Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Ting	Analyst:	Jon Feenstra	Bill Number:	AB 1175
Related Bills:	See Legislative History	Telephone:	845-4870	Amended Date:	March 21, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Exclusion/Every Kid Counts College Savings Account Earnings, Contributions, or Qualified Distributions

SUMMARY

This bill would establish the Every Kid Counts (EKC) Account Act that would provide a $100 savings account for every child born in California after a specified date.

This analysis only addresses the provisions of the bill that impact the department's programs and operations.

RECOMMENDATION – NO POSITION

Summary of Amendments

The March 21, 2017, amendments removed Education Code provisions regarding child care and development services and replaced them with an exemption from gross income for earnings, contributions and qualified distributions from an EKC college savings account. This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for this bill is to provide incentives to save money for higher education expenses and increase college enrollment for low-income students.

EFFECTIVE/OPERATIVE DATE

This bill would become effective on January 1, 2018, and would be applicable to every child born in California on or after that date. The tax provision of this act would be specifically operative for taxable years beginning on or after January 1, 2018.

FEDERAL LAW

Internal Revenue Code (IRC) section 529 (Section 529 Plan) provides tax-exempt status to qualified tuition programs.

Contributions to a qualified tuition program must be made in cash. A Section 529 Plan 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.

Qualified higher education expenses are defined as under IRC section 529(e)(3) as:

- Tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution;
- Expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance; and
- Expenses for the purchase of computer or peripheral equipment, computer software, or Internet access and related services.

Contributions are not tax deductible for federal income tax purposes, but amounts earned in the account (i.e. interest) accumulate on a tax-free basis.

Distributions from a qualified tuition program are excludable from federal tax if used for the beneficiary's qualified higher education expenses. If a distribution from a qualified tuition program exceeds the qualified higher education expenses incurred for the beneficiary, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

STATE LAW

California conforms, with modifications, to Section 529 Plans as of the “specified date” of January 1, 2015, as they relate to tax-exempt 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.

Similar to federal law, state law provides that contributions made to a qualified tuition program are not deductible.

THIS BILL

This bill would establish the EKC Act. College savings accounts would be established under the Education Code provisions for qualified tuition programs pursuant to IRC section 529. Under this act, every child born in California on or after January 1, 2018, would have $100 deposited into an account in the State Treasury by the State.

A child, his or her parents, legal guardians, grandparents, local organizations, corporations, or others would be able to make a voluntary contribution to the child’s account. An individual who is 18 years or older may withdraw funds from the account without incurring a tax liability for the purpose of paying for his or her qualified higher education.[1] “Qualified high education” also includes any costs associated with career technical education or training.

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[1] “Qualified higher education expenses” means the expenses of attendance at an institution of higher education as provided in paragraph (3) of subsection (e) of Section 529 of the IRC of 1986, as it is amended from time to time, if, as determined by the board, the amendment is consistent with the purposes of this article, and as determined and certified by the institution of higher education in the same manner as prescribed in Title IV of the Higher Education Act of 1965 (20 U.S.C. Sec. 1087ii, as amended).

The EKC account would be exempt from taxation under the Personal Income Tax Law (PITL).

If the assets of such account are paid or distributed for reasons other than the qualified purpose, then the earnings in the EKC account are required to be included in the gross income of the accountholder. The funds held in an EKC account may not be taken into account for purposes of determining the eligibility of an individual for a state program intended to provide assistance to low-income people.

For each taxable year beginning on or after January 1, 2018, the following would be excluded from the gross income of an accountholder of an EKC account:

- Any earnings in the EKC account,
- Any contribution to the EKC account, or
- Any qualified special purpose distribution amount.

If any distribution from an EKC account is not a qualified special purpose distribution as defined, any earnings in that account are includible in the gross income of the accountholder for the taxable year in which the distribution is made and is subject to a 10-percent penalty. An amount equal to the amount of initial deposit made by the state to the account ($100) must be withheld from the distribution amount by the Treasurer for the taxable year in which the nonqualified distribution occurred.

The value of the account, any earnings in that account, and investment in the account would be computed as of the close of the calendar year in which the taxable year begins. No deduction, under the PITL or Corporation Tax Law, is allowed for a contribution to an EKC account.

This bill would define the following terms:

- “Accountholder” means a child who is born in the State of California on or after January 1, 2018;
- “EKC account” means an investment account, as described in the Government Code;[2]
- ”Qualified special purpose distribution” means any payment or distribution to an accountholder of an EKC account that is used by the accountholder for one of the qualified purposes, as defined in section 99102(d).

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.

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[2] Title 19 (commencing with Section 99100) of the Government Code.

Although the bill would allow individuals other than the accountholder to contribute to the account, it is not clear whether the child's parents or guardians that normally have control over the affairs of a minor child would have any control over the funds in the account or could make decisions on behalf of the child relating to the account. To prevent any misunderstanding, it is recommended that the author clarify whether any individual other than the child has legal authority over the use of the funds in the account.

It is not clear what would happen to the funds in the account in the event the child becomes deceased before the funds are distributed. To avoid any disputes with surviving family members, the author may wish to specify whether the funds belonging to the child become a part of their estate or not.

