SENATE COMMITTEE ON EDUCATION
Senator Carol Liu, Chair
2015 - 2016 Regular

Bill No:	AB 1463		
Author:	Gatto		
Version:	June 23, 2016	**Hearing Date:**	August 3, 2016
Urgency:	No	**Fiscal:**	Yes
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Subject: Student financial aid: California Covenants Program: tuition certificates: gross income exclusion

NOTE: This bill has been referred to the Committees on Education and Governance and Finance. A "do pass" motion should include referral to the Committee on Governance and Finance.

NOTE: This bill has been amended to replace its contents and this is the first time the bill is being heard in its current form.

SUMMARY

This bill, an urgency measure, establishes, under the administration of the Treasurer, a prepaid college tuition program by which an individual may purchase a fixed percentage of the tuition for an academic year of full-time enrollment at the California State University (CSU), University of California (UC), or an independent institution of higher education. This bill requires the CSU, and requests UC and an independent institution of higher education in California to participate in the program.

BACKGROUND

1) Existing law establishes the CSU, under the administration of the Trustees of the CSU, as one of the segments of public postsecondary education in this state. The CSU comprises 23 institutions of higher education, each of which is headed by a president who is appointed by the trustees. (Education Code § 66600)

2) The California Constitution establishes the UC, a public trust to be administered by the Regents of the UC and grants the Regents full powers of organization and government, subject only to such legislative control as may be necessary to insure security of its funds, compliance with the terms of its endowments, statutory requirements around competitive bidding and contracts, sales of property and the purchase of materials, goods and services. (Article IX, Section (9)(a) of the California Constitution)

3) Existing law defines independent institutions of higher education as those nonpublic higher education institutions that grant undergraduate degrees, graduate degrees, or both, and that are formed as nonprofit corporations in this state and are accredited by an agency recognized by the United States Department of Education. (EC § 66010 (b))

4) Existing law establishes the Golden State ScholarShare Trust Program, administered by the State Treasurer's Office, which offers California families a tax-advantaged college tuition savings plan of investment and savings for a college education with state tax-deferred and federal tax-free benefits. Under this program, a participant opens an account on behalf of a designated named beneficiary. The money contributed by the participant to the account is placed in a trust, and invested in special investment portfolios designed to meet the needs of beneficiaries based on age, and different kinds of investments. The program offers federal and California income tax-free treatment for qualified withdrawals from a ScholarShare account. A qualified withdrawal is one that is used to pay for qualified higher education expenses at any eligible postsecondary educational institution throughout the U.S. (and even some outside the U.S.) including many vocational schools. (EC § 69980, et seq.)

ANALYSIS

This bill:

1) Establishes the California Covenants program under the administration of the Treasurer for the purpose of creating a prepaid college tuition program for undergraduate education at California State University (CSU), University of California (UC) and independent institutions of higher education.

2) Requires the Treasurer to issue tuition certificates for a prepaid purchase of a fixed percentage of tuition and mandatory systemwide fees (fees) for an academic year of full-time enrollment as an undergraduate at a campus of the CSU, the UC, or an independent institution of higher education and:

   a) Authorizes the Treasurer to determine the cost of the fixed percent of tuition and fees for participating institutions and to periodically adjust that cost as a result of changes in the economy of the state, cost of living, and tuition and fees charged by the participating segments.

   b) Requires that the tuition certificate specify the percentage of tuition and fees that have been purchased.

   c) Specifies that the tuition certificate cover annual tuition and fee increases of 7.5 percent or less.

   d) Sets the minimum amount of tuition certificates that an individual may purchase to $300 in a calendar year and limits the window of time for purchase to May 1^{st} through June 30^{th} commencing in 2018.

   e) Requires the beneficiary to be either a California resident or a student who is exempt from nonresident tuition, as defined, at the time a tuition certificate is used.

