

AMENDMENTS TO EDUCATION SAVINGS PROGRAM ACT

House Bill 5317 (Substitute H-2) First Analysis (11-27-01)

Sponsor: Rep. Gene DeRossett
Committee: Commerce

THE APPARENT PROBLEM:

Public Act 161 of 2000 (Senate Bill 599) created the Michigan Education Savings Program Act, under which individuals can contribute money to special accounts with the proceeds to be used to pay higher education expenses, including tuition, fees, books, supplies, and, in some cases, room and board. A person can establish one or more of these accounts for one or more designated beneficiaries. Two related acts, Public Acts 162 and 163 of 2000 (House Bills 5653 and 5654) allowed contributions to education savings accounts to be deducted from income in determining the state income tax; allowed a deduction for interest earned on such accounts; and allowed a deduction for qualified withdrawals used to pay higher education expenses. These plans are often known as 529 college savings plans because they are authorized under Section 529 of the federal Internal Revenue Code. (The same section also authorizes states to establish tuition prepayment plans, like Michigan's MET program.) Earnings accumulate in these savings plans tax free and are typically taxable at the beneficiary's lower rate when withdrawn. Recent changes in the federal law, however, make qualified withdrawals completely tax free for federal tax purposes as of January 1, 2002.

When the Michigan Education Savings Program was created, the federal law required that the states impose "a more than de minimis penalty" on distributions that were not qualified withdrawals; that is, money taken from the accounts for other than permitted uses. Michigan's plan calls for a penalty equal to 10 percent of the distribution in such cases. Some people believe that this penalty is too large, particularly considering money may have to be withdrawn to deal with family hardships, and that any penalty should only be assessed on accumulated earnings and not on the total distribution. This is the practice in many other states. Meanwhile, the recent federal tax overhaul (the Economic Growth and Tax Relief Reconciliation Act of 2001) does away with the state penalty requirement entirely as of next year and instead imposes an additional 10 percent tax at

the federal level on any distribution that is includible in gross income.

Another issue concerns who is eligible to establish an education savings account. The act currently refers to an account owner as an "individual". Some people believe the eligibility to fund higher education on behalf of designated beneficiaries should be expanded to include nonprofit corporations and trusts.

THE CONTENT OF THE BILL:

The bill would amend the Michigan Education Savings Program Act in several ways.

(1) Currently distributions that are not qualified withdrawals are subject to penalty of 10 percent of the distribution. The bill would specify that there would be no penalty under the state law for distributions made after December 31, 2001, if a tax was imposed on such distributions under Section 530 (d) (4) of the Internal Revenue Code. (The bill also changes the current penalty language from 10 percent of the distribution amount to 10 percent of the accumulated earnings attributable to the distribution amount. This would apply, presumably, if there is no federal tax penalty.)

(2) The bill also would amend the definition of "account owner". Currently, the act defines the term to refer to "the individual who enters into a Michigan education savings program agreement and establishes an education savings account". The bill would make the definition also apply to 1) an entity exempt from taxation under Section 501 (c) (3) of the federal Internal Revenue Code; and 2) a trust.

MCL 390.1472 and 390.1477

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BACKGROUND INFORMATION:

Michigan's education savings program is administered by Tuition Financing Inc. (TFI), a wholly owned subsidiary of Teachers Insurance and Annuity Association (TIAA). TFI manages MESP investments and provides advisory services. Information on the program can be found at a state web site, www.misaves.com, and at the private administrator's web site, www.tiaa-cref.org/tuition.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, eliminating the state penalty on non-qualified withdrawals would result in an indeterminate, but minor, loss of revenue to the state. (11-19-01)

ARGUMENTS:**For:**

The bill will improve the state's college saving plan in two ways. It will remove the stiff penalty for making an unqualified withdrawal, which is currently harsher than in many other states with similar plans. Altering this penalty will benefit those families that are forced through straitened financial circumstances to remove money from this kind of plan to cover other needs. And it will broaden the eligibility standards so that nonprofit corporations and trusts can also be account owners. This could lead to expanded educational opportunities for beneficiaries of these plans. The bill will help Michigan's plan compete with plans from other states (since many states operate plans open to non-residents). Both changes in the savings program respond to complaints about its current operation.

POSITIONS:

The Department of Treasury supports the bill. (11-6-01)

TIAA-CREF supports the bill. (11-6-01)

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.