HB 644

Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 644 (Delegate Lam, *et al.*)
Ways and Means

State Income Tax - Subtraction Modification - Elementary and Secondary Education Expenses

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This bill prohibits an individual from claiming the State income subtraction modification for contributions made to the Maryland College Investment Plan if the contributed funds are used for elementary or secondary education expenses as allowed under the Internal Revenue Code (IRC). The bill also prohibits an individual from claiming a subtraction modification for a distribution from the Maryland College Investment Plan or Maryland Prepaid Trust if the distribution is used for these expenses. **The bill takes effect July 1, 2018, and applies to tax year 2018 and beyond.**

Fiscal Summary

State Effect: Prohibiting individuals from claiming the subtraction modification will prevent revenue losses of $14.1 million in FY 2019 and $20.3 million annually beginning in FY 2020. Expenditures are not affected.

($ in millions)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
GF Revenue	$14.1	$20.3	$20.3	$20.3	$20.3
Expenditure	0	0	0	0	0
Net Effect	$14.1	$20.3	$20.3	$20.3	$20.3

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate increase; (-) = indeterminate decrease

Local Effect: The bill will prevent local revenue losses of $7.5 million in FY 2019 and by $10.8 million annually beginning in FY 2020. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law:

Federal Tax Benefits and 529 Plans

Qualified tuition plans, also known as 529 plans, are state programs that allow an individual to either prepay or contribute to an account established for paying a student's qualified higher education expenses. Accounts and plans must satisfy the income tax and transfer rules established under Section 529 of the IRC.

Contributions are not deductible for federal tax purposes; however, amounts deposited in the account grow tax free and distributions are not subject to federal or state taxes if the distributions are used for the qualified higher education expense of a beneficiary. These tax advantages are similar to the federal tax treatment of Roth IRAs.

The federal Tax Cuts and Jobs Act of 2017 (Public Law 115-97) was signed into law on December 22, 2017, and expands the permissible use of 529 plans by amending qualified higher education expense to include expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school. To date, the IRS has not issued guidance on the expenses that will qualify.

An account holder can withdrawal up to $10,000 in each year for expenses associated with enrollment at these schools. This limitation applies to each beneficiary rather than a per account basis – although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of $10,000 in distributions free of tax, regardless of whether the funds are distributed from multiple accounts. Any excess distribution will be treated as a distribution subject to tax under the general rules of Section 529.

The federal Act applies to distributions made after December 31, 2017.

Maryland 529 Plans

The College Savings Plans of Maryland Board currently operates two qualified tuition plans: the Maryland Prepaid College Trust and the Maryland College Investment Plan. Chapter 548 of 2008 authorized the board to establish a third plan, the Maryland Broker-Dealer College Investment Plan, but the board has yet to do so.

State Taxation of 529 Plans

Account Contributions

In addition to the federal tax benefits available to 529 plans, the State allows a person to claim a subtraction modification for the advanced amount of tuition payments made to the Maryland Prepaid College Trust or amount contributed to the Maryland College Investment Plan. The subtraction modification claimed by a taxpayer may not exceed $2,500 for each contract purchased (Maryland Prepaid College Trust) or $2,500 per beneficiary (Maryland College Investment Plan). This limitation is increased to $5,000 for married individuals who file jointly.

Any unused amount of the subtraction modification can be carried forward to future tax years until the full amount of the excess is used under the Maryland Prepaid College Trust and up to 10 tax years for contributions to the Maryland College Investment Plan.

The College Affordability Act of 2016 (Chapters 689 and 690) established a State matching contribution of $250 per beneficiary for qualified Maryland College Investment Plan accounts. An investment account holder is not eligible for the subtraction modification for contributions to an investment account in any year in which the account holder receives funds under the program.

Account Withdrawals

The State generally conforms to the federal income tax treatment of qualified 529 withdrawals – qualified distributions that are not subject to federal tax are also exempt from state taxes. A person may also claim a subtraction modification for income as a result of a distribution to a qualified beneficiary to the extent the income is included in federal adjusted gross income.

Background:

State College Investment Plans

Exhibit 1 shows the number of resident tax returns that claimed the college savings subtraction modification in tax year 2014 by federal adjusted gross income, the percentage of all returns that claimed the subtraction modification, and the average deduction claimed.

