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A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO IMPROVE 529 PLANS

MAY 21, 2015.—Ordered to be printed

Mr. HATCH, from the Committee on Finance, submitted the following

REPORT

[To accompany S. 335]

The Committee on Finance, to which was referred the bill (S. 335) to amend the Internal Revenue Code of 1986 to improve 529 plans, having considered the same, reports favorably thereon with an amendment and recommends that the bill, as amended, do pass.

CONTENTS

I. LEGISLATIVE BACKGROUND

The Committee on Finance has considered the Chairman's Mark to S. 335, a bill that modernizes and improves the treatment of college savings programs under section 529 of the Internal Revenue Code of 1986 ("529 plans"). It treats computer equipment and technology expenses as qualified higher education expenses, and removes the aggregation requirement for distributions. The bill also

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protects from Federal income tax and penalties amounts taken as distributions, paid as tuition, and then refunded, provided such amounts are re-contributed to the 529 plan within 60 days. The Committee reports favorably thereon and recommends that the bill, as amended, do pass.

Background and need for legislative action

The Committee believes that 529 plans are an important vehicle for encouraging middle-income families to save for higher education, and that these plans should be modernized, improved, and simplified for such families.

Hearings

The tax treatment of 529 plans was one of several issues discussed at a full Committee hearing held on June 24, 2014, titled "Less Student Debt from the Start: What Role Should the Tax System Play?"

II. EXPLANATION OF THE BILL

A. SECTION 529 PROGRAMS (SECS. 2, 3, & 4 OF THE BILL AND SEC. 529 OF THE CODE)

PRESENT LAW

Section 529 qualified tuition programs

In general

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). Section 529 [1] provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[2] In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program"). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are made by an individual who is not the designated bene-

[1] Except where otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[2] For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

ficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner")[3] whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

Qualified higher education expenses

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the Code, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time. For taxable years 2009 and 2010 only, qualified higher education expenses included the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used by the beneficiary or the beneficiary's family during any of the years a beneficiary was enrolled at an eligible institution.

Contributions to qualified tuition programs

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (*i.e.,* income on accounts in the plan is not subject to current income tax).

A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to direct (directly or indirectly) the investment of any contributions (or earnings thereon) more than two times in any calendar year, and must provide

[3] Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term "account owner," which is a commonly used term among qualified tuition programs.

separate accounting for each designated beneficiary. A qualified tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan.

Distributions from qualified tuition programs

Distributions from a qualified tuition program are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified higher education expenses incurred for the beneficiary.[4]

If a distribution from a qualified tuition program exceeds the qualified higher education expenses incurred for the beneficiary, the amount includible in gross income is determined, first, by applying the annuity rules of section 72[5] to determine the amount which would be includible in gross income if none of the amount distributed was for qualified higher education expenses and, then, reducing that amount by an amount which bears the same ratio to that amount as the qualified higher education expenses bear to the amount of the distribution.[6]

For example, assume a taxpayer had $5,000 in a qualified tuition program account, $4,000 of which was the amount contributed. Also assume the taxpayer withdraws $1,000 from the account and $500 is used for qualified higher education expenses. First, the taxpayer applies the annuity rules of section 72 which results in $200 being included in income under section 72 assuming none of the distribution is used for qualified higher education expenses. Then the taxpayer reduces the $200 by one-half because 50 percent of the distribution was used for qualified higher education expenses. Thus, $100 is includible in gross income. This amount is subject to an additional 10-percent tax (unless an exception applies).

The Code provides that, except as provided by the Secretary of the Treasury ("Secretary"), for purposes of this calculation, the taxpayer's account value, income, and investment amount, are generally measured as of December 31st of the taxable year in which the distribution was made. The Secretary has issued guidance providing that the earnings portion of a distribution is to be computed on the date of each distribution.[7]

In the case of an individual who is the designated beneficiary for more than one qualified tuition program, all such accounts are aggregated for purposes of calculating the earnings in the account under section 72. The Secretary has provided in guidance that this aggregation is required only in the case of accounts contained within the same 529 program, having the same account owner and the same designated beneficiary.[8]

REASONS FOR CHANGE

The Committee recognizes that computer technology is an essential part of higher education, and thus believes that funds used to purchase such technology should be considered a qualified educational expense for purposes of section 529. Additionally, the Com-

[4] Sec. 529(c)(3)(B)(i) and (ii)(I).

[5] Under section 72, a distribution is includible in income to the extent that the distribution represents earnings on the contribution to the program, determined on a pro rata basis.

[6] Sec. 529(c)(3)(A) and (B)(ii). 7 Notice 2001 81, 2001 2 C.B. 617, December 10, 2001. 8 Ibid.

[7] Notice 2001–81, 2001–2 C.B. 617, December 10, 2001.

[8] *Ibid.*

mittee believes that certain rules requiring aggregation of section 529 accounts are difficult to administer, adding a burden to 529 administrators. Finally, the Committee believes that 529 programs should be able to allow students who have received a refund of tuition that had been paid with the proceeds of a 529 account to recontribute such refund back into the account without being taxed and penalized.

