



Analysis of Amended Bill

Author: Moorlach

Sponsor:

Bill Number: SB 1344

Analyst: Davi Milam

Phone: (916) 845-2551

Introduced: February 16, 2018

Attorney: Bruce Langston

Related Bills: See Legislative
History

Amended: April 2, 2018

Subject: Education Savings Account Act of 2020/ Contributions to Coverdell or Education Savings Account Credit/ FTB in Consultation with DOF Determine Gross Reduction in State Revenue from Credit

Summary

This bill would do the following:

Provision 1: Under the Education Code (EC), create the Education Savings Account (ESA) Act of 2020, and, under the Personal Income Tax Law (PITL), provide certain income tax benefits related to the ESA.

Provision 2: Under the PITL, create a credit for contributions made to a Coverdell ESA.

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

Recommendation – No position.

Summary of Amendments

The April 2, 2018, amendments specified the applicable Senate Constitutional Amendment (SCA) related to this bill, removed the proposed education account for home-schooled children, and added an operative date related to reporting requirements for the Legislative Analyst's Office.

This is the department's first analysis of this bill.

Reason for the Bill

The reason for the bill is to give parents and students greater options to meet their individual learning needs and provide financial incentives to encourage investment in education.

Effective/Operative Date

This bill would be effective January 1, 2019, and would only become operative if Senate Constitutional Amendment 16 (SCA 16) of the 2017-2018 Regular Session is approved by the voters at the statewide general election on November 6, 2018.

The bill's provisions would be operative as follows:

Provision 1: The gross income exclusion related to the ESA Act of 2020 would be specifically operative for taxable years beginning on or after January 1, 2019.

Provision 2: The credit for contributions to a Coverdell ESA would be operative on January 1, 2019, and specifically operative for taxable years beginning on or after January 1, 2021.

Economic Impact – Summary Revenue Table

Revenue Estimate

This bill, as amended on April 2, 2018, would result in the following combined revenue loss for Provisions 1 and 2.

(\$ in Millions)

Fiscal Year	Combined Revenue
2018-2019	- \$0.0
2019-2020	- \$0.0
2020-2021	- \$11.0

This estimates assumes this bill would become operative if an unspecified SCA of the 2017-2018 Regular Session is approved by the voters at the statewide general election on November 6, 2018.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Provision 1: The Education Savings Account Act of 2020

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 provide that certain types of income are excluded from gross income, such as amounts received as a gift or inheritance, certain compensation for injuries and sickness, qualified scholarships,¹ educational assistance programs, foster care payments, and interest received on certain state or federal obligations.

Existing federal and state laws allow contributions to qualified tuition program accounts (established pursuant to Internal Revenue Code (IRC) section 529), and earnings on those accounts to accumulate on a tax-free basis. Distributions from a qualified tuition program account are generally 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.

Existing federal and state laws allow contributions to Achieving a Better Life Experience Accounts (ABLE accounts) for the qualified disability expenses of the designated beneficiary of the account. Amounts in the account accumulate on a tax-free basis. Distributions from an ABLE account are generally excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the beneficiary during the taxable year.

Existing federal and state tax laws also allow nondeductible contributions to a Coverdell ESA for the benefit of a child under the age of 18 or a special needs beneficiary. Any number of people can contribute to the child's account; however, the total contributed for the year cannot exceed the specified annual amount, even if the child has more than one ESA.²

Neither federal nor state law currently provide a tax advantaged account similar to the one this provision would create.

This Provision

This provision, under the EC, among other things, would establish the ESA Act of 2020 that would create an ESA for each child across the state, eligible to be enrolled in kindergarten, or in an elementary or secondary school, in any of grades 1 to 12, inclusive, upon request of that child's parent.

The ESAs would be administered by an Education Savings Account Trust and would be funded by the state with the amount the state currently spends on public education for each pupil, about \$11,000, at no additional cost to taxpayers.

¹ Generally, any scholarship or fellowship grant is treated as tax-free to the extent used for qualified education expenses at an eligible education institution. An education institution may also include a primary or secondary school or high school, in addition to institutions of higher-education. Certain voucher programs are treated as tax-free scholarship programs, such as the D.C. Opportunity Scholarship program that in school year 2016/2017 provided 1,154 low-income students scholarships to attend K-12 private schools.

² Additional information on Coverdell ESA's is included under Provision 2 on page 5.

Commencing with the 2019-2020 fiscal year, and on July 1 of each year, the Department of Finance (DOF) would determine the annual ESA deposit amount for the upcoming school year.

