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HOUSE COMMITTEE ON HIGHER EDUCATION

TESTIMONY REGARDING SB 2660 S.D. 3 RELATING TO COLLEGE SAVINGS PROGRAMS

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: MARCH 11, 2008

TIME: 2:15PM

ROOM: 309

This bill proposes a deduction from gross income for contributions made to 529 College Savings Plans. The Senate Committee on Education amended this measure by establishing a per account deduction limit of \$75,000.

The Committee on Economic Development & Taxation and Committee on Ways & Means made technical amendments to the measure and amended the effective date.

The Department of Taxation (Department) **supports** this measure; **however prefers the approach taken in the Administration measure, SB 3000.** The Department also **requests amendments** in order to lower the revenue impact of this measure.

I. 529 PLANS, GENERALLY

Section 529 of the Internal Revenue Code allows states to sponsor programs that allow contributions to qualifying educational accounts that grow tax-free for purposes of financing certain qualifying education costs. Hawaii's 529 college savings plan is vested in Chapter 256, Hawaii Revised Statutes, and is overseen by the Department of Budget & Finance. However, an individual is not limited to choosing Hawaii's 529 plans. Taxpayers can choose any open program across the fifty states.

529 plans allow invested amounts to grow tax free, with no tax consequences when the funds are withdrawn for a qualifying purpose. Although the federal government does not provide any tax credits or deductions for amounts invested, many states offer tax credits or deductions for contributions to 529 plans within their state. With the high costs of post-secondary education, it is important that investment vehicles with tax benefits be provided for those saving for college.

II. TECHNICAL COMMENTS ON THIS MEASURE

THE DEPARTMENT PREFERS SB 3000, WHICH IS LIMITED TO HAWAII PLANS—The Department prefers the approach taken in SB 3000 because it limits the deduction to only to those investing in Hawaii's 529 plans. As noted above, taxpayers are not limited to their own state's plan in setting up a 529 account. Opening the deduction to all 529 accounts dramatically increases the cost of the deduction to the State. The Department strongly believes that SB 3000 is superior to this bill in that it seeks to grow Hawaii's TuitionEDGE 529 plan and the Administration's amount has already been factored into the Executive Budget.

UNWORKABLE PER-ACCOUNT LIMIT—The measure provides that the lifetime limit on contributions to a 529 plan is \$75,000 per account. The Department suggests that this per account limit is unworkable, since a taxpayer merely needs to set up a new account (even at the same institution) to avoid the per account limit. The Department suggests that any limit be applied at the taxpayer level, rather than at the account level.

RECAPTURE PROVISION—The Department suggests that a recapture provision be included in this measure, which would require any amount previously allowed or allowable as a deduction from income under this measure be includible in income in a subsequent year if the plan proceeds are used for any non-qualifying purpose in a subsequent year.

PROHIBITED DEPOSITS—The Committee may also want to consider adding recapture provisions that specify any "circular" use of account funds will be precluded from qualifying for the deduction. For example, if an account holder withdraws funds from the account and uses those funds to "re-deposit" funds, no deduction should be allowed for the "re-deposit."

III. REVENUE ESTIMATE

This bill's revenue impact is indeterminate because this bill authorizes the tax deduction for Hawaii taxpayers investing in any state's 529 program.

The Department has no way of estimating how many residents invest in a 529 program across the nation; however, the loss would be substantially higher than \$2.8 million annual revenue impact estimated for the Administration bill (SB3000) because the tax deduction is limited to taxpayers investing in the Hawaii 529 plan only.

TESTIMONY BY GEORGINA K. KAWAMURA
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE HOUSE COMMITTEE ON HIGHER EDUCATION
ON
SENATE BILL NO. 2660, S.D. 3

March 11, 2008

RELATING TO COLLEGE SAVINGS PROGRAMS.

Senate Bill No. 2660, S.D. 3, proposes to provide a state income tax deduction for contributions to any qualified tuition program established pursuant to Section 529 of the Internal Revenue Code. The Bill proposes a tax deduction of up to \$5,000 for taxpayers filing individually and up to \$10,000 for married couples filing joint returns, heads of households, or surviving spouses. In addition, S.D.3 proposes establishing a \$75,000 cap on the total tax deduction that may be claimed per college savings account.

