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FISCAL IMPACT REPORT

SPONSOR Sanchez DATE TYPED 3/11/97 HB 563/aHEC/aHAFC/aHTRC/aHfl

SHORT TITLE Enacting the Education Trust Act SB

ANALYST Pacheco-Perez

APPROPRIATION

Appropriation Contained		Estimated Additional Impact		Recurring	Fund
FY97	FY98	FY97	FY98	or Non-Rec	Affected
$.	$ NA	$.	$.	NA	NA

(Parenthesis ( ) Indicate Expenditure Decreases)

REVENUE

Estimated Revenue		Subsequent	Recurring	Fund
FY97	FY98	Years Impact	or Non-Rec	Affected
$.	$ (3,900.0)	$.	Recurring	GF
$.	$Indeterminate	$.	Recurring	Ed Trust Fund

(Parenthesis ( ) Indicate Revenue Decreases)

Relates to HB652, SB677

SOURCES OF INFORMATION

New Mexico State Investment Council (SIC)
Commission on Higher Education (CHE)
LFC files
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of House Floor Amendment

This amendment provides that the Board shall promulgate rules and regulations for the administration of the programs, to protect the financial integrity of the Fund, preserve the program's benefits and assure the appropriate use of the tax benefits. Contributions for college investment agreements shall be limited to projected costs of attendance which should be calculated utilizing federal guidelines and factors.

Synopsis of HTRC Amendment

According to the TRD, the fiscal impact reflects a reduction of approximately $3.9 million to the general fund. There are two major effects pertaining to this bill as amended: the tax cost to subsidize advance investment for higher education expenses and the tax cost from tax planning. The latter is expected to be the larger. It is speculative how many taxpayers will purchase contracts for reasons of prudence or thrift. However, an estimate of $500.0 may be used. Taxpayers with positive taxable income and a beneficiary under 19 will purchase contracts if there is substantial likelihood they or their children will attend a state institution or are currently attending a state institution. This larger impact will come from essentially misuse of the tax deduction portion of this scheme as outlined below. Approximately 71,100 students were enrolled in the state's institutions in 1994. Total out-of-pocket tuition equaled $88.7 million for an average tuition of $1,247. Assuming fees average $100 per student per year, that 1/2 of the student population or their families would benefit from the tax deduction, that the average marginal tax rate ir 5.5% and that the average growth in tuition from 1994 to 1998 is 5% per year, general fund costs from abuse will equal $3.2 million. In addition, another $200.0 in general fund cost may be generated (please see #4 in Other Issues section of TRD bill analysis).

According to the TRD, a technical issue arising from this bill is that the tax deduction creates a significant loophole. Payments made on the contract are deductible from state personal income tax in the year of the payment. However, the only limitation on claiming this deduction for amounts actually paid pursuant to contract is that any contract must be entered into prior to the beneficiary turning nineteen. A few days before a persons's nineteenth birthday, parents can sign a contract that defers payments. At the time tuition and fees would ordinarily be due, the parents would pay money to the fund. The fund would pass the money to a state institution for tuition and fees. At the cost of a small amount of paperwork, parents could convert non-deductible higher education expenses into a state tax deductible item. This may be a good public policy in general, but it would be more fair and reasonable to allow the deduction for all taxpayers. This concept discriminates against students older than nineteen and individuals or families with income less than that for which a deduction has any value. It also discriminates in favor of families that can afford good tax advice.

For more detail, please see attached bill analysis from the TRD.

<u>Synopsis of HAFC Amendment</u>

This amendment eliminates the appropriation of $175.0 included in the original bill; provides that the age of eligibility be nineteen rather than eighteen years of age; and provides that refunds of principal, capital gains and interest not used for contracted higher education expenses are taxable in the year returned to the taxpayer.

According to the TRD, this program will not cause extensive administrative problems provided the program administrator notifies TRD of payments into the fund, the portion of tuition and fees paid by the fund representing federal taxable income (interest and capital appreciation) and refunds. There is a $50.0 initial programming and setup cost and $25.0 annual cost for processing and verification.