The ESA would provide for direct expenditure of funds to an “eligible school” on behalf of the beneficiary for tuition, as defined. An “eligible school” would be broadly defined to include, public, private, charter, and vocational schools, as well as institutions of higher education.

This provision, under the PITL, for taxable years beginning on or after January 1, 2019, would allow an exclusion from gross income of a beneficiary of the account or the parent or legal guardian of a beneficiary of the account, for the following:

- Any distribution or earnings under an ESA established by this provision, pursuant to the EC.³
- Any contribution to an ESA.

This bill would add severability language that would, upon any provision or application of a provision being invalidated by a court, allow the remaining provisions to remain in effect.

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.

The provision lacks a reporting mechanism for the department to verify the amount of the exclusion. For clarity and ease of administration, it is recommended that the provision be amended.

Legislative History

SB 1304 (Melendez, 2017/2018), would have created the CalKIDS Savings Trust Fund and under the PITL, would have excluded from gross income amounts deposited into a CalKIDS savings account. SB 1304 failed to pass by the constitutional deadline.

SB 752 (Dutton, et al., 2007/2008), would have established the California Kids Investment and Development Savings (KIDS) Account Act that would have allowed a \$500 savings account for children born in California after a specified date. SB 752 failed to pass by the constitutional deadline.

³ Article 19.1 (commencing with Section 69995) of Chapter 2 of Part 42 of Division 5 of Title 3 of the Education Code.

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, Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide a tax-advantaged account comparable to the account that would be allowed by this provision; however, all of the states surveyed offer tax-advantaged qualified tuition programs, Coverdell, and ABLE accounts. Additionally, *Florida* offers a scholarship program allowing students with disabilities to attend a private school of choice. The scholarship amount is generally equal to the amount a public school would have otherwise received for that student.

Fiscal Impact

The department's costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

This estimate assumes this provision would not impact state income or franchise tax revenue, unless information, such as federal guidance or memorandum, is issued to indicate otherwise.

This provision would create the Education Savings Account Act of 2020 under the EC. Under this provision, the contributions made by the state to an account for education expenses would not be includible in the gross income of the beneficiary of the account or the parent or legal guardian of the beneficiary. In addition, any distributions or earnings from the accounts would also not be includible.

Provision 2: Tax Credit for Contributions Made to a Coverdell ESA.

Federal/State Law

Coverdell ESA

Federal and state tax laws allow individuals, corporations, and trusts to make nondeductible contributions to a Coverdell ESA for the benefit of a child under the age of 18 or a special needs beneficiary. Any number of people can contribute to the child's account; however, the total contributed for the year cannot exceed the specified annual amount, even if the child has more than one ESA. For 2017, the maximum contribution limit is \$2,000. Federal and state laws are generally the same for the tax on contributions over the \$2,000 limit. However, federal law may assess an additional six percent excise tax, but California does not.

Generally, distributions are tax-free if they are made for qualified educational expenses related to enrollment or attendance at an education institution, including tuition and fees, books, supplies, and equipment, services required for special needs beneficiaries, and room and board. If the distribution exceeds the beneficiary's qualified expenses, a portion is included in taxable income. The taxable portion is the amount of the excess distribution that represents earnings that have accumulated tax free in the account.

An eligible educational institution, under the Coverdell ESA, includes a K-12 program, as well as any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education.

Neither federal nor state law currently allow a credit similar to the one that would be created by this provision.

This Provision

For each taxable year beginning on or after January 1, 2021, this provision, under the PITL, would allow a credit in an amount equal to the contribution made by a taxpayer into a Coverdell ESA subject to the maximum contribution limit per designated beneficiary under IRC Section 530, relating to Coverdell ESAs. The credit must be claimed only on a timely filed original return.

On or before an unspecified date and each unspecified date thereafter, this provision would require the Franchise Tax Board (FTB), in consultation with the DOF, to determine the gross reduction in state revenue resulting from the tax credit created by this provision for the purpose of calculating the effect of the tax credit on the minimum funding guarantee for schools required by Section 8 of Article XVI of the California Constitution and provide that determination to the Legislature. The Legislature would be required to annually appropriate an amount necessary to offset any reduction in the minimum funding guarantee for schools caused by the tax credit.

This provision would allow the FTB to adopt regulations as necessary or appropriate to carry out the purposes of this section and would exclude from the provisions of the Administrative Procedures Act any standard, criterion, procedure, determination, rule, notice, or guideline so established or issued by the FTB.

