WRITTEN ONLY

TESTIMONY BY GEORGINA K. KAWAMURA
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE HOUSE COMMITTEE ON HIGHER EDUCATION
ON
HOUSE BILL NO. 132

January 29, 2009

RELATING TO QUALIFIED TUITION PROGRAMS.

House Bill No. 132 proposes a state income tax deduction to individual taxpayers for contributions to any qualified tuition program established pursuant to section 529 of the Internal Revenue Code.

The Department of Budget and Finance opposes this bill. The bill proposes to allow a State tax deduction for contributions to <u>any</u> qualified tuition program. The revenue impact is indeterminable as there is no data available to estimate the amount of contributions being made to any 529 plan nationwide by Hawaii residents. Given the current fiscal and budgetary constraints, such an open ended State tax deduction with an unknown revenue impact should not be allowed. Should such a tax deduction be considered, the Department strongly recommends that the tax deduction be provided only to residents who contribute to the State of Hawaii's HI 529 College Savings Program. This will provide for measurable revenue impact as the State is able to provide data regarding the annual amount of contributions received for the HI 529 Program. Furthermore, the tax deduction will provide an additional incentive for residents to participate in the State's HI 529 Program and will benefit all participants in the Program.

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

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HOUSE COMMITTEE ON HIGHER EDUCATION

TESTIMONY REGARDING HB 132
RELATING TO QUALIFIED TUITION PROGRAMS

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: JANUARY 29, 2009
TIME: 2:00PM
ROOM: 309

This bill proposes a deduction from gross income for contributions made to 529 College Savings Plans.

The Department of Taxation (Department) **supports the intent** of this measure; **however is concerned with its revenue impact and that the measure does not target Hawaii's 529 Plan.**

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 ENCOURAGING HAWAII-ONLY "TuitionEDGE" INCENTIVES—The Department would prefer limiting the incentive contained in this measure to 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.

Many other states offer similar tax incentives for contributions to their respective 529 college savings plans. By providing a tax incentive to encourage investment in Hawaii's plans, Hawaii's TuitionEDGE 529 plan will become even more attractive for Hawaii residents. By increasing the amount of assets under management, the investment alternatives will increase and costs will decrease.

TAX TIMING CONFLICTS—The Department is concerned with subsection (c), which allows a person to claim a deduction for contributions made in the taxable year and through April 16 of the following year. This provision conflicts with fundamental tax timing principles, which typically only allow a deduction in the tax year of expenditure. This law would create a straddling effect by allowing taxpayers to relate-back contributions made in a subsequent tax year. The subsequent tax year principle can work for annual funding limits such as with IRAs, but not for deduction and tax timing. This provision should be eliminated and allow for the deduction to be claimed only in the year of expenditure.

SECTION 3 IS UNNECESSARY—The Department suggests eliminating Section 3. It serves no purpose.

III. FISCAL CONCERN

The Department must be cognizant of the biennium budget and financial plan. This measure has not been factored into either. And, given the forecasted decrease in revenue projections, this measure would add to the budget shortfall.

This measure is projected to result in a revenue loss of approximately $1 million per year. There are no impacts on any special funds.

TRANSMISSION OF TESTIMONY

Date: Wednesday, January 28, 2009

To: House Committee on Higher Education

From: Tax Foundation of Hawaii

TOTAL PAGES 2

For: Rep. Jerry Chang, Chair

Testifier: Lowell L. Kalapa, President - Tax Foundation of Hawaii

(Mr. Kalapa will not appear in person at the hearing)

Date of Hearing: January 29, 2009

Time of Hearing: 2:00 pm

HB 132 - Relating to Qualified Tuition Programs

Number of Copies: 1

Thank you.

SUBJECT: INCOME, Deduction for qualified tuition program

BILL NUMBER: HB 132

INTRODUCED BY: B. Oshiro

BRIEF SUMMARY: Adds a new section to HRS section 235 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 heads of households, or individuals filing as surviving spouses.

If the amount of the deduction exceeds the taxpayer's taxable income for the taxable year the contribution is made, or if the contribution is in excess of the deductible amount, the excess may be used as a deduction against the taxpayer's taxable income for up to five subsequent tax years or until the excess deduction is exhausted, whichever occurs first. Stipulates that amounts deducted shall be for contributions made by December 31 of the tax year or prior to April 16 of the succeeding year. No deduction shall be allowed for any amount derived from a withdrawal or rollover from any qualified tuition program. No deduction shall be allowed for contributions made to an account made in the same tax year that a withdrawal from that account has occurred. Delineates the conditions where a deduction shall be subject to recapture.

Amends HRS section 235-2.4 to make conforming amendments.

EFFECTIVE DATE: Tax years beginning after December 31, 2008

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 of $5,000 or $10,000 annually to encourage taxpayers to set aside funds for higher education purposes.

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 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.

Finally, if the deduction is allowed and therefore the amount would go untaxed at the time of the contribution, will the state be able to tax both the earnings on the principal amount contributed as well as the earnings when amounts are withdrawn by the beneficiary? It also raises the question of taxing the withdrawals should the account be moved out of state as well as the parents and the beneficiary. Would the state of Hawaii ever be able to tax those contributions?

Digested 1/28/09