



## **Analysis of Original Bill**

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Attorney: Bruce Langston	Related Bills: See Legislative History	

**Subject:** Income Share Agreements for Postsecondary Training

### **Summary**

The bill would, under the Civil Code, authorize income share agreements for purposes of funding postsecondary education.

This bill would, under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL), specify the portion of payments received under an Income Share Agreement (ISA) subject to state income or franchise tax.

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

**Recommendation – No position.**

### **Reason for the Bill**

The reason for the bill is to promote the mainstream usage of ISAs for funding for postsecondary training by exempting them from the usury provisions of the California Constitution.

### **Effective/Operative Date**

The tax provision in this bill would be effective and operative for taxable years beginning on or after January 1, 2018.

### **Program Background**

An example to illustrate how an Income Share Agreement (ISA) is used:

The Purdue Research Foundation<sup>1</sup> is now offering an ISA called “Back to Boiler - ISA Fund.” This fund is available to Purdue’s sophomore, junior, and senior level students. The funding is described on the school’s website as:

“In short, an ISA is an agreement where you receive funding while you are in school. When you leave school, you will pay a fixed percentage of your income for a fixed number of years. For some students, this will make sense and for others, the alternatives may be better.”

To date, there are 478 contracts with students enrolled in Back to Boiler - ISA Fund who have received funding totaling \$5.9 million. All Purdue University colleges and over 100 majors are represented in the student participation.<sup>2</sup>

## **Federal/State Law**

### *Student Loan Forgiveness in General*

Under federal and state law, gross income generally includes the amount of any discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student’s working for a certain period of time in certain professions for any of a broad class of employers.

Student loans eligible for this exception to the general rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by: (1) the United States (or an instrumentality or agency thereof), (2) a state (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a state, county, or municipal hospital and whose employees have been deemed to be public employees under state law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation.

In addition, an individual’s gross income does not include amounts from the cancellation of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations),

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<sup>1</sup> [Purdue income-share-agreement](#)

<sup>2</sup> [Purdue back a boiler](#)

cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and such work must be performed for, or under the direction of, a tax-exempt charitable organization or a governmental entity.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program or certain state loan repayment programs.

### *Federal Income-Based Repayment Programs and Loan Cancellation*

Students with higher education expenses may be eligible to borrow money for their education through the Direct Loan Program.<sup>3</sup> Prior to July 1, 2010, students may also have been eligible to borrow money through the Family Education Loan Program. Both programs are administered by the U.S. Department of Education. Each program provides borrowers with an option for repaying the loan that is related to the borrower's income level after college (the income-contingent and the income-based repayment options). Under both of these options, borrowers complete their repayment obligation when they have repaid the loan in full, with interest, or have made those payments that are required under the plan for 25 years.<sup>4</sup> For those who reach the 25-year point, any remaining loan balance is cancelled. Under current federal law, any loan balance cancelled by these programs is considered gross income to the borrower.

### *Repayment Plan for Public Service Employees*

The Public Service Loan Forgiveness (PSLF) Program cancels the remaining balance on certain federal loans made under the Direct Loan Program after 120 qualifying monthly payments are received under a qualifying repayment plan while the borrower works full-time for a qualifying employer. A qualifying monthly payment is made:

- After October 1, 2007;
- Under a qualifying repayment plan;
- For the full amount due as shown on your bill;
- No later than 15 days after your due date; and
- While employed full-time by a qualifying employer.

A qualifying employer is:

- A governmental organization at any level (federal, state, local, or tribal).

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<sup>3</sup> William D. Ford Federal Direct Loan Program; Title 20, United States Code (U.S.C.), sections 1087a through 1087j.

<sup>4</sup> The 25-year payment-period requirement is reduced to 20 years with respect to any loan made to a new borrower on or after July 1, 2014.

- A not-for-profit organization that is tax-exempt under Section 501(c)(3) of the Internal Revenue Code.
- Other types of not-for-profit organizations that provide certain types of qualifying public services.

