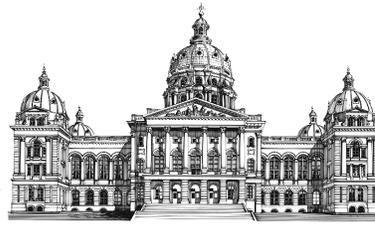


Iowa Legislative Fiscal Bureau

Dennis Prouty
(515) 281-5279
FAX 281-8451



State Capitol
Des Moines, IA 50319
September 12, 1997

Fiscal Impact of Education Provisions in Federal Tax Bill

ISSUE

This *Issue Review* provides the estimated fiscal impact of education provisions in the federal tax bill to the Iowa General Fund.

BACKGROUND

There are three types of impacts due to the federal tax bill:

- Deductibility impacts
- Behavioral impacts
- Coupling impacts

This *Issue Review* focuses on the coupling impacts of education provisions due to the federal tax bill. Please refer to the *Issue Review* titled "Taxpayer Relief Act of 1997" for the deductibility and behavioral impacts of the federal legislation. All dollar amounts specified for FY 1999 and FY 2000 are the estimated impacts compared to FY 1997. To determine the incremental (i.e., year to year) impact subtract the future year from the earlier year (FY 1999 less the FY 1998 amount) to get the incremental FY 1999 impact.

EDUCATION PROVISIONS

Hope and Lifetime Learning Credits

- **Hope Tax Credit** - A Hope Income Tax Credit is provided for qualified tuition and fees for the first two years of a taxpayer's, spouse's, or dependent's post-secondary education. The credit is nonrefundable and is available for up to 100.0% of the first \$1,000 and 50.0% of the next \$1,000 of eligible expenses, beginning with expenses incurred on or after January 1, 1998.
- **Lifetime Learning Credit** - Effective for education expenses paid after June 30, 1998, a nonrefundable Lifetime Learning Tax Credit equal to 20.0% up to \$5,000 (\$10,000 beginning in 2003) is available for students enrolled in classes at an eligible education institution to acquire or improve job skills. This applies to students in degree and non-degree programs.
- **Phase-out and Limitations** - Both credits are phased out for joint filers with modified Adjusted Gross Income (AGI) starting at \$80,000 and eliminated by \$100,000 and for single taxpayers with modified Adjusted Gross Income (AGI) starting at \$40,000 and eliminated by \$50,000. Both credits may be claimed for eligible expenses of the taxpayer and the taxpayer's spouse and

dependents. Although both credits may be taken by the taxpayer, only one credit may be used for each individual student.

- **Fiscal Impact** - There should be no fiscal impact due to these provisions because Iowa typically does not couple to federal tax law for tax credits.

Student Loan Interest Deduction

- **Student Loan Interest Deduction** - A phased-in deduction of up to \$2,500 is available for interest due and paid on qualified education loans after 1997. The deduction is an adjustment to income, so taxpayers taking the standard deduction will be eligible.
- **Limitations** - The adjustment applies to any loan during the first five years that interest payments are required. Maximum deductions are: for 1998, \$1,000; for 1999, \$1,500; for 2000, \$2,000, for 2001 and subsequent years, \$2,500. A taxpayer may claim the interest deduction only if not claimed as a dependent by another taxpayer for the tax year.
- **Phase-out** - The deduction is phased out for taxpayers with modified AGI starting at \$60,000 and eliminated by \$75,000 for joint return filers (\$40,000 and \$55,000 for singles and heads of households).
- **Estimated Fiscal Impact** - The estimated Iowa General Fund impact of the provision is listed below:

	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>
Estimated General Fund Impact	\$ 0	\$ (200,000)	\$ (500,000)

Penalty-free Withdrawals from Individual Retirement Accounts (IRAs) for Education Expenses

Taxpayers are permitted to make withdrawals from IRAs for higher education expenses of the taxpayer and the taxpayer's spouse, child, and grandchild without a penalty. The distribution will be taxed under standard IRA rules. This provision is effective beginning with the 1998 tax year for all income levels.

- **Estimated Fiscal Impact** - The estimated Iowa General Fund impact of the provision is listed below:

	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>
Estimated General Fund Impact	\$ -100,000	\$ -600,000	\$ -1,000,000

Education IRAs

- **Education IRA** - Beginning with the 1998 tax year, taxpayers will be permitted to contribute up to \$500 each year per child under age 18 to an education IRA.
- **Tax Treatment** - Education IRA contributions are not deductible, but withdrawals used to pay qualified higher education expenses will generally be tax free. Traditional IRAs are backloaded such that contributions are deductible at the beginning, but withdrawals are taxed.
- **Other Rules** - Education IRA earnings not used for qualified expenses are included in the income of the distributee and are subject to a 10.0% penalty.
- **Phase-out and Limitations** - The annual contribution limit is phased out for joint filers with modified AGI starting at \$150,000 and eliminated by \$160,000 (starting at \$95,000 and eliminated by \$110,000 for single filers).
- **Estimated Fiscal Impact** - The estimated Iowa General Fund impact of the provision is listed below:

	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>
Estimated General Fund Impact	\$ -200,000	\$ -1,700,000	\$ -3,700,000

Other Provisions

Three additional provisions of the federal legislation are listed below:

- **Qualified state tuition programs** - Prior to the adoption of the new federal law, certain qualified state tuition programs are tax exempt if the program allows persons to make contributions to an account established to meet higher education expenses of a beneficiary (tuition, fees, books, supplies, and equipment required for enrollment). The new federal law expands the qualified expenses to include room and board.
- **Extension of exclusion for employer-provided educational assistance** - For courses of instruction beginning July 1, 1997, an exclusion of \$5,250 from income for employer-provided assistance for certain undergraduate educational programs is available for courses beginning prior to June 1, 2000.
- **Certain student loan cancellation** - Expands the exclusion of income for a cancelled student loan to include tax exempt charitable organizations.
- **Estimated Fiscal Impact** - These four items have been combined into a single estimate of fiscal impact as follows:

	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>
Estimated General Fund Impact	\$ -100,000	\$ -1,600,000	\$ -2,800,000

Total Impact of Education Provisions - The total impact of the federal tax bill on the Iowa General Fund is summarized in the following table.

Total Estimated General Fund Impact of Education Provisions

	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>
IRA Withdrawals for Education	\$ -100,000	\$ -600,000	\$ -1,000,000
Education IRAs	-200,000	-1,700,000	-3,700,000
Student Loan Interest Deduction	0	-200,000	-500,000
Other Education Provisions	<u>-100,000</u>	<u>-1,600,000</u>	<u>-2,800,000</u>
Total Education Provisions	<u>\$ -400,000</u>	<u>\$ -4,100,000</u>	<u>\$ -8,000,000</u>

Source: Department of Revenue and Finance

STAFF CONTACT: Larry Sigel (Ext. 16764)

LFB:IR9LCSA.DOC/09/24/97/11:40 am/a
Fiscal Impact of Education Provisions in
Federal Tax Bill