Department of Legislative Services

Maryland General Assembly
2000 Session

FISCAL NOTE
Revised

Senate Bill 140 (Senator Miller, *et al.*)
(Administration)
Budget & Taxation/Economic & Environmental Affairs Ref. to Appropriations

Maryland Prepaid College Trust and Maryland College Investment Plan

This Administration bill makes a number of changes to the Maryland Higher Education Investment Program and creates the Maryland College Investment Plan.

The bill takes effect July 1, 2000, and applies to all prepaid contracts purchased prior to that date. The tax provisions of the bill are applicable to all taxable years beginning after December 31, 2000.

Fiscal Summary

State Effect: The financial viability of the Maryland Prepaid College Trust could improve to some degree as a result of some of the bill's changes. On the other hand, the Maryland College Investment Plan could draw participants from the Maryland Prepaid College Trust's market. Start-up costs for the Maryland College Investment Plan could be as high as $1 million in the first year of operation. State income tax revenues would decline by $120 in FY 2002 and $119 in FY 2003 and beyond for each subtraction modification of $2,500 taken by contributors to the Maryland College Investment Plan.

Local Effect: Local governments would lose $66.75 in income tax revenues for each subtraction modification of $2,500 taken by contributors to the Maryland College Investment Plan.

Small Business Effect: A small business impact statement was not provided by the Administration in time for inclusion in this fiscal note. A revised fiscal note will be issued when the Administration's assessment becomes available.

Analysis

Bill Summary:

Maryland Higher Education Investment Program

The bill makes the following changes to provisions relating to the Maryland Higher Education Investment Program:

- The name of the program is formally changed to the Maryland Prepaid College Trust (the name Maryland Prepaid College Trust is already in use for marketing purposes).

- Contributors may be granted rebates in the event that program assets exceed liabilities by 30% or more, except under certain circumstances.

- A statutory guarantee is created for the program, such that if the current prepaid contract obligations of the program exceed the market value of program assets, the Governor must include in the annual budget bill an appropriation sufficient to cover the shortfall. At the request of the Maryland Higher Education Investment Board (Board), the program must repay any such appropriated amount to the State without interest in equal amounts in each of the next two fiscal years.

- The board may only adjust the terms of subsequent or current investment contracts to ensure continued actuarial soundness of the program in the event that the full amount of a shortfall was not appropriated as requested. Under current law, the board may make such an adjustment after each annual review of the comprehensive investment plan for actuarial soundness.

- The board may allow excess prepaid contract benefits due to receipt of scholarship, tuition remission, or early graduation to be used toward the payment of other Qualified Higher Education Expenses, a term defined in the Internal Revenue Code to include tuition, fees, books, supplies, and equipment required for college attendance, as well as certain room and board expenses for students who attend college at least half-time. Currently, program funds may only be used to pay tuition and fees.

- A non-discounted refund may be made if the beneficiary graduates early from college. Under current law, a non-discounted refund is available in the event of scholarship, tuition remission, death, or disability.
- Funds may be transferred from the Maryland Prepaid College Trust to any other qualified state tuition program or from any other qualified state tuition program to Maryland Prepaid College Trust, in accordance with federal law.

- The Legislative Auditor must audit the Maryland Prepaid College Trust at least once every three years. Under current law, the Legislative Auditor is required to audit the program annually. In addition, the bill requires the program to be audited by an outside independent auditor annually. The board would no longer be required to pay for the legislative audit, but would be required to pay for the outside audit.

- The totality of the marketing efforts undertaken by the board must disclose that there is no guarantee that the earnings of assets invested in the program will generate enough money to cover the actual costs of tuition at the time of the beneficiary's enrollment in college. Under current law, any marketing efforts are required to include such a disclaimer.

Maryland College Investment Plan

The bill also creates the Maryland College Investment Plan to allow contributions to an investment account established for the purposes of meeting the Qualified Higher Education Expenses of the designated beneficiary of the account. The Maryland College Investment Plan is to be administered, managed, promoted, and marketed by the board. The board must administer the program in compliance with Internal Revenue Service standards for Qualified State Tuition Programs. The board may outsource the administration, management, promotion, or marketing of the Maryland College Investment Plan. The program must reimburse the State for any start-up expenses paid by the State. There is no State residency requirement for participation in the Maryland College Investment Plan. The assets and obligations of the program are not in any way guaranteed by the State. The assets and income of the program are exempt from State and local taxation. The program must be audited in a similar fashion as the Maryland Prepaid College Trust.

