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ALASKA STATE LEGISLATURE

Alaska State Senate

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SPONSOR STATEMENT

SB 322, ALASKA CHILDREN'S DIVIDEND FUND

This bill establishes the Alaska Children's Dividend Fund to permit children's permanent fund dividends to be deposited in a tax-deferred trust account for college or vocational education expenses.

Children between the ages of 0 to 18, or their parents on their behalf, can chose to participate in the program annually through a check-off on the Dividend Application Form. Participants would receive quarterly statements of the balance in their trust accounts.

Partial withdrawals will be allowed for post secondary or vocational educational purposes as well as for medical disability with high expenses.

Withdrawal of funds for non-educational purposes will only be allowed when the participant reaches the age of majority. If a participant is not attending school full-time at age 21 all funds will be disbursed. At age 25 all funds will be disbursed regardless of the participant's educational status.

The Alaska Children's Dividend Fund will be entirely self-funding and will not impact the State General Fund.

Alaska Children's Dividend Fund

Goal: Establish a program that permits Alaskan children to avoid current taxation on receipt of their Permanent Fund Dividends while providing a tax-advantaged vehicle to invest for college or vocational education expenses.

Concept: Set up a separate and distinct savings/investment Fund under the auspices of the Department of Revenue into which parents may direct the deposit of their children's Permanent Fund Dividend. Structured correctly under the applicable Internal Revenue Code, the children will not be taxed for receiving the Dividend, and the growth in the Fund will also be free of current taxation. The Children's Fund could be invested in a manner similar to the Permanent Fund.

Structure: In order to qualify for the favorable tax treatment accorded to non-qualified Deferred Compensation programs under the I.R.C., the Fund would be structured as a Rabbi Trust. Our research indicates that several criteria need to be addressed in the design of the program:

- Dividend must be *deferred* to the Fund prior to receipt by child/parent.
- The dividends must legally remain an asset of the State in a trust relationship to avoid the question of constructive receipt.
- There must be fairly precise restrictions on who can participate.
- Participants can access balances only in certain limited circumstances. (see suggestions under Detail section below.)
- Participant control of investment choices would be prohibited.
- Program will be self-funding and would not impact the State's General Fund.

Procedural steps:

- Gain bi-partisan legislative support, direct Legislative Research to determine if program design can comply with Deferred Compensation/Rabbi Trust requirements and I.R.C.
- Modify application to allow parents to elect to defer receipt of Permanent Fund Dividends for minors into Fund *prior* to determination of eligibility for Dividend.
- Department of Revenue establish an investment management contract with Permanent Fund Corporation for fund management and accounting/operations.
- Department of Revenue, Legislature, Permanent Fund Corporation, and fund management firm coordinate preparation of documents to implement program prior to application cycle for 1999 Permanent Fund Dividend.

- External fund management/operations assist Permanent Fund, Legislature, and Governor's office to prepare literature and public announcement material. Announce program to citizens of Alaska !

Details (miscellaneous): The following additional points/suggestions should be considered in the design and implementation of the Alaska Children's Dividend Fund:

- Eligibility for participation for deferral should be limited to children ages 0 - 18.
- Withdrawals from the account should be permitted only under the following circumstances:
 - Participant reaches age of majority (18) or becomes emancipated.
 - Participant enrollment in post-high school training/education institution will allow partial withdrawals based on tuition and room & board costs.
 - Participant suffers significant medical disability that results in either high treatment costs or permanent impairment.
 - Mandatory disbursement at age 21 if not enrolled, age 25 regardless of educational status. Mandatory disbursement any time after age 21 if participant has not satisfactorily completed 24 credit hours during prior twelve month period. Burden is on participant to provide proof of status
- Participant statements will be provided quarterly.
- Investment of the deferred dividends will **not** be self-directed: to ensure low operating costs, ease of administration, and remove concerns over constructive receipt, the trust assets will be managed on a pooled basis with an asset allocation roughly similar to the Permanent Fund. Administrative expenses would be paid from the pooled fund in a manner similar to the internal expenses of a mutual fund.
- Withdrawals scheduled twice per year, with exception for medical emergency.
- Public education concerning the benefits of the program is critical - many parents may not easily understand the significant tax advantages inherent in the deferral and the growth cycles. Most of this burden can be carried by the fund's external management, support, and operations staff.

Benefits: There are many obvious and not-so-obvious benefits to this program. The obvious ones include the tax-advantages arising from the deferral and the avoidance of taxation while account balances are growing; a disciplined investment program that will probably produce better results than most parents are able to achieve on their own; and a tie-in with Alaskan educational institutions may result in higher in-state enrollment. Other less obvious benefits include the probability that use of this program will provide college funding for worthy students that may not otherwise be able to afford higher education.

Detriment: The one obvious detriment is the reduced injection of cash into the economy which would be occasioned by this deferral process, but that would be more than off-set by the significantly larger dollar amounts which will be available in later years for spending either on tuition or other needs if the child does not attend college or vocational school.

