Legislative Analysis

Mitchell Bean, Director
Phone: (517) 373-8080
http://www.house.mi.gov/hfa

529 PLANS: EDUCATION SAVINGS PROGRAMS

House Bill 5138 as enrolled
Public Act 153 of 2007
Sponsor: Rep. Tim Melton

House Bill 5139 as enrolled
Public Act 154 of 2007
Sponsor: Brenda Clack
House Committee: Education
Senate Committee: Finance

Second Analysis (7-11-08)

BRIEF SUMMARY: The bills would allow the Department of Treasury to create a new broker-assisted 529 education savings plan to cover costs associated with higher education, with contributions to be income tax-deferred.

FISCAL IMPACT: The net fiscal impact on state government of House Bills 5138 and 5139 is indeterminate. To the extent that the establishment of an additional state-sponsored education savings plan caused an increase in the amount of contributions made by taxpayers to education savings plans, state income tax revenue would be reduced (since such contributions can be deducted from gross income at the state level). It is also possible that the state could receive a small percentage of revenue from plan contributions as part of the contract with the administrator of the new plan. The amounts and net result of these potential revenue impacts are indeterminate.

THE APPARENT PROBLEM:

Section 529 plans, also known as Qualified Tuition Programs, are set up to save for a child's college education. There are two types of Section 529 plans—prepaid tuition plans such as the Michigan Education Trust (MET) and college savings plans (such as the Michigan Education Savings Program). Both are named after Section 529 of the Internal Revenue Code, which specifies the requirements for the plans to be free from federal income taxes. Prepaid tuition plans let you lock in future tuition rates at in-state public colleges at current prices and are usually guaranteed by the state. College savings plans are more flexible, allowing you to invest more money and paying out to colleges country-wide. However, the savings plans do not offer a guarantee to cover tuition and other university-related costs.

Every state (including Washington, D.C.) now offers a Section 529 plan—with 32 states offering just college savings plans, two states offering just prepaid tuition plans, and 17 states offering both. (This information is up to date as of the end of 2007.) Michigan is one of the states that offer investors both kinds of 529 plans. (See Background Information.) Participation in Section 529 plans is growing rapidly. In 2000, a total of

$2.6 billion was invested in the plans. This grew to $14 billion in 2001 and more than $92 billion in mid-2006. According to the "Smart Student Guide to Financial Aid" (available at www.finaid.org), there will be a total of $175 billion to $250 billion invested in 10 million to 15 million accounts by the year 2010.

Section 529 college savings plans are tax-exempt college savings accounts which have little negative affect on a student's eligibility for need-based financial aid. Unlike prepaid tuition plans, there is no lock on tuition rates and no guarantee. Investments are subject to market conditions, and the savings may not be sufficient to cover all college costs. However, with this added risk comes the potential for greater returns. Federal law requires that 529 college savings plans have safeguards to prevent excessive contributions. Each state sets its own limit, basing it on an estimate of the amount of money that will be required to provide seven years of post-secondary education (including both undergraduate and graduate school). There is a considerable variation in state contribution limits, which range from $146,000 to $305,000, with a median limit of $235,000. (In contrast, prepaid tuition plans typically have a much lower contribution limit, based on the current cost of four years of in-state public colleges—which typically ranges from $50,000 to $100,000.)

Although Michigan offers residents two tax-deferred college savings accounts—both the prepaid college savings plan called MET and the college savings plan called MESP (administered for the Department of Treasury by TIAA-CREF)—the state has proposed creating a third education savings plan. According to committee testimony, the third plan would allow residents to set up accounts with the help of licensed financial advisors, rather than taking the initiative themselves. Legislation has been introduced to achieve that end.

THE CONTENT OF THE BILLS:

Each bill would amend a different act to allow the Department of Treasury to create a new 529 education savings plan to cover costs associated with higher education, with contributions to be income tax-deferred. A more detailed description of each bill follows.