Contributors may claim an income tax subtraction modification for the contributions made in that taxable year to the plan for each beneficiary. The subtraction may not exceed $2,500 per designated beneficiary for any taxable year. Contributions exceeding $2,500 per year may be carried over for ten years or until the full amount of the contribution has been taken as a subtraction. A subtraction modification may also be taken for amounts distributed to the beneficiary at the time of college attendance. Any account funds not ultimately used for Qualified Higher Education Expenses and refunded to the contributor must be added to the contributor's Maryland adjusted gross income.

Current Law: The Maryland Higher Education Investment Program, an off-budget independent State agency overseen by a nine-member board, was established in 1997. The program was created to enhance the accessibility and affordability of a college education by providing for the prepayment of projected in-State tuition and mandatory fees at Maryland public colleges. Parents, grandparents, and other interested persons may purchase a contract based on current tuition and fee amounts. The program offers several tuition plans and payment options. If the beneficiary attends an in-State public college, the program will pay the actual costs of tuition and fees when the beneficiary matriculates. If the beneficiary chooses to attend a private or out-of-state college, the program will pay the weighted average of tuition and mandatory fees of the Maryland public colleges. The purchaser or beneficiary must be a resident of Maryland or the District of Columbia at the time that the purchaser enters into the contract.

Earnings on a purchased contract are exempt from income taxation at the State level. In addition, contributors may take an income tax subtraction modification for amounts contributed to an MHEIP account. A contributor may deduct up to $2,500 each year per contract purchased until the full contribution amount has been allowed as a subtraction. At the federal level, earnings on a purchased contract are tax-deferred, and are taxed at the beneficiary's tax rate when the contract benefits are used for Qualified Higher Education Expenses.

Background:

Section 529 of the Internal Revenue Code

Section 529 of the Internal Revenue Code (26 U.S.C.§ 529) relates to qualified state tuition programs (QSTPs). A QSTP is defined as a program established and maintained by a state or agency or instrumentality of a state, under which a person:

- may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "**prepaid tuition plan**"); or

- may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account (a "**savings plan**").

Prepaid Tuition Plan - Maryland Prepaid College Trust

The first type of QSTP, the prepaid tuition plan, is analogous to a defined benefit pension plan. In a prepaid plan, contributors buy contracts to pay for a set number of academic periods or course units. The price of a contract is determined prior to purchase. The contract price depends on the type of contract purchased, the projected date of the beneficiary's enrollment, the current and projected cost of tuition, and the assumed rate of return. The programs pool all payments into one large fund and invest it with the goal of achieving a rate of return that is higher than the anticipated rate of tuition increase. The Maryland Prepaid College Trust is a prepaid tuition plan.

Savings Plan - Maryland College Investment Plan

The second type of QSTP is a savings plan, which is analogous to a defined contribution pension plan. A savings plan's return is based on investment performance, not tuition cost. Set payments are not required. The return and risk associated with a savings plan are generally higher than with a prepaid plan. The proposed Maryland College Investment Plan is a savings plan.

Currently, 45 states have QSTPs underway or enabling legislation enacted. Due to the stock market surge and other factors, savings plans have become more popular than prepaid programs in recent years.

Performance of the Maryland Prepaid College Trust to Date

Since its creation in 1997, the Maryland Prepaid College Trust has performed well below expectations. The initial application level was projected at 10,000. After two enrollment periods, only 4,076 applications were received and 3,629 prepaid contracts purchased. On February 29, 2000, the program completed its third enrollment period, during which 1,795 applications were received.

The 1997 enabling legislation required the State to provide start-up funds for the Maryland Prepaid College Trust. Subsequently, the program was to be supported solely by self-generated income from program fees and investment income above the rate of tuition growth. The program received $1,359,194 in State funds for start-up in April 1998 when it began operation, and has received an additional $2.3 million (including a $500,000 deficiency appropriation for fiscal 2000) from the State, for a total of approximately $3.6 million in general funds to date for operational expenses. The proposed 2001 State budget does not include any operating funds for the trust.

A recent Department of Legislative Services report observed that the Maryland Prepaid

College Trust is at a critical juncture. Even using optimistic assumptions, forecasts contained in the Maryland Prepaid College Trust's business plan indicate that the program's financial situation will not significantly improve in the future. It is likely that ongoing State subsidization will be required under any scenario.

State Fiscal Effect:

Maryland Prepaid College Trust

Creation of guarantee

The bill creates a statutory guarantee for the Maryland Prepaid College Trust by which the State guarantees that, should the program experience a shortfall in covering contract benefits for any given year, the Governor must include an appropriation for the amount of the shortfall. The General Assembly would retain the authority to decide whether to include the funds in the enacted budget.

