Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

SFA BILL ANALYSIS

Telephone: (517) 373-5383
Fax: (517) 373-1986
TDD: (517) 373-0543

Senate Bill 599 (Substitute S-2 as reported)
Senate Bill 600 (Substitute S-2 as reported)
Sponsor: Senator Mike Rogers
Committee: Finance

Date Completed: 4-24-00

RATIONALE

Section 529 of the Internal Revenue Code, adopted in 1996, allows a state to establish a qualified state tuition program, and exempts the program from Federal taxation. Section 529 defines a program as a program established and maintained by a state or state agency 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; or make contributions to an account that is established for the purpose of meeting a designated beneficiary's qualified higher education expenses. For purposes of Federal taxation, a qualified program works much like a traditional Individual Retirement Account (IRA). Money contributed to an account established under a qualified program is not taxed at the time it is contributed, and the interest generated by the contributions also is not taxed. When the money is withdrawn it is included in the gross income of the person to whom the distribution is made. In most instances, this will be the student, whose income probably places him or her in a lower tax bracket than the person who originally contributed the money. (Any distributions not used for qualified education expenses, made because of the death of the student, or made for other reasons specified in the Code are subject to tax and penalties.)

The ability to pay for a college education or technical training is a major concern for many parents. A qualified state tuition program offers parents an opportunity to save money toward a child's college expenses, on a weekly, monthly, or other basis, over a number of years, and defer the Federal taxes on contributions and interest. Reportedly, other states have begun to establish state tuition programs. It has been suggested that Michigan should establish a qualified State tuition program to allow people to save for college in this manner and, further, should exempt from the State income tax contributions to a program, interest earned on the contributions, and withdrawals for qualified education expenses.

CONTENT

Senate Bill 599 (S-2) would create the "Michigan Education Savings Program Act"; allow individuals to open an education savings account to save money for the qualified higher education expenses of a designated beneficiary; and provide that contributions to and interest earned on an education savings account would be exempt from taxation as provided under the Income Tax Act. Senate Bill 600 (S-2) would amend the Income Tax Act to allow a taxpayer to deduct from taxable income contributions up to $5,000 per year to an education savings account, and the interest earned on the contributions. The bills are tie-barred.

Senate Bill 599 (S-2)

Program Manager

The bill would establish the Michigan Education Savings Program within the Department of Treasury. The State Treasurer would have to solicit proposals from entities to be the "program manager", that is, the entity selected by the Treasurer to act as the manager for the program. The Treasurer would have to select as the program manager the entity that demonstrated the most advantageous combination, to both potential participants and this State, of the following factors:

-- Financial stability.
-- The safety of the investment instrument being offered.
-- The ability of the investment instrument to track the increasing costs of higher education.
-- The ability of the entity to satisfy the record-keeping and reporting requirements of the bill.
-- The entity's plan for marketing the program and the investment it was willing to make to promote the program.
-- The fees, if any, proposed to be charged to

persons for opening or maintaining an account.
-- The minimum initial deposit and minimum contributions that the entity would require, which could not be greater than $25 for a cash contribution or $15 per pay period for payroll deduction plans.
-- The ability of the program manager to accept electronic withdrawals, including payroll deduction plans.

Management Contract

The Treasurer could enter into contracts that he or she considered necessary and proper for the implementation of the program. A contract executed between the Treasurer and the program manager, the "management contract", would have to address the factors described above regarding the selection of a program manager. The management contract also would have to address the respective authority and responsibility of the Treasurer and the program manager to do the following:

-- Develop and implement the program.
-- Invest the money received from account owners in one or more investment instruments.
-- Engage the services of consultants on a contractual basis to provide professional and technical assistance and advice.
-- Determine the use of financial organizations as account depositories and financial managers.
-- Charge, impose, and collect administrative fees and service charges, which could not exceed 1% of the average daily net assets of the program, in connection with any agreements, contracts, and transactions relating to the program.
-- Develop marketing plans and promotional material.
-- Establish the methods by which funds were allocated to pay for administrative costs.
-- Provide criteria for terminating and not renewing the management contract.
-- Keep adequate records of each account and provide the Treasurer with information that the Treasurer required related to those records.
-- Compile the information contained in statements required to be prepared under the bill and provide that compilation to the Treasurer in a timely manner.
-- Hold all accounts for the benefit of the "account owner", that is, the individual who entered into a Michigan education savings program agreement and established an education savings account.
-- Provide for audits at least annually by a firm of certified public accountants.
-- Ensure that any description of the program, whether in writing or through the use of any media, was consistent with the marketing plan developed by the program manager.
-- Perform any other necessary and proper activities to carry out the purposes of the bill.