EXPLANATION OF PROVISION

The provision makes three modifications to section 529.

First, the provision provides that qualified higher education expenses include the purchase of computer or peripheral equipment (as defined in section 168(i)(2)(B)), computer software (as defined in section 197(e)(3)(B)), or Internet access and related services if the equipment, software, or services are to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible education institution.

Second, the provision repeals the rules providing that section 529 accounts must be aggregated for purposes of calculating the amount of a distribution that is included in a taxpayer's income. Thus, in the case of a designated beneficiary who has received multiple distributions from a qualified tuition program in the taxable year, the portion of a distribution that represents earnings is now to be computed on a distribution-by-distribution basis, rather than an aggregate basis, such that the computation applies to each distribution from an account. The following example illustrates the operation of this provision: Assume that two designated savings accounts have been established by the same account owner within the same qualified tuition program for the same designated beneficiary. Account A contains $20,000, all of which consists of contributed amounts (*i.e.,* it has no earnings). Account B contains $30,000, $20,000 of which constitutes an investment in the account, and $10,000 attributable to earnings on that investment. Assume a taxpayer receives a $10,000 distribution from Account A, with none of the proceeds being spent on qualified higher education expenses. Under present law, both of the designated beneficiary's accounts would be aggregated for purposes of computing earnings. Thus, $2,000 of the $10,000 distribution from Account A ($10,000 * $10,000/$50,000) would be included in the designated beneficiary's income. Under the provision, the accounts would not be aggregated for purposes of determining earnings on the account. Thus, because Account A has no earnings, no amount of the distribution would be included in the designated beneficiary's income for the taxable year.

Third, the provision creates a new rule that provides, in the case of a designated beneficiary who receives a refund of any higher education expenses, any distribution that was used to pay the refunded expenses is not subject to Federal income tax if the designated beneficiary recontributes the refunded amount to the qualified tuition program within 60 days of receiving the refund, to the extent that such recontribution is not in excess of the refund. A transition rule allows for recontributions of amounts refunded after December 31, 2014, and before the date of enactment to be made not later than 60 days after the enactment of this provision.

EFFECTIVE DATE

The provision allowing computer technology to be considered a higher education expense is effective for taxable years beginning after December 31, 2014. The provision removing the aggregation requirement in the case of multiple distributions is effective for distributions made after December 31, 2014. The provision allowing a recontribution of refunded tuition amounts is effective for tuition refunded after December 31, 2014.

III. BUDGET EFFECTS OF THE BILL

A. Committee Estimates

In compliance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the revenue provisions of S. 335 as reported.

The bill is estimated to have the following effects on Federal budget receipts for fiscal years 2015–2025:

FISCAL YEARS
[Millions of dollars]

2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2015–20	2015–25
−1	−2	−2	−3	−3	−4	−5	−6	−7	−8	−10	−15	−51

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Congressional Budget and Impoundment Control Act of 1974 ("Budget Act"),[9] the Committee states that no provisions of the bill as reported involve new or increased budget authority.

Tax expenditures

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the revenue-reducing provisions of the bill involve increased tax expenditures (see revenue table in part A., above).

C. Consultation With Congressional Budget Office

In accordance with section 403 of the Budget Act, the Congressional Budget Office has submitted the following statement on the bill:

[9] Pub. L. No. 93–344.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, May 7, 2015.

Hon. ORRIN G. HATCH,
Chairman, Committee on Finance,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for S. 335, a bill to amend the Internal Revenue Code of 1986 to improve 529 plans.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Logan Timmerhoff.

Sincerely,

KEITH HALL.

Enclosure.

S. 335—A bill to amend the Internal Revenue Code of 1986 to improve 529 plans

S. 335 would modify the tax treatment of college savings plans authorized under section 529 of the Internal Revenue Code. Under current law, income earned on amounts in those accounts accumulates on a tax-free basis, and the distribution of such income is not included in the taxable income of the recipient to the extent that it is used to pay certain higher education expenses. S. 335 would expand the qualifying expenses to include certain computer and related expenses. The bill would also modify the computation of the taxable portion of a distribution when the contributor has established multiple accounts for the student. In addition, S. 335 would allow beneficiaries to pay no tax in the event that they receive a refund from the educational institution (for example, after withdrawing from enrollment) and contribute the refunded amount back to the savings plan within 60 days.

The staff of the Joint Committee on Taxation (JCT) estimates that enacting S. 335 would reduce revenues, thus increasing federal deficits, by $51 million over the 2015–2025 period.

The Statutory Pay-As-You-Go Act of 2010 establishes budget-reporting and enforcement procedures for legislation affecting direct spending and revenues. Enacting S. 335 would result in revenue losses in each year beginning in 2015. The estimated increases in the deficit are shown in the following table.

JCT has determined that the bill contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act.

On February 19, 2015, CBO transmitted a cost estimate of the budgetary effects of H.R. 529, as ordered reported by the House Committee on Ways and Means on February 12, 2015. The language of S. 335 is identical to that of H.R. 529, and therefore the estimated budgetary effects are also the same.