The TRD raises considerable concerns regarding this bill and its amendments. Please see attached bill analysis.

<u>Synopsis of HEC Amendment</u>

This amendment clarifies that eligible institutions under the Education Trust Act are state public postsecondary institutions.

Synopsis of Bill

This bill creates the Education Trust Fund, invested by the SIC, and Education Trust Board which shall be administratively attached to the CHE. Board members shall include: the Executive Director of the CHE or his designee who shall be the ex-officio chair; the State Investment Officer or his designee; an appointed member by the Governor; a representative of a higher education institution appointed by the Speaker of the House of Representatives; and a student representative of higher education appointed by the President Pro Tempore of the Senate.

The Board is required to 1) develop a ***college investment program*** for the purpose of defraying the costs of attendance billed by institutions of higher education on behalf of a beneficiary and gives the Board the authority, subject to completion of a feasibility study, to 2) create a ***prepaid college tuition program*** for attending these institutions. As provided in this bill, "institutions of higher education" include those defined in Section 6-17-1.1 NMSA 1978, a branch, an independent community college, a technical-vocational institute, an institution licensed by the CHE or a regionally accredited independent postsecondary institution which includes private/propriety schools operating in New Mexico.

Payments may be deducted from a taxpayer's state net income in the year the payment is made and all earnings, including capital appreciation, are exempt from state income tax.

I. Provisions of the ***college investment program*** include the following:

1. the beneficiary must be a resident or the child of resident at the time the parent or benefactor enters into the college investment program;

2. the principal and accumulated earnings, including the appreciation in the value of the assets belonging to beneficiary, shall be paid directly to the institution attended by the beneficiary by the Board;

3. participation may be terminated in the event the beneficiary dies, is denied admittance or elects to discontinue attendance; and

4. the beneficiary's share of the Fund, including principal, accrued investment earnings and capital appreciation, shall be excluded from any calculation of student state financial aid eligibility.

Accompanied with the above provisions, benefactors who terminate participation may change the beneficiary or are entitled to a refund of the principal and not more than four percent interest. The balance of the beneficiary's earnings, including the appreciation in the value of the assets, will be credited to the Fund.

II. Prior to establishment of the ***prepaid college tuition program***, the Board shall contract for a feasibility study, including an actuarial analysis of the underlying assumptions contained in the study, and report its findings and make recommendations on the establishment of the program to the appropriate interim committee of the legislature by November 1, 1997.

Provisions of the *prepaid college tuition program* include the following:

1. the Board shall consider the amount and estimated rate of increase of tuition and fees at public institutions of higher education, estimated investment returns, estimated administrative costs and the period of time between the date the contract is entered into and the date the beneficiary is projected to graduate from high school in setting the price of prepaid tuition contracts;

2. public institutions of higher education are either required to participate or the Board may specify how and when they become eligible to participate;

3. benefits are excluded from any calculation of state student financial aid eligibility;

4. when fully paid, tuition contracts will cover all tuition and required fees of higher education institutions;

5. payments may be made in lump sum or installments; and

6. prepaid tuition contracts must a) allow participants to choose plans that pay the tuition and required fees, b) allow the transfer of tuition benefits from one institution to another, c) provide for penalties in the event of default and d) allow the benefactor to change beneficiaries.

Significant Issues

According to the SIC, most states allow transfer of the value of the college investment plan or tuition plan to private or out-of-state institutions if the beneficiary so chooses. According to similar programs initiated by other states and according to federal tax law, it appears that only the earnings on such programs, including capital appreciation, is deferred not exempted for such purposes of calculating federal income tax and state income taxes in other states. This bill 1) exempts the earnings from New Mexico state tax and 2) allows all payments made by the benefactors of the program as a deduction from their New Mexico net income for state income tax purposes.