The management contract also would have to address the ability of the program manager to take any action required to keep the program in compliance with the requirements of the bill and the management contract, and to manage the program to qualify as a qualified State tuition program under Section 529 of the Internal Revenue Code.

In addition, the contract would have to address the program manager's responsibility to provide the Treasurer with copies of all regulatory filings and reports related to the program made during the term of the management contract or while the program manager was holding any accounts, other than confidential filings or reports except to the extent they were related to or part of the program. It would be the responsibility of the program manager to make available for review by the Treasurer the results of any periodic examination of the manager by any State or Federal banking, insurance, or securities commission, except to the extent that the report or reports were not required to be disclosed under State or Federal law.

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 (MET). (The Met board, of which the Treasurer is a member, oversees the State's advanced tuition payment program.) The management contract would be for a term of years specified in the contract. The Treasurer could terminate the contract based on the criteria specified in it.

Education Savings Accounts/Distributions

Education savings accounts could be established under the bill beginning October 1, 2000. To open an education savings account, an individual would have to enter into a savings program agreement with the program manager. The savings program agreement would have to be in the form prescribed by the program manager and approved by the Treasurer, and contain all of the following: the name, address, and Social Security number or employer identification number of the account owner; a designated beneficiary; the name, address, and Social Security number of the designated beneficiary; and any other information that the Treasurer or program manager considered necessary.

Any individual could make contributions to an account. Contributions would have to be made in cash or by check, money order, credit card, or similar method but could not be property.

An account owner could withdraw all or part of the balance from an account on 60 days' notice, or a shorter period as authorized in the savings program agreement. Distributions from an account would have to be used to pay for "qualified higher education expenses" incurred after the account was established. "Qualified higher education expenses" would mean those expenses as defined in Section 529 of the Internal Revenue Code. (Section 529 states that "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. The term can include reasonable costs for room and board, incurred by the designated beneficiary while attending the institution, as determined under the qualified state tuition program, and as limited under the Code.)

Distributions from an account could be made only under any of the following circumstances:

-- The distribution was made directly to an "eligible education institution", i.e., a college, university, community college, or junior college described or established under the State Constitution, or described in the Federal Higher Education Act of 1965.
-- The distribution was made in the form of a check payable to both the designated beneficiary and the eligible educational institution.
-- The distribution was made after the designated beneficiary submitted documentation to show that it was a reimbursement for qualified higher education expenses that the designated beneficiary had already paid, and the program had a process for reviewing the validity of the documentation prior to the distribution.
-- The designated beneficiary certified prior to the distribution that it would be spent for his or her qualified higher education expenses within a reasonable time after the distribution was made; the program required the designated beneficiary to provide documentation of payment of qualified higher education expenses within 30 days after making a distribution, and had a process for reviewing the documentation; and the program retained an account balance that was large enough to collect any penalty owed on the distribution if valid documentation were not produced.

If a distribution that was not a "qualified withdrawal" were made, the program manager would have to withhold an amount equal to 10% of the distribution amount as a penalty, and pay that amount to the Department of Treasury for deposit into the General Fund. The penalty could be increased or decreased if the Treasurer and the program manager determined that it was necessary to increase or decrease the penalty to constitute a greater than de minimis penalty for purposes of qualifying under Section 529 of the Internal Revenue Code. (Under Section 529, a program cannot be treated as a qualified program unless it imposes a more than de minimis penalty on any refund of earnings from an account that are not used for qualified higher education expenses of the designated beneficiary; made on account of the death or disability of the designated beneficiary; or made on account of a scholarship, allowance, or payment received by the beneficiary to the extent the refund amount does not exceed the amount of the scholarship, allowance, or payment.)

