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SFA BILL ANALYSIS

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Senate Bill 536 (Substitute S-2 as passed by the Senate)
Sponsor: Senator Gary Peters
Committee: Finance

Date Completed: 1-18-02

RATIONALE

Section 529 of the Internal Revenue Code, adopted in 1996, allows a state to establish a qualified state tuition program. Section 529 defines a program as one 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, 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. In response to this provision, in 2000 the Michigan Education Savings Program Act was enacted to allow an individual to open an education savings account with a program manager (designated by the State) to save money for qualified higher education expenses of designated beneficiaries. Two other measures (Public Acts 162 and 163 of 2000) allow deductions from the State income tax for contributions to, and interest earned on, education savings accounts. The Michigan Education Savings Program Act requires distributions from an account to be used for qualified higher education expenses, and prescribes various qualified expenses.

When the Michigan Education Savings Program was created, Section 529 required states to impose a penalty on unqualified distributions. The Act provides that if a distribution that is not a qualified withdrawal is made, the program manager must withhold an amount equal to 10% of the distribution as a penalty, and pay that amount to the Department of Treasury for deposit into the General Fund. It has been pointed out that recent amendments to Section 529 eliminated the requirement that a state impose a penalty for unqualified withdrawals. It has been suggested that Michigan remove this penalty.

CONTENT

The bill would amend the Michigan Education Savings Program Act to provide that, after December 31, 2001, no penalty could be imposed for distributions that were not qualified distributions.

MCL 390.1477

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

Recent changes to the Internal Revenue Code eliminated the requirement that a state impose a penalty for unqualified withdrawals from an education savings account. Reportedly, many states have eliminated penalties for unqualified withdrawals from their state education savings programs. Michigan has had one of the most severe penalties among the states. By eliminating the penalty, the bill would further encourage families and others to open education savings accounts for young people to use for higher education.

Response: Public Act 215 of 2001, effective January 1, 2002, already made several changes to the Michigan Education Savings Program Act, including elimination of the 10% penalty for unqualified withdrawals, if a penalty is imposed on the distribution under the Internal Revenue Code. Section 530(d)(4) of the Code imposes a 10% tax on any unqualified distribution.

Legislative Analyst: G. Towne

FISCAL IMPACT

This bill would have a very minimal negative impact on General Fund revenue. To date, penalties assessed on nonqualified withdrawals from education savings accounts total less than $1,000.

Fiscal Analyst: J. Wortley

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