House
Legislative
Analysis
Section

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AMENDMENTS TO EDUCATION SAVINGS PROGRAM ACT

House Bill 5317 as enrolled
Public Act 215 of 2001
Second Analysis (1-15-02)

Sponsor: Rep. Gene DeRossett
House Committee: Commerce
Senate Committee: Finance

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.) As the plan was originally designed, earnings accumulated in these savings plans tax free and were typically taxable at the beneficiary's lower rate when withdrawn.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 Some people believe that this penalty is too large, particularly considering money may have to be withdrawn to deal with family hardships, and that any penalty should only be assessed on accumulated earnings and not on the total distribution.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.

THE CONTENT OF THE BILL:

The bill would amend the Michigan Education Savings Program Act in several ways, effective January 1, 2002.

- 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 or penalty was imposed on such distributions under the Internal Revenue Code. The bill would also changes the current state penalty from 10 percent of the distribution amount to 10 percent of the accumulated earnings attributable to the distribution amount, which would apply if there was no federal tax or penalty.)

- The definition of "account owner" would be amended. 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 an entity exempt from taxation under Section 501 (c) (3) of the federal Internal Revenue Code.

• The act puts no limit on the number of accounts an individual may open. The bill would specify that an account owner could open only one account for any one designated beneficiary. Each account opened under the act could have only one designated beneficiary.

• The act allows an individual who establishes an education savings account to select an investment strategy (from various options) only at the time the initial contribution is made. The bill would also allow the selection of an investment strategy once each calendar year with respect to the accumulated account balance and when an account owner changed the designated beneficiary of an account.

• The current maximum for total contributions for all of the accounts naming any one individual as the beneficiary is $125,000. The bill would instead limit the maximum account balance for all accounts naming any one beneficiary to $235,000 (the federal maximum). The program would have to reject a contribution to any account for a designated beneficiary if the total balance of all accounts naming that beneficiary had reached the maximum. An account could continue to accrue earnings if it had reached the maximum and would not, as a result of those earnings, be considered over the maximum. For the purposes of determining whether the maximum account balance had been reached, the bill would include in the calculation the amount of payment or payments required from a purchaser on behalf of a qualified beneficiary made under an advance tuition payment contract (i.e., prepaid tuition plan) under the Michigan Education Trust Act.

MCL 390.1472 and 390.1477

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 several ways, making it more competitive with the plans offered by other states and also taking account of recent changes in federal tax law. 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. (It should be noted that the federal law no longer requires states to impose a penalty of any kind on unqualified withdrawals, but subjects such withdrawals to a federal tax penalty.) And it will broaden the eligibility standards so that nonprofit corporations can also be account owners. This could lead to expanded educational opportunities for beneficiaries of these plans. The changes in the savings program are responses to complaints about its current operation or from changes in federal tax law.

Response:

Some people believe a state penalty should be maintained. A penalty provides an incentive to keep money in an education savings account for its intended purpose, to pay for higher education, rather than to raid it for some other purpose.

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.