Under the bill, a "qualified withdrawal" would be a distribution that was not subject to penalty or taxation under the bill or the Income Tax Act, and that was any of the following:

-- A withdrawal from an account to pay qualified higher education expenses incurred after the account of the designated beneficiary was established.
-- A withdrawal made as the result of the death or disability of the designated beneficiary.
-- A withdrawal made because a beneficiary received a scholarship that paid for all of his or her qualified higher education expenses.
-- A transfer of funds due to termination of the management contract as provided in the bill.
-- A transfer of funds due to a change of beneficiary.

Withdrawals made from education savings accounts would be taxable as provided in Section 30 of the Income Tax Act (which Senate Bill 600 would amend).

<u>Account Owners</u>

An account owner could designate another individual as a successor owner of the account in the event of the death of the account owner; change the designated beneficiary of an account to a member of the family of the previously designated beneficiary as provided in the management contract or as otherwise provided in the bill; or transfer all or a portion of an account to another education savings account for a designated beneficiary who was a member of the family. Changes in designated beneficiaries and transfers would not be permitted to the extent that a change or transfer would constitute excess contributions or unauthorized investment choices. ("Account owner" would mean the individual who entered into an education savings program agreement and established an education savings account. The account owner also could be the designated beneficiary of the account.)

No account owner or designated beneficiary of any account could direct the investment of any contributions to an account or the earnings on an account. An individual who established an account could select among different investment strategies designed exclusively by the program manager, but only at the time the initial contribution that established the account was made. The program could allow MET board members or employees of the program, or the board members or employees of a contractor hired by the program to perform administrative services, to make contributions to an account.

Neither an account owner nor a designated beneficiary could use an interest in an account as security for a loan. Any pledge of an interest in an account would have no force or effect.

A maximum of $125,000 could be contributed in total to all of the accounts that named any one individual as the designated beneficiary. Any amount in excess of $125,000 would not be considered a qualified withdrawal and would have to be promptly withdrawn or transferred to another account.

Program Manager Reports

The program manager would have to report distributions from an account during a tax year to any individual, or for the benefit of any individual, to the Internal Revenue Service and the account owner or, to the extent required by Federal law or regulation, to the distributee. The program manager would have to provide to each account owner statements that identified individual contributions made during a tax year, the total contributions made to an account for a tax year, the value of an account at the end of a tax year, distributions made during a tax year, and any other information that the Treasurer required by January 31 following the end of each calendar year.

The program manager would have to disclose the following information in writing to each account owner of an education savings account and any other person who requested information about an education savings account:

-- The terms and conditions for establishing an education savings account.
-- Restrictions on the substitutions of designated beneficiaries and transfer of account funds.
-- The person or entity entitled to terminate an education savings program agreement.
-- The period of time during which a designated beneficiary could receive benefits under the agreement.
-- The terms and conditions under which money could be wholly or partially withdrawn from an account or the program, including any reasonable charges, fees, and penalties that could be imposed for withdrawal.
-- The potential tax consequences associated with contributions to, and distributions and withdrawals from, accounts.
-- Investment history and potential growth of account funds and a projection of the impact of the growth of the account funds on the maximum amount allowable in an account.
-- All other rights and obligations under education savings program agreements and any other terms, conditions, and provisions of a contract or an agreement entered into under the bill.

The program manager also would have to file with the Treasurer and the MET board an annual report that included the names and identification numbers of account owners, designated beneficiaries, and distributees of family tuition accounts; 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 that the program manager or Treasurer required regarding the taxation of amounts contributed to or withdrawn from accounts.

Limitations

The bill provides that the proposed Act, and any agreement under it, could not be construed or interpreted to do any of the following:

-- Give any designated beneficiary any rights or legal interest with respect to an account, unless the beneficiary was the account owner.
-- Guarantee that a designated beneficiary would be admitted to an eligible educational institution or, upon admission, would be permitted to continue to attend or would receive a degree from the eligible educational institution.
-- Give residency status to an individual merely because he or she was a designated beneficiary.