Generally state tax provisions are contained solely within the Revenue and Taxation Code (R&TC), rather than in another code as this bill would. It is recommended that the tax provisions be moved to the R&TC with appropriate cross references.

Generally, the amount included in taxable income would be limited to the amount distributed within a given year. The bill appears to require that the entire amount of the investment earnings be included in gross income if there is a nonqualified distribution in any year, without explicitly ending the qualification of the account as a nontaxable account for future years. To remain consistent with general tax law, the author may want to amend the language to specify that the amount of the nonqualified distribution would be the amount subject to tax in a given year, and a nonqualified distribution would revert any funds remaining in the account from a nontaxable account to a taxable account.

If a nonqualified distribution of the funds occurs, the accountholder would be required to repay the initial deposit to the account. It is unclear whether that repayment would be required each time a nonqualified distribution occurs or only in the first instance of a nonqualified distribution. The author may want to amend the language to clarify under what conditions the repayment would be required.

The bill would provide that the Treasurer establish an account for this program but is silent about who would be responsible for investing the account or what types of investments would be permissible. It is unclear how earnings are to be actualized or who would provide the administrative support for these accounts, such as earning statements or 1099 reports required by state and federal statutes. The author may want to amend the language to clarify what functions the Treasurer or other entity would be required to perform in relation to these accounts.

This bill requires a 10-percent penalty apply to income resulting from nonqualified distributions. California conformity to IRC section 529 provides a 2.5-percent penalty which is equal to one quarter of the federal penalty of 10 percent, and similar in reduction to other areas of federal penalty conformity. The author may wish to amend the language to provide a 2.5-percent penalty.

Assuming EKC accounts, established under the California Scholarshare provisions of the Education Code, are qualified under modified California conformity to IRC section 529, the following provisions in this bill duplicate provisions of federal law. These include:

- Exemption from income of earnings, contributions and qualified distributions from EKC accounts,
- The 2.5-percent penalty on nonqualified distributions, and
- Inclusion of earnings in gross income on nonqualified distributions.

The author may wish to eliminate these provisions to reduce complexity and avoid duplication.

TECHNICAL CONSIDERATIONS

On page 3, lines 5 and 6, the words “Revenue and Taxation Code” should be replaced by “Internal Revenue Code” to reference federal law.

On page 3, line 7, the number “69989” should be replaced by “69980” to correctly reference the first section of Article 19.

On page 3, line 19, the word “high” should be replaced by “higher” to be consistent with other similar references.

Paragraph (b)(3) of Revenue and Taxation Section 17140.1 duplicates paragraph (b)(2) of that subdivision and should be removed.

On page 4, lines 11 and 32, the words “of the Government Code” should follow “Section 99102” for clarity.

LEGISLATIVE HISTORY

SB 752 (Dutton, et. al., 2007/2008), similar to this bill, would have created the California Kids Investment and Development Savings Act. SB 752 failed to pass from the Assembly by the constitutional deadline.

OTHER STATES’ INFORMATION

Review of *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York* laws found no comparable tax benefit. These states were selected and reviewed due to their similarities to California's economy and tax laws.

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 AB 1175 Every Kid Counts Act As Amended on March 21, 2017 Assumed Enactment After June 30, 2017		
2017-18	2018-19	2019-20
\a	\a	\a
\a - revenue loss less than $10,000		

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

Revenue Discussion

The estimated revenue impact of this bill depends on the amount of earnings on account balances that parents, family members, corporations, or local organizations would have otherwise saved in taxable savings accounts.

Although this bill is operative for taxable years beginning on or after January 1, 2018, the State Treasurer is not expected to have the needed infrastructure available to open accounts for each newborn in California until 2019. Therefore, deposits by the State Treasurer would not be made until 2019.

Based on California statistical abstract data from the Department of Finance, it is estimated that the combined number of births in California for 2018 and 2019 would be 1 million. This bill provides for a one-time deposit by the state, to a college savings account, of $100 for every child born on or after January 1, 2018 in California. As a result, the state's initial deposit in 2019 is estimated to be $100 million. Absent this bill, these deposits would not otherwise exist. Therefore, earnings attributed to the state's initial deposits are not included in the estimated revenue loss.

It is assumed that the number of accounts receiving additional contributions would slowly increase as the accountholder ages. It is assumed these additional contributions would have otherwise been deposited into taxable accounts. As a result, the earnings attributed to these additional contributions would result in a revenue loss.

Assuming a rate of return of 5 percent on the individual contributions and applying an average tax rate of 6 percent results in an estimated revenue loss of less than $10,000 for 2019. As number of accounts receiving additional contributions grows, the estimated revenue loss would increase as a result of the accrued earnings.

The calendar year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the table above.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that establishing a college savings account for children at birth will encourage savings for higher education and increase the number of low-income children that eventually attend college.

Opponents: Some may argue that existing law contains provisions for college savings accounts and therefore, additional state sponsored higher education savings incentives are unnecessary.

POLICY CONSIDERATION

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

This bill does not include earnings in an EKC account made on the initial $100 state deposit, when the Treasurer withholds this amount from a nonqualified distribution. It may be more equitable for the state to collect the earnings on its contribution to the account.

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