The Department of Budget and Finance supports the intent of this bill, which is consistent with the Administration's Bill that provides individuals an incentive in the form of a State tax deduction for contributions to the State of Hawaii's 529 College Savings Program called "HI 529."

However, we strongly oppose allowing the State tax deduction for contributions to any qualified 529 plan. Rather than encourage Hawaii residents to invest in other states' plans, we would like to see Hawaii's plan grow, because with the growth of Hawaii's plan, there is opportunity for our plan participants to benefit from lower program fees. Hawaii's HI 529 College Savings Program is a "direct sold" plan as opposed to an "advisor sold" plan. Typically lower costs are associated with direct-sold plans; as advisor-sold plans generally assess an

advisor fee or commission to the plan owner. Testimony submitted to the Senate Committee on Economic Development and Taxation's hearing on the bill on February 12, 2008, inferred that restricting the state tax deduction benefit to the State's 529 plan would not allow Hawaii families the benefit of being able to invest in "any" of the other state's 529 programs. On the contrary, this would not preclude any Hawaii resident from investing in any 529 plan that their financial advisor recommends. They could still open an account in any state's 529 plan that their financial advisor recommends. However, the advantage of the state tax deduction would only be available to residents who invest in a Hawaii 529 plan account. Testimony was also submitted at this same hearing that cited one source which ranked Hawaii's 529 plan at 39th in the nation. This citation was very misleading as the ranking cited was done prior to the recent revamping of Hawaii's 529 Program and contracting of a new third party administrator, Upromise Investments Inc. and investment manager, The Vanguard Group, Inc.

Of equal importance are the following additional reasons that the state tax incentive should remain with Hawaii's plan only:

1. Accountability. It would be difficult to effectively monitor and administer a program that provides a State tax benefit for contributions made to other state's 529 programs. There would be no effective policy measurement as the other state's program managers would not be able to provide necessary data to Hawaii. In contrast, the program manager for Hawaii's plan is contractually required to provide data and statistics on the program as well as geographical and socio-economic data. This data could then be used to ensure that the program is reaching a broad-base of families from a wide-range of income levels.

2. Responsible tax policy. Keeping the deduction to the “in-state” plan would provide for a more controlled tax impact. If the state tax deduction benefit were opened up to any 529 program, there would be no means on which to base a projection of the tax impact. Also, Hawaii’s program manager is contractually required to provide data necessary for the State’s Tax Department to monitor whether the tax benefits are being abused. While Standing Committee Report No 2533 stated that the Committee on Economic Development and Taxation received a fiscal impact statement from the Department of Taxation estimating the revenue impact of Senate Bill No. 2660, S.D.1, at \$1,000,000 annually, the estimate was based on the number of current participants in the Hawaii program only. The estimate did not include or address the potential revenue loss for all Hawaii residents investing in “any” 529 Program.

Senate Bill No. 2660 also proposes a maximum tax deduction of \$5,000 for taxpayers filing individually, and \$10,000 for taxpayers filing jointly. We recommend the higher maximum deductions as provided for in Senate Bill No. 3000 of \$10,000 for taxpayers filing individually, and \$20,000 for taxpayers filing jointly. We believe that the higher maximum deductions will be a greater incentive and better assist individuals and families saving for our children’s future college expenses.

In response to the proposed \$75,000 cap on the total tax deduction that may be claimed per account, we believe that such a limitation would be a disincentive to continue contributions or participation in the HI 529 Program once an account owner reaches the cap. The incentive provided should realistically enable account owners to pay for future tuition expenses. In the August 2007 issue of Money Magazine, the estimated cost for four years of tuition, room and

board at a public college is estimated to be \$125,000 by 2022; and closer to \$300,000 for a private college.

We have recently been made aware that other states with similar tax incentives have tightened-up their program to prevent possible abuse. The Department of Budget and Finance is working with the Department of Taxation to address these issues which may require additional statutory changes. The items to be addressed are:

1. Prevent account owners from depositing funds in one year, withdrawing the funds in the subsequent year, and then re-depositing the same funds and claim a deduction for both years.
2. Prevent account owners from depositing funds into a HI 529 account, taking the deduction, and subsequently transferring the funds out to another state's 529 program.

