Legislative Analysis

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ENHANCED MICHIGAN EDUCATION SAVINGS ACCOUNTS (E-MESPs)

Senate Bills 544 (S-2) & 547 as passed by the Senate
Sponsor: Sen. Patrick Colbeck

Senate Bill 545 (S-2) as passed by the Senate
Sponsor: Sen. Phillip Pavlov

Senate Bill 546 (proposed substitute H-1)
Sponsor: Sen. Judy Emmons

Senate Bill 548 (proposed substitute H-1)
Sponsor: Sen. Patrick Colbeck

House Bill 5428 as introduced
Sponsor: Rep. Tim Kelly

House Committee: Education Reform
Senate Committee: Education
Complete to 2-7-18

SUMMARY:

Senate Bills 544, 545, and 546 would create a Part 2 within the Michigan Education Savings Program (MESP) Act, which would govern an "enhanced" MESP, or E-MESP. Generally, the E-MESP would allow parents to create a savings account for each of their dependents, with funds to be used for "eligible services" (typically non-core instructional courses).

Senate Bill 547 would designate the current Act as Part 1 of the Act.

Senate Bill 548 would create a Section 1210 in the Revised School Code to require certain reporting by school districts, intermediate school districts (ISDs), and public school academies (PSAs, or charter schools) to the Michigan Department of Education (MDE) and the Michigan Department of Treasury in order to be eligible for E-MESP funds.

House Bill 5428 would amend the Income Tax Act, largely replicating the tax implications for the current Act in the proposed Part 2 and taking effect for the 2018 tax year.

Senate Bill 544

Senate Bill 544 would create an E-MESP fund in the Department of Treasury, which may consist of one or more savings plans. The state treasurer would administer and serve as trustee for the fund and, subject to appropriation, use program revenues in the fund to maintain or enhance the state's education programs. Additionally, the state treasurer could employ or contract with personnel and contract for services necessary for the administration of each savings plan under the program, as well as the investment of the assets of each savings plan and the fund under the program.

Program managers

The treasurer would select a program manager to provide services including managerial, professional, legal, clerical technical, and administrative services. Preference would be given to single entities that could provide all of these services and that demonstrate the most advantageous combination of the following factors to both potential participants and this state:

- Financial stability.
- Safety of the investment instruments being offered.
- Ability of the investment instruments to track the increasing costs of higher education.
- Ability of the entity to satisfy the record-keeping and reporting requirements of the proposed Part 2.
- The entity's plan for marketing the savings plan and the investment it is willing to make to promote the savings plan.
- Fees, if any, proposed to be charged to persons for opening or maintaining an account.
- Ability of the entity to accept electronic withdrawals, including payroll deduction plans.

Management contracts

The state treasurer must enter into a contract with each program manager, addressing the factors listed above as well as the respective authority and responsibility of the treasurer and program manager to do all of the following:

- Develop and implement the savings plan or plans offered under the program.
- Invest the money received 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 **annual administrative fees and service** in connection with any agreements, contracts, and transactions relating to individual accounts, exclusive of initial sales charges, which shall not exceed 2.0% of the average daily net assets of the account.
- Develop **marketing plans and promotional material**.
- Establish the methods by which funds are allocated to pay for administrative costs.
- Provide **criteria for terminating and not renewing** the management contract.
- Address the ability of the program manager to take any action required to keep the savings plan or plans offered under the E-MESP in compliance with its management contract and the requirements of the proposed Part 2.
- **Keep adequate records** of each account and provide the treasurer with information that the treasurer requires related to those records.
- **Compile the information contained in statements** required by the proposed Part 2 and provide that compilation to the treasurer in a timely manner.
- Hold all accounts for the benefit of the account owner.
- Provide for **audits at least annually** by a firm of certified public accountants.

- Provide the treasurer with copies of all **regulatory filings and reports** related to the savings plan or plans offered under the E-MESP made during the term of the management contract or while the program manager is holding any accounts, other than confidential filings or reports except to the extent that those filings or reports are related to or are a part of the savings plan or plans offered under the program.
- Ensure that any description of the savings plans offered under the E-MESP is consistent with the **marketing plan** developed by the program manager.
- Take any other necessary and proper actions to carry out the purposes of the proposed Part 2.