   f) Requires the purchaser of a tuition certificate to specify its intended beneficiary who may be anyone who has not yet commenced grade 11.

g) Requires that the tuition certificate be valid for up to 30 years from the purchased date.

h) Limits the use of tuition certificates to undergraduate tuition and fees at the California State University (CSU), the University of California (UC), or independent institutions of higher education.

i) Prohibits tuition certificates from being used to cover the cost of textbook, supplies, or living expenses, including, but not necessarily limited to, food, housing, and transportation.

j) Provides for the initial investment to be returned to the individual who purchased the certificate, with interest and prohibits the returned investment from being subject to a tax penalty, if the intended beneficiary of a tuition certificate is unable to, or chooses not to, attend the institution issuing the certificate.

3) Establishes a separate fund within the State Treasury for the California Covenants Program and:

a) Specifies that moneys received by the Treasurer from the sale of tuition certificates and bonds be deposited into that fund.

b) Authorizes the Treasurer to issue bonds backed by the tuition certificate revenues and specifies that bond proceeds be deposited in the program fund.

c) Authorizes the Treasurer, upon appropriation in the Annual Budget Act, to allocate moneys in the fund to CSU, UC and participating independent institutions of higher education to cover tuition and fees of beneficiaries of the program during that fiscal year.

4) Requires the Director of Finance to determine each fiscal year whether there are sufficient funds to implement the program in that year and communicate this determination to the Treasurer in a timely manner.

5) Specifies that for taxable years beginning on or after January 1, 2018, gross income does not include:

a) Moneys invested by the taxpayer, including interest accrued by that investment, in the California Covenants Program.

b) Disbursements to the taxpayer from the California Covenants Program for use by a beneficiary at an educational institution that participates in the program.

c) Tax, additions to tax, and penalties shall not apply to an amount disbursed to a taxpayer where the beneficiary does not attend an educational institution that participates in the California Covenants Program if the full amount, including interest, is returned to the taxpayer.

6) Requires the California State University (CSU), and requests the University of California (UC) and independent institutions to comply with the provisions of the bill.

7) Authorizes the Treasurer, in collaboration with the CSU Trustees and UC Regents to establish administrative guidelines and other requirements for purposes of implementing the provisions of the bill.

8) Makes the bill an urgency measure in order to immediately address heightened concerns about the rising costs of obtaining a postsecondary degree in this state.

STAFF COMMENTS

1) ***Rationale for the bill*.** This bill emerges out of a concern regarding the cost of college tuition. According to the author from 2004 to 2013, the average tuition at UC and CSU more than doubled and tuition increases have heightened concerns about the affordability of a college education. The author asserts that this bill would help families save for college by allowing the purchase of tuition certificates at today's rates which then could be redeemed in future years at participating colleges.

2) ***Recent gut and amend*.** This bill was recently gutted and amended to address a topic that has not been heard by any previous policy committee. This bill establishes a program that could effectively create a tax shelter for those purchasers who have their initial investment returned. The invested amount will not be subject to any tax treatment at the time of investment nor at the time that the initial investment is returned. Further, the Treasurer would be required to return the initial investment with interest. The bill raises a number of complex policy questions regarding tax treatment and administration of financial aid. The Committee may wish to consider whether a bill that raises such a multitude of serious policy questions would be better addressed through the regular legislative timelines. This bill was gutted and amended on June 23; the Legislature was subsequently in recess from July 1 to August 1.

