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529 COLLEGE SAVINGS PLAN

House Bill 5653 (Substitute H-2)
Sponsor: Rep. Gary Woronchak

House Bill 5654 as introduced
Sponsor: Rep. Scott Shackleton

Committee: Tax Policy

Senate Bill 599 (Substitute H-2)
Sponsor: Sen. Mike Rogers
Senate Committee: Finance
House Committee: Tax Policy

First Analysis (5-17-00)

THE APPARENT PROBLEM:

Federal tax law allows individual states to establish state-sponsored college savings plan programs under which people can make contributions to special tax-deferred savings accounts. Earnings accumulate in such an account tax free and are then distributed to a beneficiary to pay expenses associated with postsecondary education, such as tuition and fees, room and board, books, etc. Earnings on the accounts are taxable at the federal level when withdrawn for higher education expenses but at the student's (presumably lower) tax rate. When creating these special accounts, some states exempt contributions, earnings, and withdrawals from state income taxes. The plans are sometimes referred to as 529 plans because they are authorized in Section 529 of the federal Internal Revenue Code. (The same section also authorizes states to establish tuition prepayment plans, like Michigan's MET program.)

Reportedly, about 32 states have set up college savings plans as a means of helping families deal with the high costs of obtaining postsecondary education, which is increasingly seen as a necessity. The recent report issued by the Michigan Commission of Financing Postsecondary Education, chaired by Lt. Governor Dick Posthumus, recommended that Michigan create such a program, in part as a way of reducing student debt burdens. Legislation has been introduced to accomplish that goal.

THE CONTENT OF THE BILLS:

Senate Bill 599 would create the Michigan Education Savings Program Act and establish the new savings program within the Department of Treasury. The bill would allow individuals to contribute money to education savings accounts, with the proceeds to be used to pay qualified higher education expenses, including tuition, fees, books, supplies, and required equipment, as well as room and board in some cases. A person could establish one or more education savings accounts for one or more designated beneficiaries. The total contributions that could be made to all of the accounts naming any one individual as beneficiary would be $125,000. The required minimum initial deposit and required minimum contributions could not be greater than $25 for a cash contribution or $15 per pay period for a payroll deduction plan. Money in the accounts would be invested by a program manager selected by the Department of Treasury, who could charge a fee of up to one-and-one-half percent of the average daily net assets of the program. Education savings accounts could be established beginning October 1, 2000. (Further details of the bill are provided later.)

House Bill 5653 would amend the Income Tax Act (MCL 206.30) to allow a taxpayer to deduct contributions made to an education savings account, not to exceed $5,000 for a single return, or $10,000 for a joint return, per tax year. (This would apply to contributions made after October 1, 2000.) The bill also contains a provision not directly related to education savings accounts that would allow a taxpayer a deduction for withdrawals from individual retirement

accounts used to pay qualified higher education expenses.

House Bill 5654 would amend the Income Tax Act (206.30f) to allow a deduction for interest earned on contributions to an education savings account, and also to allow a deduction for a qualified withdrawal from such an account used to pay the qualified higher education expenses of the designated beneficiary of the account. The bill also would require that money withdrawn from an account and interest earned on that amount be added to taxable income if the withdrawal was not a qualified withdrawal.

The term "qualified withdrawal" is defined in Senate Bill 599 and would apply, generally speaking, to a withdrawal to pay for the qualified higher education expenses of a designated beneficiary at an eligible educational institution. The term would also apply to some other cases, such as the death or disability of the beneficiary, the awarding of a scholarship to cover some or all of education expenses, a transfer of funds due to a change in beneficiary, or a transfer of funds due to the termination of a program manager's contract. An account owner could withdraw all or part of the balance of an account on 60 days' notice or a shorter period as authorized by a savings program agreement. A distribution that was not a qualified withdrawal would also be subject to a penalty of 10 percent of the distribution, to be paid to the state's General Fund (although the penalty could be increased or decreased by the state treasurer and the program manager, based on federal requirements). The term "eligible educational institution" would refer to a college, university, community college, or junior college under the state constitution or institutions eligible to participate in student financial aid programs under the federal Higher Education Act (which includes technical and vocational schools).