Exhibit 1
College Savings Plans Subtraction Modification
Tax Year 2014

FAGI	Total Tax Returns	Claimed Either Benefit: Number	% of All Returns	Average Claim
Less than $25,000	1,032,398	598	0.1%	$2,893
$25,001-$100,000	1,400,308	8,376	0.6%	2,780
$100,001-$200,000	500,515	26,124	5.2%	3,743
$200,001-$500,000	157,246	20,064	12.8%	5,636
Over $500,000	34,077	4,277	12.6%	8,053
Total	**3,124,544**	**59,439**	**1.9%**	**$4,499**

FAGI: federal adjusted gross income

Note: Tax returns (total and those claiming the subtraction modification) reflect resident tax returns only.

Source: Comptroller's Office; Department of Legislative Services

Impact of Federal Tax Cuts and Jobs Act of 2017

In January 2018, the Comptroller's Office issued an analysis of the impact of the federal Tax Cuts and Jobs Act of 2017 on Maryland taxpayers and State and local revenues. In its revised estimate issued in February 2018, the Comptroller's Office estimates that 71% of Maryland taxpayers will pay less in federal taxes, 13% will pay more, and the remaining 16% will not be impacted. In total, federal taxes paid by Maryland residents will decrease by $2.75 billion – reflecting a decrease of $3.54 billion paid by 2.0 million taxpayers and an increase of $782 million paid by 376,000 taxpayers.

Several provisions will impact State income taxes including the expansion of 529 plans, the elimination of miscellaneous deductions and a limitation on the value of the state and local taxes paid deduction.

As a result of the increased value of the federal standard deduction, and that under current law only those taxpayers who itemize for federal income tax purposes can itemize on their State income tax return, the Act will also reduce the number of State taxpayers who itemize deductions.

The Comptroller's Office estimates that the federal legislation will not impact the State and local income taxes paid by 71% of all taxpayers. About 6% of taxpayers will pay less and about 23% will pay additional State and local income taxes. In total, the Comptroller's Office estimates that 9% of all taxpayers will have a net increase in federal, State, and local tax liabilities, and the remaining 91% of taxpayers will have no change or a net decrease in federal, State, and local tax liabilities.

As a result, the Comptroller's Office initial estimate is that the direct change to the State personal income tax in fiscal 2019 will result in a net additional $572.3 million in State and local taxes paid ($361.1 million, State; and $211.2 million, local). In fiscal 2020, the increase will total $451.0 million ($284.4 million, State; and $166.6 million, local). A significant portion of the revenue gain is due to the shift in taxpayers who will now claim the standard deduction. The Comptroller's Office estimates that up to 700,000 taxpayers who would have itemized deductions will now claim the State standard deduction, due to the federal Act.

State Revenues: The bill prohibits an individual from claiming the subtraction modification for contributions made to the Maryland College Investment Plan if the funds are used for elementary or secondary education expenses as allowed under the IRC. This change is effective beginning with tax year 2018.

The Comptroller's Office estimates that the expansion of 529 plans to primary and secondary school expenses as enacted by the federal Tax Cuts and Jobs Act will reduce State income tax revenues by $14.1 million in tax year 2018 and by $20.3 million annually thereafter. Given the timing of the federal legislation, the estimated net revenue impact of the federal Act was not included in the Governor's proposed fiscal year 2019 budget. The Board of Revenue Estimates will revise the March estimates to include the estimated net State and local revenue impact of the federal Act. Accordingly, the bill will prevent revenue losses of $14.1 million in fiscal 2019 and $20.3 million annually beginning in fiscal 2020. The estimated revenue impact assumes that the Comptroller's Office will identify and disallow any subtraction modifications that are claimed for contributions made for primary and secondary school expenses.

The bill also prohibits an individual from claiming a subtraction modification for a distribution from the Maryland College Investment Plan or Maryland Prepaid Trust if the distribution is used for elementary or secondary education expenses. Given that a qualified distribution for these expenses is exempt from federal taxation, this provision will generally prevent individuals from claiming the State subtraction modification for nonqualified distributions and any revenue impact is not expected to be significant.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office; Department of Legislative Services

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