We are also pursuing an additional statutory change to allow anyone to contribute into a HI 529 account. Currently, only the account owner is allowed to contribute into a HI 529 account, preventing for example, grandparents from contributing directly into a grandchild's account. We would like to change this restriction and will work with this Committee or subsequent committees on providing the necessary statutory language changes as this bill progresses through the legislative process.

Therefore, while we support the intent of Senate Bill No. 2660, S.D. 3, we recommend the language that provides for a state tax deduction benefit for contributions made to Hawaii's 529 program only, and no cap on the total deduction.

Thank you for this opportunity to provide testimony on this measure.

TAXBILLSERVICE

126 Queen Street, Suite 304

TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Deduction for college savings program.

BILL NUMBER: SB 2660, SD-3

INTRODUCED BY: Senate Committee on Ways and Means

BRIEF SUMMARY: Amends HRS section 235-7 to provide that the annual deductions from gross income for contributions to a qualified tuition program established pursuant to IRC section 529 shall be: (1) up to \$5,000 for individual taxpayers; (2) up to \$5,000 for married couples filing separately provided that each spouse may claim a deduction up to \$5,000; and (3) up to \$10,000 for married couples filing joint returns, individuals filing as head of households, or individuals filing as surviving spouses; but not more than the amount contributed during the taxable year; provided that the aggregate deduction amount shall not exceed \$75,000 per college saving account. If any amount of the deduction exceeds a taxpayer's taxable income for a year, the excess deduction may be used as a deduction against the taxpayer's taxable income in subsequent years until exhausted.

The amendments made to HRS section 235-7 shall not be repealed when that section is reenacted pursuant to Act 166, SLH 2007.

EFFECTIVE DATE: Upon approval; applicable to tax years beginning after December 31, 2050

STAFF COMMENTS: The legislature by Act 81, SLH 1999, established a college savers program on the state level to allow taxpayers to save for a child's college education by participating in a state college savings program. This plan is patterned on the rules governing such plans established under Section 529 of the federal Internal Revenue Code. Under that section, contributions made to such qualified programs receive no special tax treatment but the law specifies that when the distribution is made from the account for the beneficiary, the amount in excess of the contribution is taxable as part of the beneficiary's income. There is no benefit or incentive for the contributor, in other words the contribution is made with after tax dollars.

This measure proposes an income tax deduction to encourage taxpayers to participate in the college savers program. In a similar measure proposed by the state administration, their justification sheet estimated that the potential revenue loss for this proposal is \$2.8 million; however, if the measure is successful in encouraging more participation in the program, then the revenue loss would be significant.

It should be remembered that it has long been the intent of the state legislature to maintain conformity between Hawaii's income tax law and the federal Code to insure that administration and compliance costs will be minimized. Given that there is no similar provision on the federal level, this proposal would create yet another difference in the definition of income for state income tax purposes.

If it is the intent of the legislature and administration to encourage families to set money aside for their children's higher education, the deduction, as proposed, is regressive in that it favors those at the high

end of the income scale who probably would have the discretionary income to set aside funds and punishes those at the bottom end of the income scale as those families are less likely to put the maximum aside to qualify for the deduction. Inasmuch as the proposed deduction is a back door expenditure of tax dollars, it would be far more efficient for lawmakers to set up a subsidy program that would provide a sliding scale of percentages to subsidize or “match” contributions made to a qualified college savings account where the percentage of the match would be inversely graduated. Thus, those lower income families with less discretionary income would see their small contributions matched at a higher percentage while those higher income families would see the match phase-out after a certain level of contribution is made. This would take the onus of administering the program out of the tax department and places it within the financial institutions who would benefit from the use of the money. This would also insure that the contributions are made to a local institution that would participate in the state matching program. This would be far more efficient and accountable than utilizing the tax system to encourage parents to save for their children’s college education.

