SB 383

Department of Legislative Services

Maryland General Assembly
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FISCAL NOTE
Revised

Senate Bill 383 (Senator Miller, *et al.*)
Budget and Taxation Ways and Means

Qualified Tuition Programs - Income Tax Treatment

This bill clarifies and alters existing State subtraction modifications for tax deferred contributions to higher education prepaid tuition programs and investment programs.

Specifically, the bill clarifies that: (1) a subtraction modification of up to $2,500 per contributor per beneficiary is available for contributions to any qualified prepaid tuition program under federal law; and (2) a subtraction modification of up to $2,500 per contributor per beneficiary is available for contributions to any qualified higher education investment program under federal law. The bill expands the types of programs that qualify for the subtraction modifications to any qualified tuition program under federal law. Under current law, these subtraction modifications are limited to contributions made only in the State prepaid and investment plans.

The bill also clarifies that the subtraction modifications as well as an existing addition modification do not include any amounts from the tax-free rollover from another prepaid tuition program or another higher education investment program. Finally, the bill repeals a subtraction modification that is now obsolete because of changes made by the 2001 federal tax act.

The bill takes effect July 1, 2002 and applies to all taxable years beginning after December 31, 2001.

Fiscal Summary

State Effect: General fund revenue loss could be mitigated significantly as a result of limiting the number of subtraction modifications that may be taken by one contributor for one beneficiary. The amount of savings depends on the number of accounts opened per beneficiary compared to current law. Potential significant revenue decrease associated with the subtraction modification being claimed for contributions made to other state plans. The net effect of the bill cannot be reliably estimated at this time but could be significant.

Local Effect: Local government revenues would increase due to the limitations put in place by the bill. Local government revenues increase by approximately 2.8% of any increase in adjusted gross income.

Small Business Effect: None.

Analysis

Current Law: Chapter 494 of 2001 established the Maryland College Investment Plan as part of the Maryland Higher Education Investment Program. Chapter 494 provided State income tax benefits for those participating in the program similar to the tax benefits available to those participating in the Maryland Prepaid College Trust. Taxpayers are allowed a subtraction modification of up to $2,500 for amounts contributed to an investment account under the Maryland College Investment Plan. Contributions in excess of $2,500 for any taxable year may be carried forward and used as a subtraction for up to ten succeeding tax years. A subtraction modification is also allowed for distributions to a qualified designated beneficiary under an investment account, to the extent the distributions are included in federal adjusted gross income. Chapter 494 also required that any refunds from an investment account or distributions that are not used for qualified higher education expenses of the qualified designated beneficiary must be added back to determine Maryland taxable income.

Background: The Maryland Higher Education Investment Program is an off-budget independent State agency governed by a nine-member board. The program was established in 1997 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. The program operates in accordance with Section 529 of IRC, which provides for 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 that 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 that is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account (a "savings plan").

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 and has been in existence since 1997.

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 costs. Set payments are not required. The return and risk associated with a savings plan are generally higher than with a prepaid plan. The Maryland College Investment Plan, which started in December 2001, is a savings plan.

Qualified state tuition programs such as the College Investment Plan and the Maryland Prepaid College Trust receive federal income tax advantages under § 529 of the Internal Revenue Code. The federal Economic Growth and Tax Relief Reconciliation Act of 2001 made significant changes regarding § 529 plans. Among other changes, the 2001 federal tax act greatly enhanced the attractiveness of these plans as education savings vehicles by providing a federal income tax exemption for distributions from qualified state tuition plans to the extent the distributions are used for qualified higher education purposes. Under former federal law, a federal tax deferral was allowed as earnings accrued under a § 529 plan, but the tax was imposed on earnings when distributions were made from a plan.

Most states have established § 529 plans qualifying for the special tax advantages provided under the federal income tax. Several states, like Maryland, provide state tax deductions for contributions to the plans. Many other states provide an exemption for earnings from the plans for state income tax purposes but do not provide a deduction for contributions.

Several issues regarding the Maryland income tax treatment of the Maryland § 529 plans arose after the College Investment Plan began in December 2001. These involve two separate provisions of the Maryland income tax law relating to the Maryland § 529 plans:

- the deduction for contributions to an investment account under the Maryland College Investment Plan; and

- the addition modification for refunds or distributions not used on behalf of the designated beneficiary for qualified higher education expenses.

Deduction for Contributions -- Maximum Deduction

Under the federal income tax law, while earnings under a § 529 plan accrue tax-free and may be distributed for education purposes tax-free, no deduction is allowed for contributions to a § 529 plan. For purposes of the Maryland income tax, however, an individual may claim a subtraction modification (deduction) for contributions to a Maryland-sponsored § 529 plan. The law limits the subtraction modification to $2,500 for any taxable year "for each investment account," and provides that excess contributions may be carried over and used for up to ten years, subject to the $2,500 limitation each year.

The law authorizing the College Investment Plan allows the plan to be divided into multiple investment portfolios. The board, in setting up the College Investment Plan, provided that an individual may establish multiple "accounts" for a single beneficiary, a separate "account" being established for each investment option or portfolio selected. The plan currently provides for ten separate investment options, so that as it was marketed by the board, an individual could open up to ten separate "accounts" for the same beneficiary, with $2,500 contributed to each "account" and receive a total deduction of $25,000 for one taxable year.

