayer's filing status is single or married filing separately, $75,000 or less.
    - ➢ If the qualified taxpayer files as a head of household or surviving spouse, as defined under Section 17046[2], or married filing jointly, $150,000 or less.

[1] For example, assume a taxpayer had $5,000 in a qualified tuition program account, $4,000 of which was the amount contributed. Also assume the taxpayer withdraws $1,000 from the account and $500 is used for qualified higher education expenses. First, the taxpayer applies the annuity rules of IRC section 72 which results in $200 being included in income under IRC section 72 assuming none of the distribution is used for qualified higher education expenses. Then, the taxpayer reduces the $200 by one-half because 50 percent of the distribution was used for qualified higher education expenses. Thus, $100 is includible in gross income, and this amount is subject to the additional 10-percent tax (unless an exception applies) for federal purposes, and also subject to the additional 2.5-percent tax (unless an exception applies) for California purposes.

[2] In general, for the two years following a spouse's death, the surviving spouse can file as a qualifying widow or widower. That basically lets you continue to use the same tax brackets that apply to married-filing-jointly returns.

- "Qualified tuition program" means a qualified tuition program, as defined under IRC Section 529(b) and as established pursuant to Golden State Scholarshare Trust Act, Article 19 (commencing with Section 69989) of Chapter 2 of Part 42 of Division 5 of Title 3 of the Education Code.

In the case of any distribution in excess of qualified higher education expenses, this bill would require a qualified taxpayer to add to the tax the allowed aggregate amount of credit in the taxable year that the distribution in excess of qualified higher education expenses was made.

The Franchise Tax Board (FTB) would be authorized to prescribe rules, guidelines, or procedures necessary or appropriate to administer the credit, and any standard, criterion, procedure, determination, rule, notice, or guidelines established or issued by the FTB would be exempt from the Administrative Procedures Act.

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

This bill would specify objectives, performance indicators, data collection, and reporting requirements as provided under R&TC section 41. The FTB would be required to report within 120 days from the filing date of the tax return of a taxable year to the Scholarshare Investment Board , the number of and the dollar amount of tax credits issued, and the amount of tax credits issued and taxpayer income.

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.

The department would be required to report to the Scholarshare Investment Board within 120 days from the filing date of a tax return's taxable year under this bill. Because personal income tax returns may be filed, with extension until October 15, it would be difficult to provide reports within 120 days from the filing date of a tax return's taxable year. Additionally, the department normally finishes compiling the year's tax return information in January of the second succeeding year. For example, complete information for the 2017 taxable year for personal income tax returns would be compiled in January 2019. For ease of administration and if the author's intent is to have each report contain complete information for the taxable year, the due date of the report should be changed.

This bill is silent on whether rollover contributions from one qualified tuition program to another would qualify for the credit, if this is contrary to the author's intent, the bill should be amended.

It is unclear how the department could verify that a contribution was made to the qualified tuition program. The lack of guidance could result in disputes between taxpayers and the department.

TECHNICAL CONSIDERATIONS

Department staff has identified the following technical considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill uses the phrase "credit issued", however, "credit claimed" is the customary phrase used within a franchise or income tax credit statute. This phrase has the benefit of past usage and common understanding within the context of a tax credit statute and for consistency and harmony with other tax credit language should be used in this bill. It is recommended that this bill be amended to reference the correct phrase for franchise and income tax purposes.

In defining "qualified tuition program" this bill would provide a cross reference to the reporting requirements under the Education Code section 69989, if this is contrary to the author's intent, the bill should be amended.

LEGISLATIVE HISTORY

AB 17 (Bonilla, et al., 2015/2016), would have created a credit for contributions to a Scholarshare account. AB 17 failed to pass out of the Assembly Appropriations Committee.

OTHER STATES' INFORMATION

Florida does not have a personal income tax and 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

This bill 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

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 2726 As Introduced on February 19, 2016 Assumed Enactment After June 30, 2016 ($ in Millions)		
2016-17	2017-18	2018-19
- $23	- $18	- $20

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 Section 529 College Savings Plan data from the College Savings Plan Network, there were approximately 270,000 qualified tuition program (hereinafter referred to as ScholarShare) accounts in 2015.

Using 2013 California AGI data, approximately 60 percent, or 160,000 of the estimated California resident owners meet the income requirements specified in this bill. After applying a 4.5 percent average annual historical growth rate for Section 529 College Savings Plans to the 2015 Scholarshare account volume, there would be an estimated 170,000 ScholarShare accounts in 2016, which would meet the bill's specified income requirements. To account for the incentive impact of the tax credit, the number of Scholarshare accounts was grown by an additional 5 percent for tax year 2017 and then by an additional 1 percent for 2018, 2019, and 2020.

Based on TIAA-CREF Financial Services data, approximately 50 percent of account holders make regular annual contributions. This percentage rises to 58 percent in states with deductions or nonrefundable tax credits for contributions. This estimate assumes 60 percent, or 100,000, of the qualifying account holders would make regular contributions.

It is assumed single taxpayers with AGI less than $25,000 and married filing joint taxpayers with AGI less than $40,000 would not contribute to ScholarShare because they would lack the funds to be able to contribute to the Scholarshare account. For taxpayers with AGI higher than $25,000 or $40,000, depending on the filing status, it is assumed that 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 for residents would be $85 million in taxable year 2016.

The total estimated contributions was multiplied by 20 percent to arrive at a potential tax credit of $17 million in taxable year 2016.

The estimate assumes 80 percent of the credit would be claimed in the year generated, or $13 million in 2016, and 100 percent each year thereafter. The taxable year estimates were reduced by one percent to account for taxpayers with distributions in excess of qualified higher education expenses. It is assumed that the taxpayer would include the income from excess distributions in the following year.

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

SUPPORT/OPPOSITION

Support: California State Treasurer John Chiang (Sponsor).

Opposition: None provided.

ARGUMENTS

Proponents: Some 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 bill lacks carryover language. As a result, any unused credit would be lost if the taxpayer is unable to use the entire credit amount in the year claimed. The author may wish to add language allowing a limited carryover period.

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