Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

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Increase Individual Income Tax Deduction for College Tuition (General Fund Taxes -- Individual and Corporate Income Taxes)

[LFB 2005-07 Budget Summary: Page 173, #2]

CURRENT LAW

Current law provides a deduction of up to $3,000 per student for tuition paid on behalf of a claimant, the claimant's spouse, or the claimant's dependent. Eligible expenses include tuition paid to any university, college, technical college, or a school approved by the Educational Approval Board that is located in Wisconsin. The deduction also applies to tuition expenses for a public vocational school or public institution of higher education in Minnesota under the Minnesota-Wisconsin tuition reciprocity agreement. The maximum deduction is phased out over specified ranges of federal adjusted gross income (AGI), which vary by filing status. The phase-out ranges are as follows: (a) $50,000 to $60,000 for single and head-of-household tax filers; (b) $80,000 to $100,000 for married couples filing joint returns; and (c) $40,000 to $50,000 for married couples filing separate returns.

A federal deduction for qualified higher education expenses is also available for tax years 2002 through 2005. The maximum federal deduction was $3,000 in 2002 and 2003 and is $4,000 in 2004 and 2005. The deduction is also subject to income limits. Wisconsin does not allow the federal deduction for state tax purposes. Therefore, a Wisconsin resident claiming the federal deduction must add back the amount that was excluded from federal AGI and then deduct the amount allowable for state tax purposes.

In addition to the income tax deductions described above, other federal and state income tax provisions allow a favorable treatment of expenses related to higher education. These provisions are described in the appendix.

GOVERNOR

Increase the maximum tuition deduction from $3,000 to the greater of $5,100 or twice the average amount charged by the Board of Regents of the University of Wisconsin at four-year institutions for resident undergraduate academic fees for the most recent fall semester, as determined by the Board of Regents by September 1 of that semester. The provision would first apply to taxable years beginning on January 1 of the year in which the bill takes effect, except that if the bill takes effect after July 31, the provision would first apply to taxable years beginning on January 1 of the following year. The administration's intent is that this provision would take effect for tax year 2005. Under the bill, it is estimated that the proposal would reduce state individual income tax revenues by $4,900,000 in 2005-06 and by $5,300,000 in 2006-07.

DISCUSSION POINTS

1. The state deduction for college tuition was created under 1997 Wisconsin Act 237, the 1997-99 budget adjustment bill and was first available for tax year 1998. The maximum deduction and phase-out ranges established under Act 237 have not been changed since that time. The administration indicates that the proposal is intended to adjust the current law deduction to reflect increases in tuition since 1998.

2. Based on simulations with the 2003 Wisconsin tax sample, it is estimated that the tuition deduction under current law reduced state tax collections for 2003-04 by approximately $16 million. Information from the tax sample indicates that 115,000 Wisconsin taxpayers, or 4.5% of all taxpayers in 2003, received a tax reduction as a result of claiming the tuition deduction. For these taxpayers, the average benefit was $139. Taxpayers with incomes between $30,000 and $80,000 received 72.8% of the total tax benefit and made up 62.7% of all taxpayers with a tax benefit.

3. Under the bill, the maximum tuition deduction, per student, would be limited to the greater of $5,100 or twice the average amount charged at four-year UW institutions for resident undergraduate academic fees for the most recent fall semester. Under this provision, if the tuition amount were lower than $5,100, the maximum deduction would be $5,100. However, if the average tuition amount were higher than $5,100, the maximum deduction would be the average tuition amount.

4. According to information from the June 2, 2004, meeting of the Board of Regents of the University of Wisconsin System, the average amount charged at four-year institutions for the 2004-05 academic year was $4,243. Average tuition of $5,100 in the subsequent year would represent a 20% increase. However, under the Governor's budget provisions, it is anticipated that tuition would increase, on average, by 6% per year over the 2005-07 biennium. Therefore, under the bill, the $5,100 maximum allowable tuition deduction would exceed expected average tuition expenses.

5. It should be noted, however, that the estimated costs of the proposal included in the bill ($4.9 million in 2005-06 and $5.3 million in 2006-07) are more consistent with the 6% increases

in average tuition expected under the Governor's budget than with a maximum deduction of $5,100. The administration has indicated that, based on the actual language in the bill, the estimated costs would have to be increased to $6.6 million in 2005-06 and $7.1 million in 2006-07. The revised cost estimates are $1.7 million and $1.8 million higher in the first and second years, respectively, than the estimates included in the budget. The administration has requested that the bill be modified to delete the reference to the $5,100 figure in determining the maximum allowable tuition deduction under the proposal. If the modification were adopted, the estimates in the bill would not have to be revised. However, in the absence of such a modification, the estimated cost of the proposal would have to be increased as described above.