In December, questions arose as to whether the board's interpretation of this provision was consistent with the statute. The Comptroller's Office indicated that it would accept the board's interpretation for tax year 2001, to avoid problems in the marketing of the plan.

Treatment of Tax-Free Rollovers from One § 529 Plan to Another

A second issue regarding the income tax treatment of the Maryland Higher Education Investment Program involves the treatment of "rollover" contributions from one § 529 plan to another. Under the federal income tax law, a distribution from a qualified tuition plan, generally taxable unless used for qualified higher education expenses of the designated beneficiary, is not taxable if it is transferred within 60 days ("rolled over") to another qualified tuition plan for the benefit of the designated beneficiary or for the benefit of members of the original designated beneficiary's family.

Current Maryland income tax law requires an addition modification for refunds or distributions under the Maryland plans that are not used on behalf of the designated beneficiary for qualified higher education expenses. The law does not specify how tax-free "rollovers" under federal law are to be treated for purposes of this addition modification. Amounts rolled over to another § 529 plan are not technically being "used" for qualified higher education expenses, so the literal language of the addition modification would seem to require the addition modification for amounts distributed from the Maryland plans, regardless of whether those amounts are "rolled over" under federal law. Along similar lines, the Maryland law allowing the subtraction modification for contributions to the Maryland plan is also silent as to the treatment of "rollover" contributions.

The bill is intended to clarify these provisions of the statute.

Currently, 22 states, including Maryland, provide some type of income tax benefit for contributions made to the state's 529 plans.

State Fiscal Effect: This bill has the effect of reducing the State revenue loss associated with the Maryland College Investment Plan.

For the first month of the program (December 2001), a total of 27,499 college investment accounts were opened. In that time period there were 3,911 instances where one account holder opened more than one investment account for the same beneficiary. Under the current interpretation of the law, these taxpayers could claim an income tax subtraction modification of $2,500 for each account opened for one beneficiary.

Exhibit 1 shows the revenue impact for tax year 2001 as a result of the interpretation that a $2,500 subtraction may be taken for each account opened for a single beneficiary.

Exhibit 1
TY 2001 Impact Under Current Law

Number of Accounts For One Beneficiary	Number of Accounts Purchased	Average Account Balance	Total Subtraction Allowed Per Account	Amount to Be Deducted
2	1,586	$3,398	$5,000	$7,930,000
3	447	$3,091	$7,500	$3,352,500
4	728	$2,621	$10,000	$7,280,000
5	159	$2,808	$12,500	$1,987,500
6	110	$2,370	$15,000	$1,564,200
7	40	$2,367	$17,500	$662,760
8	112	$2,731	$20,000	$2,240,000
9	25	$2,336	$22,500	$525,600
10	784	$2,756	$25,000	$19,600,000
Total	3991			$45,142,560
Total State Revenue Loss				**$2,144,272**

Exhibit 2 shows the revenue loss if the bill was in effect for tax year 2001.

Exhibit 2
TY 2001 Impact Under HB 437

Number of Accounts For One Beneficiary	Number of Accounts Purchased	Average Account Balance	Total Subtraction Allowed Per Account	Amount to Be Deducted
2	1,586	$3,398	$2,500	$3,965,000
3	447	$3,091	$2,500	$1,117,500
4	728	$2,621	$2,500	$1,820,000
5	159	$2,808	$2,500	$397,500
6	110	$2,370	$2,500	$260,700
7	40	$2,367	$2,500	$94,680
8	112	$2,731	$2,500	$280,000
9	25	$2,336	$2,500	$58,400
10	784	$2,756	$2,500	$1,960,000
Total	3991			$9,953,780
Total State Revenue Loss				$472,805

If the bill was in effect for tax year 2001, the revenue loss in fiscal 2002 would be reduced by approximately $1.7 million. Therefore, assuming current participation in the Investment Plan, State revenue losses would diminish as result of the bill.

However, due to the changes made by the bill, it is difficult to estimate what participation in the plan will be in future years. The possibility exists that due to the publicity surrounding the program and the speculation that changes were going to be made to the plan that would make it a less attractive investment opportunity for income tax purposes, it is difficult to estimate how many of these accounts were opened to take advantage of the current interpretation that a $2,500 subtraction is allowed for each account opened.

Some taxpayers would still open more than one account per beneficiary. However, under the bill, these taxpayers would only be allowed one subtraction of $2,500 no matter how many accounts were opened.

Each $2,500 subtraction for contributions reduces State income tax revenues by $119 for tax years 2002 and later.

The bill also extends the subtraction modification to contributions made to other state or private plans. Under current law, the subtraction modification is only allowed for contributions made to the two existing Maryland plans.

To the extent that individuals make contributions to other state or private plans instead of the Maryland plans, revenues would decrease. The number of individuals who this would apply to cannot be reliably estimated. It has been estimated that nationally, Section 529 plan contributions will increase significantly -- from $7.2 billion in contributions in 2001 to $51 billion in 2006 -- over the next five years. However, except for those individuals making contributions to other state or private plans, any increase in the cost of the Maryland College Savings Plans would not occur as a result of the bill.

Local Fiscal Effect: The limitation put in place by the bill regarding the number of subtractions that may be taken per beneficiary would have the effect of increasing adjusted gross income. Local government revenues would increase by approximately 2.8% of any increase in adjusted gross income.

Additional Information

Prior Introductions: None.

Cross File: HB 437 (Delegates Hixson and Rawlings) – Ways and Means.

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

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