Based on the results of a marketing survey, the Maryland Prepaid College Trust has identified the lack of a guarantee to be a major reason for the poor enrollment experienced so far. It is believed that potential participants are reluctant to participate in the program because they feel that the lack of a guarantee means the program lacks financial security. The majority of states with a prepaid program have a state guarantee. Although it is probable that a statutory guarantee would increase program enrollment, the precise degree of any such enrollment increase is unknown.

The long-term effect of a statutory guarantee on the State's bond rating is not known.

Marketing efforts

The Maryland Prepaid College Trust's current program booklet is a lengthy, dense document containing detailed disclosure statements. The Office of the Attorney General has required extensive disclosure within the program booklet because the program qualifies as a security under federal and Maryland securities laws. While apparently necessary, the risk disclosures are such that they probably serve to deter program participation. Legislative Services has recommended that risk disclosures be placed in a separate document to be included with the program booklet. The bill's modification of the disclosure requirement could provide the program with greater flexibility in its marketing efforts, thereby improving program participation.

Audits

The Office of Legislative Audits (OLA) advises that changing the audit requirement for the Maryland Prepaid College Trust from every year to every three years would result in an expense reduction of $40,000 over three years. Adding the audit requirement for the Maryland College Investment Plan would result in an increase in expenses of $20,000 every third year for OLA. The combined fiscal impact to OLA would be an expense reduction of $20,000 over a three-year period, or approximately $6,700 annually. OLA absorbed the cost of auditing the Maryland Prepaid College Trust when it was established in 1997 (that is, no additional positions were added or funds appropriated), although it was not required by law to do so.

Other

It is expected that the bill's other changes to the Maryland Prepaid College Trust would, for the most part, tend to improve the attractiveness of the program to potential investors and, as such, could serve to improve the financial viability of the program to some degree.

Savings Program

Start-up Costs

MHEIP did not provide Legislative Services with an estimate of Maryland College Investment Plan start up costs, on the ground that the board is not yet far along in its decision-making process.

The costs to implement the Maryland College Investment Plan would depend largely upon whether and to what degree administration functions would be outsourced. (The Maryland Prepaid College Trust currently outsources marketing, actuarial, banking, financial advisory, and recordkeeping functions, but the program is administered in-house). In states that outsource their program administration, the outsourced functions are generally handled by a large brokerage house, such as Merrill Lynch, or a bank. The QSTP itself usually maintains only a small staff. The brokerage company or bank usually fronts marketing expenses and is compensated through investment and/or application fees.

If administrative functions remain in-house, operational costs would increase. The program would probably have to expand its staff above its current level of six employees. **The Maryland Prepaid College Trust has previously stated that start-up costs for the new program could be as high as $1 million in the first year.**

Effect on Existing Prepaid Program

The Maryland Prepaid College Trust has contended that the addition of a savings plan would provide a strong positive benefit to the prepaid plan. Legislative Services disagrees with this assertion. While a savings plan administered by an outside party could be self-sustaining, the operating expenses of the existing prepaid plan would not be reduced. Moreover, it is counterintuitive that the addition of a savings plan, which would be more attractive to investors with higher risk-bearing abilities, would cause increased participation in the prepaid plan. The prepaid plan has tended to attract higher income participants, with 74% of contracts held by families with annual incomes of more than $60,000. If a savings plan is created, it is likely that it would draw many of its participants from the prepaid program's market.

Tax Revenues

Each $2,500 subtraction for contributions would reduce State income tax revenues by $120 for tax year 2001 and $119 for tax years 2002 and later. (It is assumed that contributors would not begin taking subtractions until tax year 2001, to allow for start-up time for the program). The subtraction for each tax year would likely reduce revenues in the following fiscal year when returns are filed. The provision creating tax-exempt status for account earnings would also reduce State income tax revenues. This reduction effect would not begin until at least a year after the program begins operation, and would gradually build up as more and more beneficiaries reach college age.

The total amount of any decrease in State revenues cannot be determined at this time. The actual decrease in revenues for any given year would depend upon the number of accounts purchased, the dollar amounts of contributions, amounts refunded, effective tax rates, the ages of beneficiaries, and plan performance.

Local Revenues: On average, local governments would lose $66.75 in tax revenues for each subtraction of $2,500.

Additional Comments: The Comptroller's Office advises that the addition modification may be difficult to administer. For tax preparation purposes, a taxpayer receiving a refund from the plan would need to be notified as to how much of the refund represents interest. The Comptroller's Office should also be sent such notification.

Additional Information

Prior Introductions: HB 1121 of 1999 sought to create the Maryland College Tuition Savings Plan. That bill was not reported out of the Appropriations committee.

Cross File: HB 11 (Administration) - Appropriations.

Information Source(s): Comptroller of the Treasury (Bureau of Revenue Estimates), Maryland Higher Education Commission, Maryland Higher Education Investment Program, Department of Legislative Services

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