Digested 3/7/08

March 10, 2008

The Honorable Jerry L. Chang
Chair, House Higher Education Committee
Hawaii State Capitol, Room 309
Honolulu, HI 96813

RE: S.B. 2660, SD2 Relating to College Savings Programs

Dear Chairman Chang:

The Securities Industry and Financial Markets Association (SIFMA)¹ is writing to express its strong support for S.B. 2660 (SD2). This legislation would allow Hawaii residents who contribute to any qualified 529 plan to deduct the amount of that contribution – up to a maximum of \$10,000 per year per married couple filing jointly – from their gross income for state tax purposes.

Saving for your children's college education can be a daunting task. The College Board reports that the current price tag for **one year** of undergraduate education is \$13,589 for public institutions and \$32,307 for private institutions. Multiply that number by four years, and parents and students are facing total college costs that currently range between roughly \$54,000 and \$130,000. Furthermore, college costs are only going up. Over the last five years, after adjusting for inflation, total costs have increased 40% at four-year public colleges and 30% at four-year private colleges and universities. In light of these numbers, a U.S. Commerce Department report that the personal savings rate of Americans in 2006 (the last year for which data is currently available) has dropped to negative 1% is particularly troubling.

Paying for college requires extensive planning and saving. Many entities, including Kiplinger's and savingforcollege.com, believe that 529 plans are the best college savings vehicle. A major reason why these plans are so attractive is that the Economic Growth and Tax Relief Reconciliation Act of 2001 makes earnings on 529 plans free from federal tax so long as they are used for qualified education expenses. In addition, most states- including Hawaii – have followed the federal government's lead and don't tax 529 earnings.

S.B. 2660 is good public policy because it gives Hawaii residents an additional incentive to save for college. Residents who contribute to any qualified 529 plan would be permitted to deduct contributions of up to \$10,000 per married couple filing jointly from their state taxable income.

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

We applaud you for advancing legislation that further encourages Hawaii residents to save for the education needs of their children.

As you undoubtedly know, an educated population provides tremendous benefits to the state. According to the U.S. Census Bureau, people with bachelor's degrees earn over 70% more on average than those with only a high school diploma, and the earnings gap between a high school and a college graduate is more than \$1,000,000 over a lifetime. In addition, a College Board report entitled "Education Pays" concluded that college graduates not only make more but they also have lower levels of unemployment, are less likely to depend on social programs, and have lower smoking and incarceration rates.

For the reasons stated above, SIFMA encourages the Committee to support S.B. 2660 (SD2). Please feel free to contact me at 212-313-1311 or my lobbyists, Red Morris and John Radcliffe, at 808-531-4551 if you have any questions.

Sincerely,

A handwritten signature in black ink that reads "Kim Chamberlain". The signature is written in a cursive, flowing style.

Kim Chamberlain
Managing Director & Counsel
State Government Affairs

TESTIMONY BY PATRICK W. MCKEON
CHIEF COMPLIANCE OFFICER, UPROMISE INVESTMENTS, INC.
PROGRAM MANAGER FOR HI529 – HAWAII'S COLLEGE SAVINGS PROGRAM
TO THE HOUSE COMMITTEE ON HIGHER EDUCATION
SENATE BILL NO. 2660, S.D.3

March 11, 2008

Representative Jerry L. Chang, Chair
Representative Lyla B. Berg
Representative Scott Y. Nishimoto
Representative Maile S. L. Shimabukuro
Representative Dwight Y. Takamine
Representative Glenn Wakai
Representative Lynn Finnegan

Representative Joe Bertram, Vice-Chair
Representative Rida T. R. Cabanilla
Representative Scott K. Saiki
Representative K. Mark Takai
Representative Roy M. Takumi
Representative Corinne W. L. Ching

RELATING TO THE STATE OF HAWAII SECTION 529 COLLEGE SAVINGS PROGRAM.

Introduction

Thank you for the opportunity to provide testimony relating to S.B. 2660, which would provide a state income tax deduction for contributions to any state-sponsored qualified tuition program established pursuant to Section 529 of the Internal Revenue Code. Upromise Investments, Inc. (Upromise) currently serves as Program Manager for HI529 – Hawaii's College Savings Program, with responsibility for coordination of services to the State of Hawaii and its college savers, including marketing, recordkeeping, administration, investment management, and client services.