<u>House Bill 5138</u> would amend the Michigan Education Savings Program Act (MCL 390.1472 et al) to enable the creation of *one or more* savings plans within the Michigan Education Savings Program already established at the Department of Treasury. Currently the act allows the creation of just one savings plan. Under the bill, "savings plan" or "plans" is defined to mean a plan that provides different investment strategies and allows account distributions for qualified higher education expenses. Currently under the law, the state treasurer administers the Michigan Education Savings Program and is the trustee for its funds. The bill would clarify that the treasurer could use program revenues to maintain or enhance the state's qualified tuition programs.

Under the law, the treasurer may select a program manager by entering into a management contract that has the most advantageous terms for both the state and potential plan participants. That contract must address eight specific factors. Further the contract must address the authority and the responsibility of both the treasurer and the program manager.

For example, currently, the annual administrative fee charged, imposed, and collected in connection with any agreements, contracts, and transactions relating to individual accounts, cannot exceed 1.5 percent of the average daily net assets of the account. Under House Bill 5138, the cap on the annual administrative fee would be 2.0 percent, and be exclusive of initial sales charges.

The bill would also modify the definition of "qualified withdrawal"—that is, a withdrawal that is not subject to a penalty or a tax—to include a withdrawal made because a beneficiary attended a service academy to the extent that the amount of the withdrawal does not exceed the cost of the advanced education attributable to the beneficiary's attendance in the service academy. [The bill defines "service academy" to mean the United States Military Academy, United States Naval Academy, United States Air Force Academy, United States Coast Guard Academy, or United States Merchant Marine Academy.]

House Bill 5139 would amend the Income Tax Act of 1967 (MCL 206.30) to clarify the method of calculating the deduction for contributions to education savings accounts, to allow a deduction for *each* savings account, in the event the taxpayer has more than one.

Currently under the law, Section 30 of the state Income Tax Act lists many adjustments and deductions available to taxpayers when they calculate their taxable income—that is, the income on which tax is owed. Among the adjustments is one for the total of all contributions made on and after October 1, 2000 by the taxpayer (less qualified withdrawals) to education savings accounts under the Michigan Education Savings Program Act, not to exceed $5,000 for a single return or $10,000 for a joint return per tax year. House Bill 5139 would modify this provision to specify that contributions would be "calculated on a per education savings account basis," and to ensure that the amount calculated for each education savings account not be less than zero. The limit on the total amount of the credit that could be claimed, however, would not be changed.

The bill also would make technical updates to the exemption for retirement income from income tax liability to reflect the changes in the maximum exemptions that have resulted from the indexing for inflation.

BACKGROUND INFORMATION:

For further information about Michigan's Education Savings Program located in the Department of Treasury, visit: www.misaves.com

Two websites (of many) with useful information on Section 529 plans are:
www.savingforcollege.com and finaid.org

ARGUMENTS:

For:

According to the Department of Treasury, Michigan has one of the lowest cost college savings programs in the country. To take advantage of the tax-deferred program—by investing either in the prepaid MET Plan or in the MESP Plan—Michigan residents can contact the Department of Treasury themselves and arrange to join. No broker or financial advisor is necessary; a citizen need simply take the initiative. Nonetheless, a spokesman for the Department of Treasury notes that hundreds of millions of Michigan dollars have gone to aggressive broker-backed college savings plans in other states, particularly Virginia. Brokers often do not recommend the Michigan plans because there is no monetary incentive for them to do so.

This legislation will allow the Department of Treasury to set-up a third college savings plan that is broker-assisted. Some investors want financial advice and ongoing guidance when they buy financial products. They will invest only with the help of a broker. This legislation offers investors that option. The bills will ensure that Michigan investment dollars stay in Michigan, and they offer Michigan parents (and grandparents) yet another option when they invest early to pay for their children's future college and university studies.

Legislative Analyst: J. Hunault
Fiscal Analyst: Kyle Jen
Rebecca Ross