Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Baker, et al.	Analyst:	Jane Raboy	Bill Number:	AB 1041
Related Bills:	See Legislative History	Telephone:	845-5718	Introduced Date:	February 26, 2015
		Attorney:	Bruce Langston	Sponsor	

SUBJECT:	Coverdell Education Savings Account Deduction

SUMMARY

This bill, under the Personal Income Tax Law, would allow a deduction for contributions to a Coverdell education savings account (Coverdell Account).

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for this bill is to encourage families to start planning for primary, secondary and college education by investing for qualified educational expenses.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2015.

FEDERAL/STATE LAW

Existing federal and state laws allow for the deduction of certain expenses when calculating adjusted gross income (AGI), such as moving expenses and interest on education loans, certain ordinary and necessary trade and business expenses, losses from the sale or exchange of certain property, contributions for pension, profit-sharing and annuity plans of self employed individuals, retirement savings, and alimony. Thus, all taxpayers with these types of expenses receive the benefit of the deduction, regardless of whether the taxpayer itemizes deductions or uses the standard deduction. These are known as “above-the-line” deductions.

Federal Law

Under Section 530 of the Internal Revenue Code (IRC Section 530), a Coverdell Account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary. For 2014, the maximum annual contribution to a Coverdell Account may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary).

Board Position:						Executive Officer	Date
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The contribution limit is phased out for taxpayers with modified adjusted gross income (MAGI) between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the MAGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Contributions to a Coverdell Account are not tax-deductible, but the earnings grow tax-free. Distributions from a Coverdell Account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell Account distribution not used to pay qualified education expenses is includible in the gross income of the beneficiary and generally is subject to an additional 10-percent tax.

As defined under IRC Section 530,[1] qualified education expenses include “qualified higher education expenses” and “qualified elementary and secondary education expenses”. The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. The funds for "qualified elementary and secondary education expenses" can be used to cover the costs of attending elementary and secondary school, kindergarten through grade 12. In addition to tuition, these costs can include uniforms, tutoring, computers, software, and transportation.

Assets may be rolled over from one Coverdell Account to another or the designated beneficiary can be changed. The beneficiary's interest can be transferred to a spouse or former spouse because of divorce.

State Law

California law[2] conforms to IRC Section 530 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 education expenses. 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 does not allow a deduction for contributions to a Coverdell Account.

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[1] See Department of the Treasury, Internal Revenue Service, Publication 970, "Tax Benefits for Education", at < http://www.irs.gov/pub/irs-pdf/p970.pdf>, dated 03/18/2015, for more details.
[2] Revenue and Taxation Code (R&TC) section 23712.

THIS BILL

This bill would allow a deduction for an amount contributed by a taxpayer during the taxable year to a Coverdell education savings account, not to exceed $750 per taxable year, except as otherwise provided.

This bill would define "Coverdell education savings account" to have the same meaning as defined by IRC Section 530, as modified by R&TC section 23712 (see Federal/State Law section of this analysis).

This bill would require that the basis of the Coverdell Account be reduced by any amount deducted.

For taxable years beginning on or after January 1, 2014, the deduction allowed by this bill would reduce gross income in determining adjusted gross income (referred to as an “above-the-line” deduction).

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.

This bill is silent on whether amounts transferred or rolled over from one Coverdell Account to another would qualify for the deduction and how the department could verify that a contribution was made to a qualified tuition program. The lack of guidance could cause disputes between taxpayers and the department.

TECHNICAL CONSIDERATIONS

On page 2, line 9, the bill incorrectly refers to taxable years beginning on or after January 1, 2014. The bill should be amended to replace “2014” with the correct year, “2015”.

LEGISLATIVE HISTORY

AB 2426 (Nestande, et al., 2013/2014), substantially similar to this bill, would have allowed a deduction for contributions to a Coverdell Account. AB 2426 failed to pass out of the Assembly Appropriations Committee without further action.

AB 757 (Niello, 2009/2010) would have allowed an amount deposited by a taxpayer during the taxable year in an education savings account, including a Coverdell account, to be excluded from the gross income of the beneficiary of the account. AB 757 failed to pass out of the Assembly Revenue and Taxation Committee.

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 does not have personal income tax, and therefore does not provide a deduction comparable to the deduction proposed by this bill.

Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a deduction from gross income comparable to this bill.

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 1041 As Introduced February 26, 2015 Assumed Enactment After June 30, 2015		
2015-16	2016-17	2017-18
- $350,000	- $450,000	- $450,000

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 as well as Coverdell Account data from the Investment Company Institute, it is estimated there would be $13.5 million in Coverdell Account contributions in 2015 and $14 million in 2016.

It is estimated this bill would incentivize contributions to Coverdell Accounts resulting in a 5 percent increase over 2015 contributions and a 20 percent increase each year thereafter. This results in $14 million in total Coverdell Account contributions for 2015, and $17 million for 2016.

Based on the estimated average annual contributions, it is expected that 42 percent of annual contributions would be equal to or less than the $750 maximum deduction. This results in $6 million of 2015 and $7 million of 2016 contributions qualifying for the deduction. An average tax rate was then applied to the qualifying contributions resulting in revenue losses of $360,000 in 2015 and $430,000 in 2016.

This bill would require reductions to the basis of the Coverdell Accounts by any amount deducted. In calculating the reduction to the basis of the Coverdell Accounts, it is assumed distributions from the accounts would be minimal in the first few years and only a small share of deductions would be related to distributions. The impact of the basis adjustment would increase over time as the share of deductions taken versus contributions grows. Therefore, in the first few years the revenue impact of the basis adjustment would be minimal.

The tax year estimates were converted to fiscal year estimates, and then rounded to arrive at the estimates reflected in the table above.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Supporters may argue that a deduction for contributions to a Coverdell Account could reduce the need for student loans and other educational borrowing by encouraging increased savings for education expenses.

Opponents: Some may argue that Coverdell Accounts are vehicles for saving that may not be used by less sophisticated families that may be in greater need of assistance.

POLICY CONCERNS

This bill would establish a deduction from gross income for which federal law has no counterpart, thus increasing nonconformity.

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