6. An increase in the tuition deduction would provide a tax benefit to certain taxpayers, but other individuals and families with tuition expenses would not receive a benefit. For example, lower-income families and individuals that do not currently have a tax liability would not receive a benefit. To illustrate, a self supporting student with annual income below the sum of the personal exemption amount ($700) and the income threshold for receiving the maximum sliding scale standard deduction ($11,700) would not owe any income taxes under current law and would, therefore, not receive a benefit from the proposal. Others without a benefit would include those with federal AGI exceeding the maximum income levels for the phase-out of the deduction ($60,000 for single individuals and heads-of-households, $100,000 for married taxpayers filing joint returns, and $50,000 for married individuals filing separate returns). Such taxpayers would be ineligible for the deduction under current law as well as under the proposal. Finally, taxpayers with tuition expenses below the current law deduction of $3,000 would also not receive a benefit under the proposal. Based on information in the 2003 tax sample, it is estimated that taxpayers with AGI between $30,000 and $80,000 would receive approximately 80% of the tax benefit under the tuition deduction as included under the bill and also under the modification requested by the administration and described above.

7. It should be noted that, while the tuition deduction primarily benefits taxpayers with federal AGI from $30,000 to $80,000, lower-income families and independent students benefit from state and federally funded need-based grant programs. The number of eligible students and the average amount of each award are determined by formula using nationally approved needs methodology and overall eligibility is based on other factors aside from total family income. Based on data from the Higher Educational Aids Board (HEAB), recipients of state-funded need-based grants in the UW System generally have family income of less than $38,000. The Governor has proposed a net increase of $22.9 million for state-funded need-based grant programs in the 2005-07 biennium. In 2003-04, $73.1 million was provided for need-based assistance through HEAB.

8. As noted, it is the administration's intent for these provisions to first apply for taxable years beginning January 1, 2005. The bill could be modified to clarify that the January 1, 2005, initial applicability date would apply regardless of the general effective date of the bill.

ALTERNATIVES

1. Approve the Governor's proposal to increase the maximum tuition deduction to the

greater of $5,100 or twice the average amount charged by the Board of Regents of the University of Wisconsin at four-year institutions for resident undergraduate academic fees for the most recent fall semester, as determined by the Board of Regents by September 1 of that semester. Increase the estimated fiscal effect of the provision from $4.9 million in 2005-06 and $5.3 million in 2006-07 to $6.6 million in 2005-6 and $7.1 million in 2006-07, for a biennial increase of $3.5 million. In addition, specify that this provision would take first apply for taxable years beginning on January 1, 2005.

Alternative 2	GPR-REV
2005-07 REVENUE (Change to Bill)	- $3,500,000

2. Approve a modified proposal to increase the tuition deduction, as requested by the administration, that would specify that the maximum deduction would be twice the average amount charged by the Board of Regents of the University of Wisconsin at four-year institutions for resident undergraduate academic fees for the most recent fall semester, as determined by the Board of Regents by September 1 of that semester. The reference to a potential maximum deduction of $5,100 would be eliminated. The estimated fiscal effect would be to reduce state income tax revenues by $4.9 million in 2005-06 and $5.3 million in 2006-07, which is the same as the estimated fiscal effect included in the bill. In addition, specify that this provision would take first apply for taxable years beginning on January 1, 2005.

3. Maintain current law. Compared to the bill, increase general fund tax revenues by $4.9 million in 2005-06 and by $5.3 million in 2006-07.

Alternative 3	GPR-REV
2005-07 REVENUE (Change to Bill)	$10,200,000

Prepared by: Faith Russell

APPENDIX

Federal and State Income Tax Provisions Related to Higher Education Expenses

EdVest College Savings Programs. The Wisconsin EdVest program offers two college savings options that meet federal standards for a qualified state tuition program [QSTP] and may, therefore, offer favorable tax treatment. The first program is the college tuition and expenses program, under which an individual may purchase "tuition units" for a designated beneficiary. This program was started in 1997, and is administered by the State Treasurer's office with investments managed by the State of Wisconsin Investment Board. The second EdVest program is the college savings account program, under which individuals contribute to a college savings account for a designated beneficiary (rather than purchasing tuition units). The savings account program is managed by an 11-member College Savings Program Board, and began offering accounts in 2001.

While both types of college savings programs continue to be authorized by state statute, the State Treasurer's office has closed the tuition unit option to all new investments, effective December 20, 2002. Instead, EdVest is now offering a wider variety of investment options through the newer, more flexible college savings account program.