The bills apply to tax years beginning after December 31, 1999. House Bills 5653 and 5654 are tie-barred to the Senate Bill 599, which in turn is tie-barred to the two House bills.

Among the provisions of Senate Bill 599 are the following:

Program Administration

• The purposes, powers, and duties of the Michigan Education Savings Program would be vested in and exercised by the state treasurer or a designee of the treasurer and the treasurer would be responsible for administering the program and would be the trustee of the program's funds.

• The treasurer would have to solicit proposals from entities to be the program manager, and would have to give preference to proposals from single entities that could provide all of the necessary functions (managerial, professional, legal, clerical, technical, and administrative) and that demonstrated the most advantageous combination of financial stability, investment safety, the ability of investments to track increasing costs of higher education, the ability to meet record keeping and reporting requirements, the plan for marketing and the investment in promotion, the fees to be charged to people for opening and maintaining accounts, the minimum initial deposit and minimum contributions to be required, and the electronic withdrawal and payroll deduction capabilities.

• The treasurer would have to enter into a contract with the program manager delineating who had the authority and responsibility for various functions, such as the development and implementation of the program, investing the money from account owners, developing marketing plans and promotional material, establishing methods by which funds were to be allocated to pay for administrative costs, engaging the services of consultants to provide professional and technical assistance and advice, determining the use of financial organizations as account depositories and financial managers, keeping adequate records and providing the state treasurer with needed information, compiling information, holding accounts, providing for audits at least annually by a firm of certified public accountants, providing the treasurer with copies of all regulatory filings and reports related to the program, ensuring that the description of the program was consistent with the marketing plan, and taking the necessary actions to keep the program in compliance with state and federal law and the management contract. The treasurer would be responsible for the ongoing supervision of the management contract in consultation with the board of directors of the Michigan Education Trust. The contract would be for a term of years as specified in the contract, and the state treasurer would be able to terminate the contract based on criteria specified in the contract.

• The program manager would be required to file an annual report with the state treasurer and the MET board, to include the names and identification numbers of account owners, designated beneficiaries, and distributees of education savings accounts, none of which would be subject to the Freedom of Information Act; the total amount contributed to all accounts during

the year; all distributions from all accounts and whether or not each distribution was a qualified withdrawal; and any information the program manager or treasurer required regarding the taxation of amounts contributed to or withdrawn from accounts.

Savings Accounts

• An individual could open one or more education savings accounts to save money to pay the qualified higher education expenses of one or more beneficiaries. To open an account, the individual would enter an agreement with the program manager. The agreement would designate a beneficiary. Any individual could make a contribution to an account. Contributions could only be made in cash, or by check, money order, credit card, or by a similar method, but could not be property. An account owner could change the designated beneficiary to a member of the family of the previous beneficiary and could transfer all or a portion of an account to another account if the designated beneficiary of the second account was a member of the family. An account owner could designate another individual as the successor owner of the account upon his or her death.

• Distributions from an account would have to be used to pay for qualified higher education expenses and only in the following ways: directly to an eligible educational institution; in the form of a check payable to both the beneficiary and the educational institution; as reimbursement for educational expenses already paid, with the necessary documentation submitted; the beneficiary certified that the distribution was to be spent for educational expenses within 30 days and the account retained a balance large enough to collect any penalty owed if valid documentation of the payment was not subsequently produced. As mentioned earlier, there would be a 10 percent penalty for a distribution that was not a qualified withdrawal, with the penalty going to the state's General Fund.

• The account owner and the designated beneficiary would not be able to direct the investment of any contributions to the account or the earnings on the account. The individual who established the account would be able to select among different investment strategies designed exclusively by the program manager only at the time the initial contribution was made establishing the account. Interest in an account could not be used as security for a loan. Amounts contributed in excess of the $125,000 maximum per beneficiary would be promptly withdrawn or transferred to another account.