Upromise recognizes that determination of tax and other public policies with respect to HI529 remains the discretion and responsibility of the State. As Program Manager for HI529, we hope that the following testimony provides helpful information as the Committee considers this bill, including additional context on the recent enhancements to the State's college savings program, as well as observations on state tax incentives related to 529 plans, consistent with our experience as a service provider to the 529 industry.

Overview of Services and Recent Enhancements for Hawaii's College Savings Program

Upromise began providing services to HI529 in November of 2007, after being selected as Program Manager through a competitive RFP bidding process administered by the State of Hawaii's Department of Budget and Finance. The State and Upromise worked together to transition services for HI529 from the previous Program Manager, and in the process, introduced a number of significant enhancements, including:

- An immediate cost reduction of more than 20% for all Program participants, with commitments to further reduce price as the program grows
- An expanded investment line-up featuring high-value, low-cost options from The Vanguard Group, a trusted leader in mutual fund investing

- Significantly increased client service functionality, including full online account opening and account maintenance
- Marketing capabilities focused on reaching all audiences, including novice investors, middle-income families, and even lower-income households
- Additional savings opportunities through the free Upromise Rewards Service, which provides college savings back on families' everyday spending

Reaching College Savers of All Demographics

Upromise has worked successfully with state partners to offer high-value, low-cost "Direct-sold" 529 programs to the full range of college savers – from novice investors that include middle- and even lower-income families to more sophisticated participants. "Direct-sold" plans, like HI529, are offered directly to participants without sales commissions or other Advisor fees.

"Advisor-sold" 529 programs are plans through which participation is driven largely by financial Advisors working with their clients. Typically, individuals who work with financial Advisors tend to be more affluent and sophisticated investors, who are willing to pay more for the advice and guidance of an Advisor. As a result, Advisor-sold 529 programs are on average more expensive than programs that are Direct-sold.

Upromise Experience with 529 State Tax Incentives

Upromise provides 529 plan services to 11 state partners, and administers over 1.5 million college savings accounts. As a service provider solely dedicated to the 529 industry, Upromise has a mission that mirrors the goal of our state partners: to make college more affordable and accessible for all American families, regardless of income or other demographics.

Upromise contributes to this mission by providing 529 technology and client services designed to make it as easy as possible for a family to get started saving. Upromise's 529 system has been designed so that in 10 minutes or so, a busy parent or grandparent – who has just a few free moments in the day – can open a 529 account, establish an automatic investing plan from their bank account, or contribute through payroll deduction at work, enroll in the Upromise Rewards Service for additional savings (if desired), and put their college savings strategy on auto-pilot.

Upromise has observed the positive effect that a state income tax deduction can have in providing a significant incentive for getting started and staying engaged with a college savings strategy. The majority of Upromise's state partners provide a state tax deduction on contributions made to the home state's 529 plan. These deductions range from \$5,000 per year for one state to an unlimited deduction on annual contributions for another.

Across 529 plans administered by Upromise, state plans that provide a state tax deduction experience significantly higher participation in comparison to those that do not. In addition, Upromise has observed in-state participation significantly increase after the introduction of a state tax deduction for state plans that previously did not offer any incentive on contributions. For example, annual contributions by state residents more than doubled, on average, for the two Upromise-administered state plans that recently implemented a state tax deduction for 529 contributions.

Considerations in Providing a Tax Deduction on Contributions to Any State's 529 Plan

The Committee may want to consider certain potential consequences if Hawaii were to provide a State income tax deduction on contributions to any state 529 plan:

- 1. Reduced control over how 529 plan information is marketed within Hawaii.** Currently, the State has control and oversight over how HI529, as a municipal security sponsored by the State of Hawaii, is marketed and distributed to Hawaii residents. The State reviews and approves all Program materials and outreach efforts, and can help ensure that the Program's marketing tactics are consistent with the State's overall goal of helping all residents save for college.

