NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: SB 466 (First Edition)

SHORT TITLE: Tax Exempt Parental Savings Trust Fund

SPONSOR(S): Senators Hartsell and Lee

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 1997-98	FY 1998-99	FY 1999-00	FY 2000-01	FY 2001-02
REVENUES					
General Fund	-	($3,269)	($20,413)	($54,244)	($105,704)

NOTE: The revenue loss will increase to $819,000 in year 2007 and remain at that level. See assumptions and methodology.

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: State Education Assistance Authority, Department of State Treasurer

EFFECTIVE DATE: The act is effective for taxable years beginning on or after January 1, 1998.

BILL SUMMARY: The bill exempts the earnings of the Parental Savings Trust Fund from state individual income tax.

BACKGROUND: The 1996 General Assembly established a Parental Savings Trust Fund to encourage parents and others to save for postsecondary education expenses. (1996, 2nd Extra Session, c. 18, s.16.7) The Fund is administered by the State Education Assistance Authority and Fund investments are made by the State Treasurer. Within the Fund there will be two accounts. One account will be for qualified expenses - tuition, fees, books, supplies and equipment. Earnings from this account are exempt from federal and state individual income tax until the proceeds are distributed to the beneficiary (and taxed at the beneficiary's tax rate). The second account will be for non-qualified expenses - travel, room, board, and incidentals. Earnings from this account are assigned to the contributor and taxed in the year earned. The Authority will ask contributors to the Fund whether they are saving for a public or private institution, then determine how much should be placed in each account based on average college costs.

To assist those parents or interested parties whose savings in the Fund are insufficient to pay for all college expenses, the General Assembly authorized the State Education Assistance Authority to develop a loan program in conjunction with the Parental Savings Trust Fund.

ASSUMPTIONS AND METHODOLOGY: The consultant that developed the Parental Savings Trust Fund concept for the State Education Assistance Authority assumes the following criteria in projecting the number of participants in the Fund:

1) Children age birth to 16 are eligible for the account. Establishing an account for a person over age 16 would not yield sufficient savings in time for college.

2) Approximately 64,000 children finish high school in the state each year and approximately 43% of them pursue higher education (excluding community college).

3) Using the data above, the target population is approximately 448,000

   16 (age levels) X 64,000 (high school graduates in each age group) X .43 (percent going to college)

4) Each year between .6% and 1.2% of this target population will start savings accounts.

This fiscal note assumes the Fund will attract 1.2% of the target population or 5,376 new accounts each year. The Fund anticipates receiving its first accounts in October 1997. The average account holder will contribute $125 a month. The average interest rate earned by these contributions is 5.5%. (This is equivalent to the State Treasurer's short term interest rate of 6.5% minus 1% in administrative charges.) There will be no payouts from the Fund for the first six years.

Based on the above assumptions, the interest earned by the Fund each calendar year is as follows:

1998	$ 93,426
1999	$ 583,240
2000	$ 1,549,839
2001	$ 3,020,115
2002	$ 5,022,482
2007	$12,600,000 (max)

For this fiscal note, it is assumed that half of the Fund earnings will be credited to qualified expenses and tax deferred. Federal tax law allows the earnings on qualified expenses (tuition, fees, books) in the Fund to be tax deferred until the student attends college. State tax law conforms with the federal law on this topic. For private schools, tuition and fees might be 70% of the overall cost of attending the university. For public schools, tuition and fees may average about 30% of the cost of a university education. Since there is no sound basis to judge the college destination of future Fund participants, this fiscal note chooses the mid-point of 50%.

Thus 50% of the earnings will be taxed at the student's tax rate when the funds are paid out and 50% of the earnings will be taxed at the contributors' rate when earned each year.

Under SB 466, the interest earned in 1998 on non-qualified expenses accounts in the Fund will be tax exempt when individuals file their income tax returns in the spring of 1999. It is assumed that the average Fund contributor pays a 7% individual income tax rate. The tax loss for non-qualified expenses is 50% of the estimated earnings on page 2 times the 7% tax rate.

FY 1998-99	$ 3,269
FY 1999-00	$ 20,413
FY 2000-01	$ 57,244
FY 2001-02	$105,704
FY 2006-07	$441,000

The interest on qualified expenses would be taxable under current law when the first payouts are made in FY 2004-05. SB 466 would exempt the earnings on qualified expenses from tax. If the average student works in the summer, works part-time in school, and is claimed as a dependent on his/her parents' tax return, then it is possible that the distribution from the Fund will be subject to the minimum state income tax of 6%. In FY 2006-07, the total earnings in the Fund are estimated to be $12.6 million, with 50% of this amount or $6.3 million designated for qualified expenses. Applying a 6% tax rate to $6.3 million is equal to $378,000.

The maximum tax loss for qualified and non-qualified expenses based on the scenario outlined above is $819,000 beginning in FY 2006-07.

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