For state tax purposes, effective with tax year 2001, donors may deduct up to $3,000 in contributions to an EdVest account if the beneficiary is the purchaser, the purchaser's spouse, or the purchaser's dependent child. Under 2001 Wisconsin Act 109, the deduction for contributions to EdVest programs was extended to grandparents of a beneficiary, effective with tax year 2002. Under 2003 Wisconsin Act 289, effective January 1, 2004, the deduction for contributions was again extended, this time to include contributions by great-grandparents, aunts, and uncles of account beneficiaries.

Wisconsin has provided an income tax exemption for EdVest earnings and qualified distributions since 1997. Under the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA), the federal government adopted a similar exemption for earnings and distributions from any QSTP. EGTRRA also provided that, effective with tax year 2004, the exemption for earnings and distributions is extended to earnings and distributions from qualified tuition programs offered by private institutions in addition to state-sponsored plans. These federal provisions also apply for state purposes.

Employer Payment of Educational Expenses. Payments of up to $5,250 received by an employee for tuition, fees, and supplies may be excluded from income for both federal and state income tax purposes.

Coverdell Education Savings Accounts. Under federal law, individuals (including a beneficiary) may contribute up to $2,000 per designated beneficiary per year to a Coverdell Education Savings Account (CESA, formerly called an Education IRA). There are no relationship requirements between the contributor and the beneficiary. While contributions are not deductible from income, interest earnings are tax exempt and withdrawals are excluded from the beneficiary's income if used for eligible education expenses. Under coordination rules with other tax deductions and credits for education, qualified expenses for purposes of a CESA are reduced to reflect other education tax benefits taken.

The ability of an individual to make a contribution to a CESA is gradually phased out for contributors with taxable income between $95,000 and $110,000 (between $190,000 and $220,000 for joint filers). Starting with tax year 2002, funds from a CESA may be used to pay for qualified elementary and secondary education expenses in addition to qualified higher education expenses. These federal provisions also apply for state tax purposes.

IRA Withdrawals for Education Expenses. Early withdrawals (before age 59½) from a traditional IRA are not subject to the 10% federal tax penalty (or a state penalty, which is typically 33% of the federal penalty) provided that distributions are used for postsecondary education expenses of the taxpayer, spouse, child, or grandchild.

Student Loan Interest Deduction. For federal and state income tax purposes, an individual may deduct up to $2,500 of interest paid on student loans for qualified higher education expenses. The deduction is phased out for single filers with modified federal AGI (prior to taking the student loan interest deduction) between $50,000 and $65,000 and for joint filers with income between $100,000 and $130,000.

Hope Credit. The federal Hope credit is available to individuals who pay qualified tuition and related expenses of higher education for either themselves or a dependent. Degree-seeking students who are enrolled at least half-time and are in one of the first two years of college are eligible for a tax credit of up to 100% of the first $1,000 and 50% of the second $1,000 in tuition expenses. Eligible expenses include tuition and required fees less any grants, scholarships or other tax-free financial assistance. For tax year 2005, the credit is gradually phased out for taxpayers with taxable incomes between $43,000 and $53,000 (for single filers) and between $87,000 and $107,000 (for joint filers). The maximum credit amounts as well as the income limits are indexed for inflation.

Lifetime Learning Credit. A federal lifetime learning credit is provided to taxpayers paying qualified tuition or other higher education expenses of an eligible student. An eligible student can be the taxpayer, a spouse, or a dependent claimed as an exemption for tax purposes. Students beyond the first two years of college or those enrolled for less than half-time are eligible for a 20% tax credit on the first $10,000 in expenses. Eligible expenses include tuition and required fees less any grants, scholarships or other tax-free financial assistance. For tax year 2005, the credit is gradually phased out for taxpayers with taxable incomes between $43,000 and $53,000 for single filers, and between $87,000 and $107,000 for joint filers.

Federal law does not allow a double benefit with respect to the tax treatment of higher education expenses. For example, neither the Hope nor the lifetime learning credits may be claimed for higher education tuition expenses that were deducted from federal income. Similarly, a Hope credit and a lifetime learning credit may not be based on the same qualified education expenses. However, a state resident may deduct qualified tuition expenses for state tax purposes even if such expenses have been included in the calculation of the federal Hope or lifetime learning credits.

Education Savings Bonds. Federal law excludes from income interest from qualified U.S. savings bonds that are cashed in and used to pay for qualified higher education expenses. The exclusion is phased out at higher income levels. Under state law, all interest from U.S. Savings bonds is exempt, regardless of whether or not the interest is used to pay for qualified educational expenses.