This credit would become operative on January 1, 2019, and specifically operative for taxable years beginning on or after January 1, 2021, only if SCA 16 of the 2017–2018 Regular Session is approved by the voters at the statewide general election on November 6, 2018.

This provision, under the Corporation Tax Law, for taxable years beginning on or after January 1, 2021, would modify the state's Coverdell ESA law by adding an eligible school under the ESA Act of 2020, pursuant to the EC. This provision would become operative on January 1, 2019, beginning in the specified taxable year, only if SCA 16 of the 2017-2018 Regular Session is approved by the voters at the statewide general election on November 6, 2018.

This provision, as required under Revenue and Taxation Code (R&TC) section 41, would include specific goals, purposes, objectives, and performance measures for the credit created by this provision. The Legislative Analyst's Office would be required to collect and remit data to the Legislature with the assistance of the Superintendent of Public Instructions. This reporting requirement would become operative on January 1, 2019, only if SCA 16 of the 2017-2018 Regular Session is approved by the voters at the statewide general election on November 6, 2018.

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.

Implementing this provision would require some changes to existing tax forms and instructions and information systems.

The FTB, in consultation with the DOF, would be required to report to the Legislature by an unspecified date the state revenue loss resulting from the tax credit created by this provision. Personal income tax returns for taxable year 2021, the first year of the proposed credit, would be considered timely filed if filed by the extended deadline of October 15, 2022. The department generally processes returns within six months of receipt. 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 after April 2023. Additionally, the DOF calculates the minimum funding guarantee for schools; thus, the DOF, rather than the FTB, has the expertise related to school funding.

It is unclear whether the "maximum contribution limit per designated beneficiary" would limit a taxpayer to a maximum credit of \$2,000 per year, or if the taxpayer has multiple Coverdell ESAs could a \$2,000 credit be claimed for each beneficiary? For clarity and consistency with the author's intent, it is recommended that the bill be amended.

Legislative History

SB 1218 (Gaines, 2017/2018) would allow a deduction for contributions to a qualified tuition program. SB 1218 is pending before the Senate Appropriations Committee.

AB 1956 (Bonilla, et al., 2013/2014) would have created a refundable credit for contributions to a qualified tuition program. AB 1956 failed to pass by the constitutional deadline.

Other States' Information

Illinois, Massachusetts, Michigan, Minnesota, and New York laws lack a tax-credit comparable to the credit that would be allowed by this provision. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

Fiscal Impact

The department's costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

This provision would result in the following revenue loss:

Estimated Revenue Impact of Provision 2 of SB 1344 as Amended on April 2, 2018
For Taxable Years Beginning On or After January 1, 2021
Assumed Enactment after June 30, 2018

(\$ in Millions)

Fiscal Year	Revenue
2018-2019	- \$0.0
2019-2020	- \$0.0
2020-2021	- \$11.0

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

Based on Section 529 College Savings Plan data from the College Savings Plan Network as well as Coverdell ESA data from the Investment Company Institute, it is estimated there would be \$18 million in Coverdell ESA contributions in 2021.

It is estimated this provision would incentivize contributions to Coverdell ESA resulting in a 30 percent increase to contributions. This results in \$24 million in total Coverdell ESA contributions for 2021.

Because the credit allowed is equal to the contributions made by the taxpayer subject to the maximum contribution limits for Coverdell ESAs, the credit generated for 2021 is an estimated \$24 million. The credit may be claimed only on a timely filed original tax return, reducing the credit generated to \$23 million. Of those, it is assumed 80 percent, or \$19 million of the credit would be used in 2021.

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

Support/Opposition

Support: Choice 2020.

Opposition: None provided.

Arguments

Proponents: Some may say that the tax incentives offered by this bill would encourage savings for future education costs.

Opponents: Some may argue that the tax incentive that would be allowed by this bill would be overly broad and would result in revenue losses, which have to be paid for with higher taxes or reductions in services.

Policy Concerns

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

This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same moneys deposited into a Coverdale ESA.

The credit would be allowed for contributions to another state's Coverdell ESA. Thus, this provision could provide a credit for activity that has no connection to the state.

Although this bill limits the credit amount per Coverdale ESA, it fails to limit the total amount of the credit that may be taken. Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of a tax benefit by the Legislature.

Legislative Staff Contact

Davi Milam
Legislative Analyst, FTB
(916) 845-2551
davi.milam@ftb.ca.gov

Jame Eiserman
Revenue Manager, FTB
(916) 845-7484
jame.eiserman@ftb.ca.gov

Diane Deatherage
Legislative Director, FTB
(916) 845-6333
diane.deatherage@ftb.ca.gov