• The program manager would be required to disclose in writing to each account owner, and any other person who requested it, the following information: the terms and conditions for establishing an account; restrictions on the substitutions of designated beneficiaries and transfer of account funds; the person or entity entitled to terminate a program agreement; the period of time during which a beneficiary could receive benefits under an agreement; the terms and conditions under which money could be wholly or partially withdrawn from an account or the program; potential tax consequences associated with contributions, distributions, and withdrawals; and the investment history and potential growth of account funds, including a projection of the impact of the growth of funds on the maximum allowable amount in an account. The program manager would also be required to report distributions to the Internal Revenue Service and the account owner or distributee.

• The bill stipulates that the new act would not create and could not be construed to create any obligation upon the state or any state agency or instrumentality to guarantee for the benefit of an account holder or a designated beneficiary the rate of interest or other return on an account or the payment of interest or other return on an account. The contracts and other documents used in connection with an account would have to clearly indicate that the account was not insured by the state and that the money deposited and the investment earned in the account were not guaranteed by the state. The act and any agreement under the act also could not be construed or interpreted to give any designated beneficiary any rights or legal interest with respect to an account unless the designated beneficiary was the account owner; guarantee that a designated beneficiary would be admitted to an eligible educational institution, allowed to continue at an institution, or would receive a degree from an institution; give residency status to a designated beneficiary; or guarantee that amounts contributed to an account would be sufficient to cover the qualified higher education expenses of a beneficiary.

HOUSE COMMITTEE ACTION:

The House substitute for Senate Bill 599 reported by the House Tax Policy Committee differs primarily from the Senate-passed version in that it adds several provisions emphasizing that the purposes, powers, and duties of the Michigan Education Savings Program would be vested in and exercised by the state treasurer or a designee of the treasurer and that the treasurer would be responsible for administering the program

and would be the trustee of the program's funds. The House substitute also increases the maximum administrative fee the program manager can charge from one percent to one-and-one-half percent of average daily net assets.

FISCAL IMPLICATIONS:

The House Fiscal Agency reports that the combined impact of the bills would be to reduce income tax revenue by about $5 million annually. (HFA fiscal note dated 4-18-00)

ARGUMENTS:

For:

The Michigan Education Savings Program would provide Michigan families with a new tool to use in paying for postsecondary education, whether at a four-year school, a community college, or a training school. The program is designed to meet the federal IRS requirements for education savings plans and allow individuals to contribute to tax-deferred savings accounts. Post-secondary education is commonly viewed as a necessity in today's economy, yet the costs of higher education strain family budgets and sometimes make schooling impossible. Some students acquire significant debt, which can distort their career choices. Families who begin early to use education savings plans can, by taking advantage of compounding, turn even small regular contributions into substantial savings. Education savings accounts allow grandparents, parents, and other relatives (or anyone else) to contribute to an account on behalf of a prospective student, and gain state tax advantages. A person can even create an account with himself or herself as the beneficiary. The program is open to postsecondary students of all ages and situations and participants can be from all income levels. Students can attend schools in the state or outside of the state, public schools or private schools. And money in the account can cover a wide range of educational expenses, including room and board for full-time students, not just tuition. Moreover, the use of these accounts does not prevent a taxpayer from making use of other federal education tax programs, such as the Hope credit and lifetime learning credit (as some existing savings programs do).

The accounts will be administered by a program manager selected by the state treasurer, so that account owners and beneficiaries can rely on professional money managers, which is preferable to the savings and investment strategies individuals without knowledge of investing might engage in on their own. Contributions grow tax deferred for federal tax purposes, with taxes due on earnings only when withdrawn by the student. Contributions, earnings, and withdrawals will be deductible for purposes of the state income tax.

Response:

Some people suggest that without a limit on the income of people who can contribute to an education savings account, the bills favor upper income individuals, who could simply move other savings into the new account to get tax savings. (They need only contribute 60 days before a distribution.) The contribution cap of $125,000 similarly favors the affluent. Some people have objected to the administrative fee being applied to the accounts opened by low and moderate-income contributors. More needs to be done to encourage lower income people to participate.

POSITIONS:

The Department of Treasury supports the bills. (5-16-00)

Indicating support for the bills to the House Tax Policy Committee were representatives from TIAA-CREF and Manufacturers Life Insurance Company (U.S.A.). (5-16-00)

Analyst: C. Couch

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.