-- Guarantee that amounts contributed to an account would be sufficient to cover the qualified higher education expenses of a designated beneficiary.

The bill specifies that it would not create, and could not be construed to create, any obligation upon the State or any agency or instrumentality of the State to guarantee for the benefit of an account owner or designated beneficiary the rate or payment of interest or other return on an account. The contracts, applications, deposit slips, and other similar documents used in connection with a contribution to an account would have to clearly indicate that the account was not insured by the State, and that money deposited into and investment return earned on an account were not guaranteed by the State.

Senate Bill 600 (S-2)

The bill would amend the Income Tax Act to allow a taxpayer to deduct, to the extent not deducted in determining the taxpayer's Federal adjusted gross income (AGI), both of the following for tax years beginning after 1999:

-- The total of all contributions made on and after October 1, 2000, by the taxpayer in a tax year to education savings accounts pursuant to the proposed Michigan Education Savings Program Act, not to exceed $5,000 for a single return or $10,000 for a joint return.
-- Interest earned in the tax year on contributions to the taxpayer's education savings accounts if the contributions were deductible as provided above.

Further, the bill provides that for tax years beginning after 1999 a taxpayer could deduct, to the extent included in AGI, distributions that were qualified withdrawals from an education savings account to the designated beneficiary of the account.

If a withdrawal were not a qualified withdrawal as provided in the proposed Michigan Education Savings Program Act, the taxpayer would have to add to taxable income the amount of money withdrawn by the taxpayer in the tax year from education savings accounts, and the interest earned on that amount.

MCL 206.30 (S.B. 600)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Many parents, especially those who have large families, rightfully are concerned about paying the high costs of higher education for their children. The foundation of a successful career often hinges on the ability of an individual to obtain a college degree or some kind of advanced technical training. It is imperative for today's youngsters that parents be given every opportunity, and a range of options, to save for children's advanced education. The Michigan Education Trust (MET) program, which allows people to purchase contracts with the State for the future payment of college tuition, has thousands of participants but is limited in that its contracts have fixed costs that many cannot afford. Further, the program covers only the cost of tuition, which is often less than half of the total costs associated with higher education. Many people simply put money in a savings account for future use, but this has no tax advantages and no guarantee that the money will not be used for something else before being used for college expenses. Investing money in growth funds has its advantages, but the owners of an account (parents) often lack investment knowledge, there is no guarantee that the investments will grow and, once again, the money can be diverted to other uses before it is needed for college.

The bills propose an ideal program for people to save money to further the education of their children, or grandchildren for that matter. An education savings account could be opened for a minimal amount, and contributors could dedicate any amount they wished (up to the maximum), at any time. This would allow great flexibility, and encourage poor, middle, and upper income citizens to contribute to an account. Once contributed, the money would have to be used for qualified education expenses, or withdrawals would be subject to penalties. This would provide a strong incentive to leave contributions in an account to be used for their original purpose. Finally, contributions, interest earned in an account, and withdrawals would be exempt from State taxation. Thus, the bills would allow parents or other contributors to maximize the full value of their investments, which would further encourage the use of such accounts.

Response: Without a limit on the income of people who could contribute to an education savings account, the bills would favor upper income individuals, who could deposit the most into an account and, consequently, receive the greatest tax break. Furthermore, the $125,000 cap on the amount that could be contributed to a beneficiary's account also would favor those who could afford to deposit large sums.

A9900\s599a
This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.

Legislative Analyst: G. Towne

FISCAL IMPACT

These bills would reduce income tax revenue an estimated $4.6 million in FY 2000-01, and $5.4 million in FY 2001-02. This loss in revenue would reduce General Fund/General Purpose revenue an estimated $4.4 million in FY 2000-01 and $5.1 million in FY 2001-02, and School Aid Fund revenue would be reduced $0.2 million in FY 2000-01 and $0.3 million in FY 2001-02.

Fiscal Analyst: J. Wortley