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FINAL FISCAL NOTE

Drafting Number: LLS 20-0802 Date: September 2, 2020
Prime Sponsors: Sen. Pettersen; Story Bill Status: Postponed Indefinitely
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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 (unchecked)
Local Government (unchecked)
Statutory Public Entity (unchecked)

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

Appropriation Summary: For FY 2020-21, the bill would have required and included an appropriation of \$11,040 to the Department of Revenue.

Fiscal Note Status: This final fiscal note reflects the reengrossed bill. The bill was not enacted into law; therefore, the impacts identified in this analysis do not take effect.

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), 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 their 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the deduction reduces income tax owed is subject to recapture, with penalty and interest, if deducted contributions are withdrawn for purposes other than "qualified higher education expenses."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. Effective 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 expenses for tuition in connection with enrollment at a K-12 public, private, or religious school.

Beginning January 1, 2021, the bill requires that CollegenInvest make annual reports to the Department of Revenue (DOR) concerning 529 account contributions and withdrawals to verify that deducted contributions were spent for qualified purposes. Reports must include the following information for transactions beginning in tax year 2020:

- identity and contribution information for all Colorado taxpayers who contributed to their 529 accounts during the tax year;
- identity and contribution information for Colorado taxpayers who contributed to another person's 529 account and intended to take the state income tax deduction; and
- dates, amounts, and reasons for withdrawals from 529 accounts owned by Colorado taxpayers that did not qualify for the state income tax deduction.

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. The bill is assumed to codify this current practice.

CollegelInvest 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 CollegelInvest's reports to the Internal Revenue Service. The DOR does not currently receive any information that it would need to identify taxpayers making withdrawals for K-12 purposes.

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. It is assumed that the reports required in the bill are functionally the same as those that will be produced by the reporting system that CollegelInvest has already financed. CollegelInvest has indicated that the system will be able to report nonqualified withdrawals for the 2020 tax year, and will include the reason for which they were not qualified beginning for tax year 2021.

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 \$11,040 in FY 2020-21 only. Additionally, the bill indeterminately increases DOR workload for tax enforcement on an ongoing basis beginning in FY 2020-21.

Department of Revenue. This bill requires expenditures of \$11,040 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 annual data reports supplied by CollegelInvest. Programming costs are estimated at \$7,200, representing 32 hours of programming at a rate of \$225 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 refunds. The state is not expected to collect revenue above the TABOR limit in either FY 2020-21 or FY 2021-22, and refund obligations are not anticipated for these years. This bill does not change these expectations concerning refunds to taxpayers. A forecast of state revenue subject to TABOR is not available beyond FY 2021-22.

Effective Date

The bill was postponed indefinitely by the House Education Committee on May 26, 2020.

State Appropriations

For FY 2020-21 only, the bill would have required and included a General Fund appropriation of \$11,040 to the Department of Revenue.

State and Local Government Contacts

Education
Law

Higher Education
Revenue

Information Technology