A qualifying repayment plan includes all of the income-based repayment plans and the 10-year standard repayment plan.<sup>5</sup>

IRC section 108(f) also provides an income exclusion for amounts received under the National Health Service Corps loan repayment program or certain state loan forgiveness and repayment programs that are intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the state).

### **This Bill**

This bill would authorize an individual to enter into ISAs with any person for payments to or on behalf of that individual for costs associated with certain education or training programs in exchange for agreeing to pay to the holder of the ISA a specified percentage of the individual's future income, subject to certain terms and conditions not discussed in this analysis. The bill would exempt these ISAs from the usury provision of the California Constitution. This bill would, under the PITL, provide that gross income does not include any payments made under an ISA to or on behalf of the receiver.

Payments received by an ISA funder pursuant to an income share agreement shall be treated as follows:

- First, with respect to an ISA, as a repayment of investment in the contract that reduces the ISA funder's basis in that ISA.
- Second, as income on the ISA that is included in gross income.

The bill provides the following definitions:

"Income share agreement" means an agreement between an individual in this state and an ISA funder under which the individual commits to pay a specified percentage of the individual's future income, for a specified period of time, in exchange for payments to or on behalf of such individual for costs associated with certain education or training programs.

- "ISA funder" means the person who pays amounts to, or on behalf of, an individual under an ISA in exchange for the right to receive a specified percentage of the individual's future income or a successor in interest of an ISA funder.

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<sup>5</sup> Title 20, U.S.C., section 1078(b)(9)(A)(i).

- “Receiver” means the individual receiving funds under an ISA who agrees to pay a specified percentage of his or her income to an ISA funder under that ISA.

### **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.

It is unclear how the department would identify which payments should or shouldn’t be excluded by the lender. Until the bill is further developed, it is unclear how this exclusion would impact the department.

The provisions of the bill that define what is an “income share agreement” are unclear and use undefined terms. It is unclear how the department would know whether or not an agreement made to pay for a student’s school is a valid “income share agreement.”

### **Legislative History**

No similar legislation has been identified.

### **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. No similar income share agreements were identified.

### **Fiscal Impact**

This bill would require some changes to the existing tax forms and instructions, and information systems. As the bill continues to move through the legislative process, costs will be identified.

### **Economic Impact**

#### Revenue Discussion

The revenue impact of this bill depends on the number of student receivers who choose to enter into an ISA and the terms of the agreements between the student receivers and the ISA funder.

In the analysis of this bill, FTB noted two potential revenue impacts.

First, the repayment amounts received by ISA funders would first be considered a repayment of the investment in the contract and thus reduce the ISA funder’s basis and would not be included in the ISA funder’s gross income. Gross income would be recognized when amounts paid by the student receiver exceed the investment amount. The timing of this would depend on the terms of the contracts between ISA funders and student receivers. It is estimated that

on average, a revenue recognition from the gain on the investment would not occur for ten years after the student receiver begins making payments. Under current law, to finance their education, students contract with loan providers and would make payments of both principal and interest and the ISA funder would recognize the interest as income in the year received. Under this proposal, the delay in interest recognition from the repayments of ISAs would result in a revenue loss for an average of 10 years. This loss is a timing difference that would be begin to be offset by a corresponding gain in the years following the tenth year of repayment.

Second, current law allows students to claim a tax deduction for interest paid on student loans. Because the provisions of this bill do not follow California usury laws, payments made by the student receiver to the ISA funder in excess of the investment amount would not be considered interest. Thus, the student receivers would be unable to claim the student loan interest deduction that would otherwise be allowed on loan repayments. As a result, an offsetting revenue game would be recognized from the student's inability to claim a deduction on the interest paid on the student loan.

To estimate the revenue impact of this bill, the amount of ISA contracts entered into and the terms of these contracts would need to be known. Because it is difficult to predict the frequency and the value of future investment contract activities, the revenue impact is unknown.

### **Support/Opposition**

Support: None provided.

Opposition: None provided.

### **Arguments**

Proponents: Some may argue that an ISA is another option for students to receive funding for their postsecondary training, and should be encouraged.

Opponents: Some may argue that exempting any entity from the usury provisions of the California Constitution sets a bad precedent and should be avoided.

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