FISCAL IMPLICATIONS

The appropriation of $175.0 contained in this bill is a non-recurring expense to the general fund. Any unexpended or unencumbered balance remaining at the end of FY98 shall revert to the general fund. The appropriation is made to the CHE for the purpose of advertising, conducting feasibility studies and other costs associated with implementing the provision of the Education Trust Act.

According to the SIC, additional appropriations may be needed during the first two or three years to provide proper staffing levels to administer the program. The number and amount needed will depend upon the level of participation by New Mexico residents and beneficiaries. In time, however, the Fund should be self-supporting and should have the ability to repay the general fund for appropriations made in the interim.

ADMINISTRATIVE IMPLICATIONS

According to the SIC, seventeen states currently have similar programs. While one state uses outside providers for administration with minimum staffing levels, most states administer their programs internally and require from three to more than a dozen persons to administer them, depending on the various levels of participation.

According to the CHE, this Act will require significant staff time.

CONFLICT/DUPLICATION/COMPANIONSHIP/RELATIONSHIP

According to the SIC, House Bill 652 and Senate Bill 677 relate to this bill. HB652 is applicable only to a college tuition plan invested by the State Treasurer and administered by a board appointed by the Governor. It has no provision for a college investment or "savings" plan for college expenses and no provision for deferment, exemption or deduction from New Mexico income taxes. SB677 provides for a feasibility study of college tuition plans.

TECHNICAL ISSUES

The SIC suggests that federal tax status of "deferred gains" and proposed tax status for New Mexico income tax purposes should be examined.

The CHE suggests the following amendment: page 2, line 9 - "institution of higher education" means a state public postsecondary educational institution as defined in Section 6-17-1.1 NMSA 1978, a branch college, an independent community college, a technical and vocational institute, an institution licensed by the CHE or a regionally accredited independent postsecondary institution operating in New Mexico."

According to the CHE, the above amendment is necessary because Section 6-17-1.1 NMSA 1978 is a listing which includes the New Mexico School for the Deaf and the New Mexico School for the Visually Handicapped which are institutions for which this program wasn't intended. It may also be necessary to specifically state that the branch, independent, and technical-vocational institutes be state institutions.

The CHE suggests the following amendment: beginning on page 8, the prepaid tuition section, all references to "public institutions of higher education" should instead read "state public institutions of higher education."

According to the CHE, the above amendment is necessary to clarify that the prepaid tuition investments and earnings are not for enrollment at out-of-state public institutions. If students wish to go out of state, they should participate in a College Investment Agreement instead.

OTHER SUBSTANTIVE ISSUES

According to the SIC, this bill provides an incentive for parents and others to plan and assist others in getting their college education in New Mexico.

Given the breadth of oversight and administrative responsibilities, a possible amendment may involve expanding the membership of the Board.

According to the Congressional Research Service, the Higher Education Act of 1965 (HEA) is scheduled for reauthorization during the next Congress. Congressional Members have already begun the review of proposals which, among other things, will address the rising costs of higher education; simplify student financial aid and institutional aid programs; and promote savings for postsecondary education. Work already begun by the Clinton Administration would allow families to choose between an annual $10.0 tax deduction and a $1.5 tax credit to help pay for college. (Restrictions for second year eligibility requiring a B average are currently being debated.) Families could also withdraw money, tax- and penalty-free, from an expanded Individual Retirement Account to pay college costs.

Congressional Republican proposals pertaining to college savings and prepaid tuition plans include: allowing parents to deposit up to $1.0 a year per child in accounts to pay for college whereby interest earned would be tax free; and making funds disbursed from a state's prepaid tuition plan tax-free to students, allowing such disbursements to cover room and board and not just tuition. Currently, state-level versions of these tax-protected accounts have federal tax code implications as ruled by the Internal Revenue Service. In addition, implications should be monitored with regard to eligibility for federal aid under Title IV which are the federal student aid formulas that determine need and size of award, taking into account both the financial circumstances of the student (parents) as well as the cost of attendance.

APP/gm
Attachment