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FISCAL NOTE

Drafting Number: LLS 20-0802 Date: January 21, 2020
Prime Sponsors: Sen. Pettersen; Story Bill Status: Senate Education
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Bill Topic: NO 529 ACCOUNT INCOME TAX DEDUCTION FOR K-12 EXPENSES

- Summary of Fiscal Impact:
- State Revenue (checked)
- State Expenditure (checked)
- State Transfer (unchecked)
- TABOR Refund (checked)
- Local Government (unchecked)
- Statutory Public Entity (unchecked)

The bill clarifies that the state income tax deduction for 529 account contributions is not allowed for contributions that are spent for K-12 education purposes, and requires CollegenInvest to make quarterly reports to facilitate income tax recapture. It indeterminately increases state revenue and workload on an ongoing basis and requires one-time expenditures for implementation.

Appropriation Summary: For FY 2020-21, the bill requires an appropriation of \$11,840 to the Department of Revenue. The bill also requires the expenditure of \$500,000 from cash funds continuously appropriated to CollegenInvest.

Fiscal Note Status: This fiscal note reflects the introduced bill.

Table 1
State Fiscal Impacts Under SB 20-073

Table with 3 columns: Category, FY 2020-21, FY 2021-22. Rows include Revenue, Expenditures (General Fund, Cash Funds, Total), Transfers, and TABOR Refund.

## **Summary of Legislation**

Under current law, a taxpayer may deduct contributions to a CollegenInvest qualified state tuition program account (529 account) when computing his or her Colorado taxable income. The amount by which the deduction reduces income tax owed is subject to recapture, with penalty and interest, if deducted contributions are withdrawn for purposes other than "qualified higher education expenses." Under current law, qualified higher education expenses are defined in the same way as in a specific subsection of federal law. In 2018, federal law was amended to allow 529 accounts to be used to pay for K-12 education at public, private, or religious schools. This change to federal law did not appear in the specific subsection referenced in Colorado law.

This bill amends the definition of qualified higher education expenses to clarify that it includes only expenses for higher education. It specifies that the state income tax deduction is not allowed if the contribution is intended for K-12 education expenses.

Beginning January 1, 2021, the bill requires that CollegenInvest make quarterly reports to the Department of Revenue (DOR) concerning 529 account contributions and withdrawals as the DOR determines is necessary to verify that deducted contributions were spent for qualified purposes. Reports must include:

- identifying information for all 529 account holders and beneficiaries;
- contribution dates, amounts, and identifying information for contributors; and
- withdrawal dates, amounts, and reasons for withdrawals.

## **Background and Assumptions**

**Contributions.** Under current federal law, 529 accounts at CollegenInvest may be used to pay for K-12 educational expenses. This is assumed to remain true under the bill.

Under current state law, all 529 account contributions qualify for the state income tax deduction at the time that they are made. While the bill specifies that contributions intended to be spent for K-12 purposes do not qualify for the deduction, this provision is assumed only to provide guidance to the DOR and to taxpayers. There is no way for CollegenInvest or the DOR to determine the intent of a contribution at the time when it is made.

**Withdrawals.** CollegenInvest and the DOR interpret current state law as requiring income tax recapture if contributions for which the state income tax deduction was taken are later spent for K-12 purposes. The bill provides clarity consistent with the agencies' interpretation of current law.

**Administration of recapture.** CollegenInvest currently shares 529 account contribution information with the DOR when contributions are made by account holders or by other contributors who indicate that they plan to take the state income tax deduction. CollegenInvest currently does not share contribution information when contributors indicate that they do not plan to take the state income tax deduction, as doing so may violate federal Municipal Securities Rulemaking Board (MSRB) and Securities and Exchange Commission (SEC) regulations that apply to CollegenInvest. See the Technical Note section of this fiscal note.

CollegenInvest currently does not share any 529 account withdrawal information with the DOR directly. For withdrawals made for a purpose unrelated to education, the DOR receives the information necessary to administer recapture via CollegenInvest's reports to the Internal Revenue

Service. Because the DOR does not receive any information that it would need to identify taxpayers making withdrawals for K-12 purposes, it is assumed that the DOR will not conduct any income tax recapture through at least 2020.