3) ***Is another tuition assistance program necessary?*** This bill limits the use of tuition certificates to the cost of tuition while the existing ScholarShare program allows savings to be used for numerous educationally-related expenses. Further, between existing state, federal and institutional aid programs, many families with financial need pay no tuition at CSU and UC. These programs include all of the following:

   a) **Cal Grant program.** The Cal Grant program provides grants to financially needy students to attend college at the California Community Colleges, CSU and UC, Private Non-Profit Independent Colleges and Universities, and eligible Private For-Profit Colleges. Cal Grants cover up to $12,240 annually for up to four years of assistance with tuition and system-wide fees and eligibility is based upon financial need. Under the Cal Grant program a student who is exempt from nonresident tuition as referenced in the bill qualify for California Dream Act Aid.

b) **Middle Class Scholarship Program.** The Middle Class Scholarship will provide up to 40% of statewide fees and tuition at the University of California (UC) and the California State University (CSU) campuses for families with assets and income up to $150,000 that do not qualify for other financial aid programs.

c) **Federal Pell Grant program**. Currently, the Pell Grant covers up to $5,775 annually depending on financial need. The grant can be used toward the cost of attendance including tuition and fees; room and board; and books, supplies and transportation.

d) **Institutional aid.** Institutional aid policies at each campus of the CSU and UC and independent institutions offer tuition assistance directly to students**.**

e) **Savings program.** The Golden State ScholarShare Trust Program, administered by the State Treasurer's Office, which offers California families a tax-advantaged college tuition savings plan of investment and savings for a college education with state tax-deferred and federal tax-free benefits. The money contributed by the participant to the account is placed in a trust, and invested in special investment portfolios. The program offers federal and California income tax-free treatment for qualified withdrawals from a ScholarShare account. A qualified withdrawal is one that is used to pay for higher education expenses including but not limited tuition, fees, books or supplies at public and private institutions and certain proprietary schools throughout the country**.**

4) ***Who pays the difference between the value of a tuition certificate and actual cost of tuition?*** The tuition certificate appears to work like a voucher where an individual can purchase a certificate at $300 increments that would go towards a percentage of tuition. For example, $300 would purchase a certain percentage of tuition at 2018-19 rates. The certificate would cover annual tuition and fee increases of 7.5% or less. The tuition certificate is valid for up to 30 years from the purchased date and the gap between the actual cost of tuition and the value of the certificate could grow exponentially. As tuition fluctuates over time, it is unclear whether institutions, the state, tax payers or the purchaser would make up the difference, should tuition increase beyond the 7.5%.

How would funds be invested to produce the returns needed to cover the 7.5% annual increases?

Could the state be responsible for the investment risk if tuition growth out paces the 7.5% growth that is required of the tuition certificate?

Would the state reimburse institutions based on tuition increases of 7.5% or less?

5) ***What has been the experience in other states?*** There are 17 states currently operating prepaid tuition plans, four structured by unit price and 13 by tuition

contracts which resemble the model represented by this bill. Several of these programs have experienced some fiscal difficulty leading to closure for new purchasers, limitations on purchases, and/or significantly increased premiums. Of the four structured by unit purchase, three are closed to new purchases (Ohio, Washington and Texas). Of the 13 structured by contract, six are closed to new purchases (Alabama, Kentucky, Mississippi, South Carolina, Texas and West Virginia). It is unclear when or if any of the 17 states will reopen their program as many of the programs have been closed since 2004. In addition, at least two other states (New Mexico and Tennessee) previously operated prepaid tuition plans but recently terminated their programs. Tennessee for example, shut down the program due to weak investment earnings and steep tuition increases. Staff notes that California has never offered a prepaid college savings plan.

6) ***Could this program create a false sense of security for certificate beneficiaries?*** Investment in a prepaid tuition program can provide families with peace of mind regarding their ability to meet future fee increases and enroll in an institution of their choice, to the extent the student is hoping to attend a California State University (CSU), University of California (UC) or an independent institution. However, this may not be the case since CSU is required to comply but participation for UC and independent institutions is voluntary under the provisions of the bill. In addition, the actual price of attendance at any of these institutions is greater than the amount of fees and includes books, supplies and other living expenses not covered by the tuition certificate proposed by this bill.

Funding for this program is based on participation and requires the Director of Finance to each fiscal year determine whether there are sufficient funds to implement the program in that year. What assurances do families have that the program will be funded every year?