SAMPLE CALCULATION WHERE DIVIDEND AND INTEREST IS SUBJECT TO TAX																					
Analysis assumes Dividend is received at end of Calendar year and that taxes are paid at beginning of following year.																					
Assumed Rate of Return	7.50%	Dividend Payout Growth/YR	2.42%																		
Standard Deduction	\$650	Population Growth/YR	1.00%																		
Assumed Marginal Tax Rate-Child	15.00%	Estimated Growth in Dividend Amount/YR	1.42%																		
Assumed Marginal Tax Rate-Parent	28.00%																				
Initial Dividend Amount	\$1,296																				
		VALUE AT END OF YEAR																			
Dividend Received End of YR	Estimated		Dividend less Tax																		
	Dividend	Tax		1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
1997	1,296	97	1,199	1,264	1,332	1,404	1,480	1,560	1,644	1,733	1,826	1,925	2,029	2,138	2,254	2,376	2,504	2,629	2,782	2,932	3,090
1998	1,314	102	1,213		1,278	1,347	1,420	1,497	1,578	1,663	1,753	1,847	1,947	2,052	2,163	2,280	2,403	2,533	2,670	2,814	2,966
1999	1,333	107	1,226			1,293	1,362	1,436	1,513	1,595	1,681	1,772	1,868	1,969	2,075	2,187	2,305	2,430	2,561	2,699	2,845
2000	1,352	112	1,240				1,307	1,378	1,452	1,530	1,613	1,700	1,792	1,889	1,991	2,098	2,211	2,331	2,457	2,589	2,729
2001	1,371	117	1,254					1,322	1,393	1,468	1,547	1,631	1,719	1,812	1,910	2,013	2,122	2,236	2,357	2,484	2,618
2002	1,391	123	1,268						1,336	1,409	1,485	1,565	1,649	1,738	1,832	1,931	2,035	2,145	2,261	2,383	2,512
2003	1,411	128	1,282							1,351	1,424	1,501	1,582	1,668	1,758	1,853	1,953	2,058	2,169	2,287	2,410
2004	1,431	134	1,297								1,367	1,440	1,518	1,600	1,687	1,778	1,874	1,975	2,082	2,194	2,312
2005	1,451	140	1,311									1,382	1,457	1,535	1,618	1,706	1,798	1,895	1,997	2,105	2,219
2006	1,472	146	1,326										1,398	1,473	1,553	1,637	1,725	1,818	1,916	2,020	2,129
2007	1,493	151	1,341											1,414	1,490	1,570	1,655	1,745	1,839	1,938	2,043
2008	1,514	157	1,357												1,430	1,507	1,588	1,674	1,765	1,860	1,960
2009	1,535	163	1,372													1,446	1,524	1,607	1,693	1,785	1,881
2010	1,557	170	1,388														1,463	1,542	1,625	1,713	1,805
2011	1,579	176	1,404															1,480	1,559	1,644	1,732
2012	1,602	183	1,459																1,552	1,651	1,756
2013	1,625	186	1,479																	1,573	1,673
2014	1,648	190	1,498																		1,594
TOTAL																					40,275

**COMPARISON OF DISPERSAL OPTIONS
LUMP SUM COMPARED TO 4 and 7 YEAR PAYOUT**

	LUMP SUM	4-YEAR PAYOUT TOTAL	4-YEAR PAYOUT				7-YEAR PAYOUT							
			YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	
TOTAL	54,706	54,706	13,676	13,676	13,676	13,676								
LESS: EXEMPTION (\$2,650) AND STANDARD DEDUCTION (\$4,150)	6,800	27,200	6,800	6,800	6,800	6,800								
TAXABLE INCOME	47,906	27,506	6,876	6,876	6,876	6,876								
TAX ON DISPERSAL (\$24,650 @ 15 %; Balance @ 28 %)	10,209	4,126	1,031	1,031	1,031	1,031								
AFTER TAX	44,496	50,580	12,645	12,645	12,645	12,645								
TOTAL	54,706	54,706	7,815	7,815	7,815	7,815	7,815	7,815	7,815	7,815	7,815	7,815	7,815	7,815
LESS: EXEMPTION (\$2,650) AND STANDARD DEDUCTION (\$4,150)	6,800	47,600	6,800	6,800	6,800	6,800	6,800	6,800	6,800	6,800	6,800	6,800	6,800	6,800
TAXABLE INCOME	47,906	7,106	1,015	1,015	1,015	1,015	1,015	1,015	1,015	1,015	1,015	1,015	1,015	1,015
TAX ON DISPERSAL (\$24,650 @ 15 %; Balance @ 28 %)	10,209	1,066	152	152	152	152	152	152	152	152	152	152	152	152
AFTER TAX	44,496	53,640	7,663	7,663	7,663	7,663	7,663	7,663	7,663	7,663	7,663	7,663	7,663	7,663