CollegelInvest has expended \$400,000 from its administrative funds to issue annual reports of nonqualified 529 account withdrawals for which the state deduction was taken beginning in 2021. Reports will include the purpose of the withdrawal, which would be sufficient for the DOR to administer recapture if necessary. Since federal law was changed to allow 529 accounts to be used for K-12 purposes, the DOR has not received an appropriation to administer additional recaptures of deducted 529 account contributions. Accordingly, actual recaptures enforced under current law beginning in 2021 are assumed to be limited by the DOR's resources.

### **State Revenue**

The bill is expected to increase state General Fund revenue by an indeterminate amount beginning in FY 2020-21 and ongoing. Any increase is expected to occur in income tax revenue, penalties, and interest, all of which are subject to TABOR. State revenue will increase depending on the extent to which the bill changes taxpayer behavior or results in additional income tax recapture.

**Taxpayer behavior.** The bill will increase state income tax revenue to the extent that it discourages taxpayers who would otherwise take the state income tax deduction from doing so. Since early 2019, both CollegelInvest and the DOR have advised taxpayers that income tax benefits from deducted 529 account contributions used for K-12 purposes are subject to recapture. Based on this guidance, it is assumed that most taxpayers who use CollegelInvest accounts no longer claim the deduction for contributions they expect to spend for K-12 purposes. Because account withdrawals are not currently reported, this assumption cannot be verified or contradicted based on available data.

**Recapture.** The bill will increase revenue from income taxes, penalties, and interest to the extent that it results in more income tax recapture than would otherwise occur. Because CollegelInvest is expected to begin reporting unqualified withdrawals to the DOR in 2021 under current law, the bill is not expected to affect the amount of information available to the DOR to administer recapture. Additional recapture may occur to the extent that resources are available for tax enforcement; however, the amount of new recapture that will occur cannot be estimated because data on unqualified withdrawals are not currently available.

### **State Expenditures**

The bill requires one-time General Fund expenditures of \$11,840 and one-time cash fund expenditures of \$500,000 in FY 2020-21 only. Additionally, the bill indeterminately increases DOR workload for tax enforcement on an ongoing basis beginning in FY 2020-21.

**CollegelInvest.** The bill will require CollegelInvest to contract for the development of a software system to generate quarterly reports of all 529 account contributions and withdrawals, including all contributor identifying information and withdrawal purposes. This system is expected to require \$500,000 from continuously appropriated cash funds. Development of this system exceeds the cost of the system for which CollegelInvest has already outlaid \$400,000 because it requires every transaction to be reported and requires reports to be produced on a quarterly basis rather than an annual basis.

**Department of Revenue.** This bill requires expenditures of \$11,840 to program, test, and update database fields in the DOR's GenTax software system in order to process information and generate work items from the quarterly data reports supplied by CollegenInvest. Programming costs are estimated at \$8,000, representing 32 hours of programming at a rate of \$250 per hour. Costs for testing are estimated at \$3,840, representing 160 hours at a rate of \$24 per hour.

The bill also increases DOR workload to investigate work items related to income tax recapture on an ongoing basis. Because the amount of new work items cannot be estimated, the workload increase is assessed as indeterminate. Any additional resource requirement will be addressed through the annual budget process.

**TABOR refund.** To the extent that the bill increases state General Fund revenue in FY 2020-21 and FY 2021-22, it will correspondingly increase state General Fund obligations for TABOR refunds in the same years. Under current law and the December 2019 Legislative Council Staff forecast, the measure will correspondingly increase the amount refunded to taxpayers via sales tax refunds made available on income tax returns for tax years 2021 and 2022, respectively. A forecast of state revenue subject to TABOR is not available beyond FY 2021-22.

### **Technical Note**

CollegenInvest may not be able to report certain information required in the bill to the DOR under federal MSRB and SEC regulations. In particular, CollegenInvest is prohibited from sharing information unnecessary for the administration of state tax and identifying information for 529 account contributors who are not state taxpayers. As written, the bill may require CollegenInvest to refuse contributions from persons who are not Colorado taxpayers in order to comply with both federal regulations and state law. If contributions cannot be accepted, deposits to 529 accounts and cash fund revenue available for CollegenInvest's administration will decrease.

### **Effective Date**

The bill takes effect upon signature of the Governor, or upon becoming law without his signature.

### **State Appropriations**

For FY 2020-21 only, the bill requires a General Fund appropriation of \$11,840 to the Department of Revenue. The bill also requires the expenditure of \$500,000 from cash funds continuously appropriated to CollegenInvest.

### **State and Local Government Contacts**

Education  
Law

Higher Education  
Revenue

Information Technology