The CBO staff contact for this estimate is Logan Timmerhoff. The estimate was approved by David Weiner, Assistant Director for Tax Analysis.

CBO ESTIMATE OF PAY-AS-YOU-GO EFFECTS FOR S. 335, AS ORDERED REPORTED BY THE SENATE COMMITTEE ON FINANCE ON APRIL 29, 2015

	By fiscal year, in millions of dollars—												
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2015–2020	2015–2025
NET INCREASE IN THE DEFICIT													
Statutory Pay-As-You-Go Impact ...	1	2	2	3	3	4	5	6	7	8	10	15	51

Source: Staff of the Joint Committee on Taxation.

IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of Rule XXVI of the standing rules of the Senate, the Committee states that, with a majority and quorum present, S. 335 was ordered favorably reported on April 29, 2015 as follows:

Amendment #5, Wyden/Brown #1, as Modified—Removing 529 plan balances from the TANF asset test—defeated by roll call vote, 12 ayes, 14 nays.

Ayes: Wyden, Schumer (proxy), Stabenow, Cantwell, Nelson (proxy), Menendez (proxy), Carper, Cardin, Brown, Bennet, Casey, Warner.

Nays: Hatch, Grassley, Crapo, Roberts (proxy), Enzi (proxy), Cornyn (proxy), Thune (proxy), Burr (proxy), Isakson (proxy), Portman, Toomey (proxy), Coats, Heller (proxy), Scott (proxy).

Amendment #11, Stabenow/Bennet/Brown/Wyden/Warner #2, as Modified—Improving information students and their families receive about federal tax credits for higher education—defeated by roll call vote, 12 ayes, 14 nays.

Ayes: Wyden, Schumer (proxy), Stabenow, Cantwell, Nelson (proxy), Menendez, Carper (proxy), Cardin, Brown, Bennet, Casey, Warner.

Nays: Hatch, Grassley, Crapo, Roberts (proxy), Enzi (proxy), Cornyn (proxy), Thune (proxy), Burr (proxy), Isakson (proxy), Portman, Toomey (proxy), Coats, Heller, Scott (proxy).

Amendment #16, Menendez/Schumer/Brown/Stabenow/Warner/Cantwell #1, as Modified—Student Loan Tax Relief Act—defeated by roll call vote, 12 ayes, 14 nays.

Ayes: Wyden, Schumer (proxy), Stabenow, Cantwell, Nelson (proxy), Menendez, Carper (proxy), Cardin (proxy), Brown, Bennet, Casey, Warner.

Nays: Hatch (proxy), Grassley, Crapo (proxy), Roberts (proxy), Enzi (proxy), Cornyn (proxy), Thune, Burr (proxy), Isakson (proxy), Portman, Toomey (proxy), Coats (proxy), Heller (proxy), Scott (proxy).

Amendment #26, Bennet/Brown/Wyden/Schumer #9, as Modified—Fully excluding Pell Grants from Gross Income—defeated by roll call vote, 12 ayes, 14 nays.

Ayes: Wyden, Schumer (proxy), Stabenow (proxy), Cantwell, Nelson (proxy), Menendez, Carper (proxy), Cardin (proxy), Brown, Bennet, Casey (proxy), Warner.

Nays: Hatch (proxy), Grassley, Crapo (proxy), Roberts (proxy), Enzi (proxy), Cornyn (proxy), Thune, Burr (proxy), Isakson (proxy), Portman (proxy), Toomey (proxy), Coats, Heller (proxy), Scott (proxy).

Final Passage of the S. 335, A Bill to Amend the Internal Revenue Code of 1986 to Improve 529 Plans, as Modified—approved by roll call vote, 26 ayes, 0 nays.

Ayes: Hatch, Grassley, Crapo, Roberts, Enzi (proxy), Cornyn, Thune, Burr, Isakson, Portman, Toomey, Coats, Heller, Scott, Wyden, Schumer, Stabenow, Cantwell, Nelson, Menendez, Carper, Cardin, Brown, Bennet, Casey, Warner.

V. REGULATORY IMPACT AND OTHER MATTERS

A. Regulatory Impact

Pursuant to paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as amended.

Impact on individuals and businesses, personal privacy and paperwork

The bill modifies the treatment of 529 plans. The provisions of the bill are not expected to impose additional administrative requirements or regulatory burdens on individuals or businesses.

The provisions of the bill do not impact personal privacy.

B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (Pub. L. No. 104–4).

The Committee has determined that the tax provisions of the reported bill do not contain Federal private sector mandates or Federal intergovernmental mandates on State, local, or tribal governments within the meaning of Public Law 104–4, the Unfunded Mandates Reform Act of 1995.

C. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 ("IRS Reform Act") requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Treasury Department) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code and has widespread applicability to individuals or small businesses. The staff of the Joint Committee on Taxation has determined that there are no provisions that are of widespread applicability to individuals or small businesses.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).

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