A State tax deduction only for HI529 would effectively increase this influence over how 529 plans are marketed within the State, by further underscoring HI529 as the 529 plan designed specifically for Hawaii residents. By instituting a tax incentive to further encourage Hawaii families to consider their home state's plan first, the State can help ensure that Hawaii residents are presented with 529 information and disclosure that was designed for them, with control and oversight by the State.

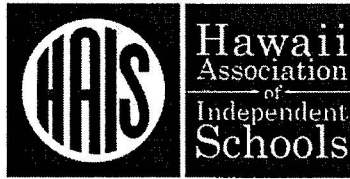
The State does not have control over how other states' plans are marketed within Hawaii. In a scenario where a State tax deduction were available on contributions to any state's 529 plan, the State may, in effect, reduce its influence over how 529 plan information is presented to Hawaii residents and would not be able to control the promotion of HI529 as a low cost alternative with special benefits. This consideration may be especially relevant at a time when the marketing and distribution practices of the 529 industry are under scrutiny, particularly with respect to the sale of out-of-state plans to in-state residents.

- 2. Potential negative effect on State's goal of helping Hawaii families of all demographics save for college.** Providing a State income tax deduction on contributions to any state's 529 plan would not necessarily advance the State's goal of helping all Hawaii families save for college, particularly middle- and even lower-income families. There is the potential that other state 529 plans would leverage the deduction primarily to market to more affluent investors – i.e., individuals that traditionally work with financial Advisors – leaving the State of Hawaii to market HI529 to the rest of the population. This loss of 529 plan assets to other states' plans potentially could have a significant impact on the scale advantages of HI529, as described below.

Upromise recognizes the value and role of an Advisor to certain investors and has developed technology and client service functionality that can be deployed in service to HI529 in order to enable Hawaii-based Advisors to stay engaged with their clients' college investing activity. This functionality includes the ability to receive duplicate account statements and the potential to view client accounts online.

3. Reduced participation and scale for HI529, which impacts pricing and benefits for Hawaii residents. HI529 benefits from contractual commitments to further reduce the cost to Hawaii participants as the Program grows, reflecting the economies of scale associated with increased Program assets as well as Upromise's history of continuing to drive down costs for state partners and plan participants. A State tax deduction on contributions to any state's 529 plan would potentially result in reduced scale and/or slower growth for HI529, which may impact the State's ability or timing to offer further cost reductions and other benefits to Hawaii 529 Program participants.

Again, thank you for the opportunity to provide these observations. Upromise is pleased to be of service to Hawaii in helping to achieve the State's objectives for college savings, and looks forward to continuing to work with the State to enhance HI529 and to help all Hawaii families save for college.



March 11, 2008
2:15 p.m.
Conference Room 309

TESTIMONY TO
THE HOUSE COMMITTEE ON HIGHER EDUCATION

SB 2660 SD2 – Relating to College Savings Programs

Dear Chair Chang, Vice Chair Bertram, and Members of the Committee:

My name is Robert Witt, executive director of the Hawaii Association of Independent Schools, which represents approximately 100 private and independent schools and educates over 30,000 elementary and secondary school students in our state.

Our association supports the intent of SB 2660 SD2, which is consistent with that of SB 3000—to provide taxpayers with a state tax deduction for contributions to Hawaii's 529 College Savings Program; however, along with the State Department of Budget and Finance, we prefer allowing state tax deductions only for contributions to Hawaii's 529 College Savings Program rather than the broader scope of programs described in this measure. In addition, we are in support of the higher maximum deductions given in SB 3000, rather than those given in this measure.

Most prominent among our reasons for supporting SB 2660 SD2 is the recently adopted goal of the Hawaii P-20 initiative to work strenuously over the next decade to significantly increase the percentage of adults living in Hawaii with a four-year college degree. This measure would provide significant financial incentives for parents, grandparents and family members to save the funds necessary to send more high school graduates to college over the next ten years than have ever attended before.

Our association has supported the 529 College Savings Program for many years, posting information about the program on our website and allocating space in our annual private school guide to present families with information about how to participate. We have recently renewed our commitment to advancing this program with an even greater number of families and, working together with the State Department of Budget and Finance, will continue to add value to the program in the years ahead, beginning by advocating for the tax deduction proposed by this bill.

Thank you for this opportunity to testify.