

GENERAL ASSEMBLY OF NORTH CAROLINA



Session 2007

Legislative Fiscal Note

BILL NUMBER: Senate Bill 1141 (First Edition)

SHORT TITLE: Section 529 Plan - Tax Deduction.

SPONSOR(S): Senator Hoyle

FISCAL IMPACT					
	Yes ()	No ()	No Estimate Available (X)		
	<u>FY 2007-08</u>	<u>FY 2008-09</u>	<u>FY 2009-10</u>	<u>FY 2010-11</u>	<u>FY 2011-12</u>
REVENUES					
	Potential significant impact on General Fund; see Assumptions & Methodology				
PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED:	Department of Revenue				
EFFECTIVE DATE:	Taxable years beginning on or after January 1, 2007				

BILL SUMMARY: Senate Bill 1141 expands the income tax deduction for contributions to 529 college savings accounts to include contributions made by North Carolina residents into out-of-state 529 savings plans. Taxpayers with adjusted gross incomes below specified levels may take a deduction from taxable income based on contributions to any qualified tuition program organized under section 529 of the federal Code. Current law limits the deduction to the NC program.

ASSUMPTIONS AND METHODOLOGY: As of June 31, 2004, Americans had invested \$52 billion in 529 college savings plans. Recent projections made by Financial Research Corporation indicate a 30.5% growth rate for 529 savings plans, leading to more than \$100 billion in 2006 and \$250 billion by 2009.¹ Additionally, the ratification and signing of the federal Pension Protection Act of 2006, which made permanent investors' ability to withdraw earnings from 529 programs tax-free if used for qualified education expenses, is consistently cited in news sources and academic journals as a major factor contributing to the aggressive growth forecast for investment in 529 savings plans over the foreseeable future.

¹ Financial Research Corporation, "Factors Driving 529 Plan Asset Growth; An Examination of College Savings Plan Marketplace Trends." Press release, 2005. Available online at http://www.frcnet.com/Studies05/factsheets/529_YIR_Vision_MktPg_Jun05.pdf

Additionally, different tax advantages by state have a major impact on a plan's profitability for investors. In general, 529 savings plans that offer tax advantages to in-state residents are ranked higher in terms of overall value, but in recent years 529 savings plans have been the subject of both industry and Congressional scrutiny due to high costs, poor disclosure, and complex program structures resulting in decreased value for investors.

It is generally accepted that an up-front tax deduction for contributions into a 529 savings program increases the value of the investment for most participants by a significant margin. A 2004 study published in the *National Tax Journal* showed that not only do tax-deductible 529 savings programs provide the highest return to investors regardless of income class, but that the largest increases in after-tax returns accrue to the highest income group, both in dollar terms and relative terms.² **The income limitations set forth in Senate Bill 1141 are comparable to limits set forth in other states and would allow the majority of the tax benefit to be claimed by individuals in the middle and lower tax brackets. They would also reduce the fiscal impact of the expanded deduction, but without extensive and detailed data on North Carolina residents' investment as well as filing status, an estimate of the cost savings of this measure is not available.**

All of Morningstar's five top-rated 529 savings plans for 2007 offer a tax deduction for in-state residents participating in either in-state or out-of-state 529 savings plans. However, four of the five offer a relatively modest deduction – from \$1,000 to \$4,000 annually – and only one offers a deduction up to the full annual contribution limit of \$28,000.

In 2006, Maine, Kansas, and Pennsylvania all passed “tax parity” laws extending each state's tax deductions on contributions to residents who invest in out-of-state 529 savings plans. Regarding state action or inaction on this issue, Morningstar.com fund analyst Kerry O'Boyle recently noted that while the financial industry generally favors this sort of legislative action because they believe it empowers investors, tax parity can be a “double-edged sword for college savers tempted to flit back and forth or chase performance, or for those persuaded to take their tax break and go out of state to a more expensive or conceivably worse plan.”³

Fiscal Impact

From a State revenue perspective, extending favorable tax treatment to a nationwide, high-growth investment sector could have a significant impact on the General Fund. However, without detailed data on North Carolina residents' investment in all 50 states' 529 savings plans, a reliable fiscal estimate on this proposal is not available. In addition, the possibility of capricious investor behavior in the form of fund rollovers between different state 529 savings plans could result in significant and unpredictable year-to-year tax expenditures in the form of personal income tax deductions claimed.

² Dynarski, Susan. “Who Benefits from the Education Savings Incentives? Income, Educational Expectations, and the Value of the 529 and Coverdell.” *National Tax Journal*, Vol. LVII, No. 2, Part 2: June 2004.

³ O'Boyle, Kerry. “The Best and Worst 529 College Savings Plans,” published March 1, 2007, and available online at <http://news.morningstar.com/article/printArticle.asp?id=187673>

As of June 30, 2006, the total value of North Carolina's National College Savings Program trust fund was \$238.7 million. Total contributions into the program for FY 2005-06 were \$43.2 million, a 22% increase over the previous fiscal year. If all \$43.2 million in FY 2005-06 contributions had been fully tax-deductible and claimed in full, it would have impacted the General Fund by \$3.0 to \$3.5 million. If total national investment in 529 savings plans is \$150 billion in 2007 and the North Carolina plan experiences the same projected rate of growth as other plans nationwide (30.5% to \$311), the plan's total trust fund assets held will account for approximately 2.1% of total 529 savings plan investment nationwide. Due to this difference in scale, past estimates developed by Fiscal Research on the fiscal impact of making contributions into the North Carolina 529 savings plan are not comparable or useable for purposes of this bill.

SOURCES OF DATA: National Tax Journal, Morningstar.com, Financial Research Corporation, College Foundation of North Carolina National College Savings Program

TECHNICAL CONSIDERATIONS: None

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