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January 25, 2006

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Substitute Amendment 1 to Senate Bill 351: Individual Income Tax Deduction for Certain Contributions to College Savings Programs

Senate Bill 351 would provide nonrefundable credits against the individual income tax based on certain amounts paid into an account in a Wisconsin college savings program. The bill was introduced on September 28, 2005, and referred to the Senate Committee on Job Creation, Economic Development, and Consumer Affairs. Senate Substitute Amendment 1 to SB 351, which would convert the proposed tax credit to a tax deduction, was recommended for passage by that Committee on October 24, 2005, by a vote of five to zero. On October 27, 2005, the substitute amendment was referred to the Joint Committee on Finance.

CURRENT LAW

Federal Law

As provided under federal law, a qualified tuition program (QTP), also known as a section 529 plan (in reference to the section of the Internal Revenue Code authorizing such plans), is a program that allows individuals to either purchase pre-paid tuition units or contribute to a college savings account established for paying a student's qualified education expenses at an eligible educational institution. A QTP can be established and maintained by a state, or an agency or instrumentality of a state, and by an eligible educational intuition. For programs satisfying the federal QTP requirements, federal law has provided an individual income tax exemption for earnings in and distributions from (but not contributions to) QTPs established by states since tax year 2002. Effective with tax year 2004, the federal exemption was extended to earnings in and distributions from QTPs offered by eligible private institutions in addition to state-sponsored plans.

State Law

Current law authorizes two types of Wisconsin section 529 programs. The first program is a pre-pay plan, under which an individual may purchase tuition units for a designated beneficiary. This program, sometimes referred to as EdVest I, was started in 1997 and is administered by the State Treasurer's office with investments managed by the State of Wisconsin Investment Board.

The second type of section 529 plan authorized by the state is the college savings account program, under which individuals make payments into a college savings account approved by the 11-member College Savings Program Board on behalf of a designated beneficiary (rather than purchasing tuition units). The College Savings Program Board has approved college savings accounts offered through EdVest, referred to as EdVest II, as well as through Tomorrow's Scholar, which is managed by American Express. Section 529 college savings accounts were first offered by the state in May, 2001.

State statutes continue to authorize both the tuition unit type of section 529 programs (offered through EdVest I) and the college savings account type of section 529 programs (offered through EdVest II and Tomorrow's Scholar). However, as a result of the greater complexity of the tuition unit option and following a decline in public interest in purchasing tuition units, EdVest I was closed to new investments, effective December 20, 2002.

State tax law conforms to the federal provisions providing an exemption from income tax for earnings in, and qualified distributions from, state approved section 529 plans. In addition, for state tax purposes, donors have been permitted to deduct up to $3,000 in amounts paid into a Wisconsin section 529 plan if the beneficiary is the purchaser, the purchaser's spouse (for a married couple filing a joint tax return), or the purchaser's dependent child. Under 2001 Wisconsin Act 109, the deduction for amounts paid into Wisconsin section 529 accounts was extended to grandparents of a beneficiary, effective with tax year 2002. Under 2003 Wisconsin Act 289, effective January 1, 2004, the deduction was again expanded, this time to include amounts paid by great-grandparents, aunts, and uncles of account beneficiaries. The annual deduction for amounts paid into one or more state approved section 529 account for a specific beneficiary is limited to $3,000 per claimant. A married couple filing a joint return is considered one claimant.

SUMMARY OF SUBSTITUTE AMENDMENT

Under current law, a parent is permitted to make a tax deductible contribution to an EdVest account on behalf of a child only if the parent can claim that child as a dependent for tax purposes. The substitute amendment would eliminate this requirement. As a result, in the case of divorced or legally separated parents of a child, or in the case of parents who are married but filing separate tax returns, each parent could claim a deduction for up to $3,000 for amounts paid by such parent into a Wisconsin section 529 account on behalf of a child. Under current law, only the parent that claims the child as a dependent is permitted to do so. This provision would first apply to taxable years beginning on January 1 of the year in which the substitute amendment takes effect, unless the effective date is after July 31, in which case the provision would first apply to taxable years beginning on January 1 of the following year.

FISCAL EFFECT

It is not possible to determine with precision how many taxpayers would claim additional deductions for amounts contributed to EdVest as a result of the substitute amendment. However, based on information about current Wisconsin section 529 accounts in Wisconsin and on a variety of assumptions related to noncustodial parents, it is estimated that state individual income tax revenues would be reduced by approximately $200,000 annually, starting in 2006-07.

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