7) ***Cart before the horse*.** Since the 1996 sunset of the Maddy-Dills Act, the state has lacked a clear policy on higher education fees. The Maddy-Dills Act previously required fees to be (1) gradual, moderate and predictable, (2) limited fee increases to not more than 10 percent a year, and (3) fixed at least ten months prior to the fall term in which they were to become effective. The policy also required sufficient financial aid to offset fee increases. However, flexibility was provided when the state faced serious budgetary challenges in order to provide relief to institutions suffering from a lack of state General Fund support.

Historically, fees have fluctuated in response to the State's fiscal condition and the stated needs of UC and CSU, as negotiated in the budget deliberations. The charts below illustrate the fluctuation in fees at the UC and the CSU over the last several years.

CSU Mandatory Systemwide Student Fees Resident Undergraduates		
Year	Fee Amount	Percent Change from Prior year
1997-98	$1584	N/A
1998-99	$1,506	-4.9%
1999-00	$1,428	-5.2 %
2000-01	$1,428	0.0%
2001-02	$1,428	0.0%
2002-03	$1,500	5.0%
2003-04	$2,046	**36.4%**
2004-05	$2,334	**14.1%**
2005-06	$2,520	8.0%
2006-07	$2,520	0.0%
2007-08	$2,772	10.0%
2008-09	$3,048	10.0%
2009-10	$4,026	32.1%
2010-11	$4,429	10.0%
2011-12	$5,472	23.5%
2012-13	$5,472	0%
2013-14	$5,472	0%
2014-15	$5,472	0%
2015-16	$5,472	0%

UC Mandatory Systemwide Student Fees Resident Undergraduates		
Year	Fee Amount	Percent Change from Prior year
1997-98	$3,799	N/A
1998-99	$3,609	-5.0%
1999-00	$3,429	-5.0%
2000-01	$3,429	0.0%
2001-02	$3,429	0.0%
2002-03	$3,834	11.8%
2003-04	$4,984	**30.0%**
2004-05	$5,684	14.0%
2005-06	$6,141	8.0%
2006-07	$6,141	0.0%
2007-08	$6,636	8.1%
2008-09	$7,126	7.4%

2009-10	$8,958	**25.7%**
2010-11	$10,302	**15.0%**
2011-12	$12,192	**18.3%**
2012-13	$12,192	0%
2013-14	$12,192	0%
2014-15	$12,192	0%
2015-16	$12,240	5%

To date, the state has no long-term policy regarding the way in which mandatory student fees are determined. In the absence of such a policy, should the state adopt a prepaid tuition program when the cost of tuition going into the future cannot be predicted?

8) ***Other policy alternatives*.** The Committee may wish to consider whether families would be better served through enhanced state aid programs or the ScholarShare 529 savings plan rather than establishing a new program that could pass investment risks to public institutions or the state. Additionally, the Committee may want to consider:

- If state and federal assistance programs currently cover tuition for needy families and because the certificate solely covers tuition, who would benefit from this program?
- Would this program primarily benefit upper income individuals who have the ability to purchase tuition certificates?
- If the intent is to serve financially needy students, is a new tuition program necessary or could students be better served by enhancing existing aid programs to cover the total cost of attendance such as increasing the Cal Grant B access award?
- Could this bill result in transferring investment risk to a public institution or to the state to cover the difference between the amount invested and the cost of tuition at the time of attendance for individuals who may not be financially needy?
- Should public funds be used to subsidize tax liability for individuals who have their initial investment returned?

9) **Double referral.** This bill contains provisions that allow purchasers to recover their initial investment including interest accrued without tax penalty. Without a penalty for not using funds for tuition (intended purpose), is there potential for abuse? Should they be exempted from tax penalties? This bill has been double referred where these questions can be better assessed by the Committee on Governance and Finance.

SUPPORT

None received.

OPPOSITION

None received.

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