The treasurer would be responsible for ongoing supervision of each management contract, which would be for a term of years specified in the contract. The treasurer could terminate a management contract based on criteria specified in the management contract.

<u>Reporting and disclosure requirements for all program managers</u>
All program managers must report **distributions** from an account to a public school or other organization for the benefit of the student and distributions from an account for postsecondary education expenses during a tax year to the Internal Revenue Service (IRS) and the account owner or, to the extent required by federal law or regulation, to the entity to which the distribution is made.

Program managers must also provide **statements** identifying the contributions made during the tax year; the total contributions made to the account for the tax year; the value of the account at the end of the tax year; distributions made during the tax year; and any other information that the treasurer requires to each account owner on or before the January 31 following the end of each calendar year.

In addition, program managers must disclose the following information in writing to each account owner of an E-MESP and any other person who requests information about an account:

- The terms and conditions for establishing an account.
- Restrictions on the substitutions of students and transfer of account funds.
- The person entitled to terminate a program agreement.
- The period of time during which a student may receive benefits under the program agreement.
- The terms and conditions under which money may be withdrawn from an account or the program, including any reasonable charges and fees and penalties that may be imposed for withdrawal.
- The potential tax consequences associated with contributions to and distributions and withdrawals from accounts.
- The investment history and potential growth of account funds and a projection of the impact of the growth of the funds on the maximum amount allowable in an account.
- All other rights and obligations under program agreements and any other terms, conditions, and provisions of a contract or an agreement entered into under the proposed Part 2.

Annual report

The bill requires each program manager to file an annual report with the state treasurer and the board of directors of the Michigan Educational Trust that includes all of the following:

- Names and ID numbers of account owners and students. (This information would not be subject to the Freedom of Information Act (FOIA).)
- Total amount contributed to all accounts during the year.
- All distributions from all accounts.
- Any information that the program manager or treasurer may require regarding the taxation of amounts contributed to or withdrawn from accounts.

Tax-exempt status

Under the bill, contributions to an account, interest earned on an account, and qualified withdrawals made from an account would be exempt from taxation.

Effect of the proposed Part 2 and agreements thereunder

The bill states that the proposed Part 2 and any agreements under it may not be construed or interpreted to guarantee admission to, continued attendance at, or the conferral of a degree from a public school. Additionally, they would not guarantee that contributions to an E-MESP would be sufficient to cover the **eligible services**, or the rate or payment of interest or return on an account.

> ***Eligible services***: except as otherwise provided, any courses and services offered to students by a public school or any other organization that the MDE determines pursuant to this part are qualified for payment from an account. Eligible services include educational materials and supplies and other fees and costs that are related to the eligible courses and services as determined by the MDE. Eligible services do not include any fees and costs that are necessary elements of a school's activities or an integral, fundamental part of an elementary and secondary education.

Senate Bill 545

Senate Bill 545 would require the Michigan Department of Education (MDE) to determine what constitutes an "eligible service" that may be purchased using an account, based on the information received from each public school under Senate Bill 548. Eligible services would include services, courses, materials, and other fees and costs offered by public schools. Core instructional courses are not eligible services that may be purchased using an account unless the foundation allowance available for that student has been exhausted.

MDE would divide the services into the following five categories:

- Core instructional courses.
- Noncore instructional courses.
- Extracurricular activities.
- Support activities.
- Course materials.

Each public school that complied with SB 548's reporting requirements (described below) would be eligible to receive payments from an E-MESP. Additionally, MDE may designate other organizations that provide the services described in the categories above as eligible to receive payments.

E-MESP website

The bill would require MDE to establish and maintain an E-MESP website within one year after the bill takes effect. The website would serve as the portal for information about E-MESP accounts and the services and courses offered by each public school and any other organization in Michigan. It would also include a breakdown of the minimum requirements for annual course loads and course descriptions, as well as a mechanism for the enrollment of students into services and to allow for the payment of those eligible services from each student's account by the account owner.

Senate Bill 546

Senate Bill 546 would provide that, beginning with the school year starting one year after the bill takes effect, parents may open an account for each dependent who is a student. Opening an account would allow for the enrollment in and payment for eligible services (either at a public school or another organization) and would allow payment for postsecondary education expenses. A parent may open only one account for each dependent. Each savings plan under the program must provide separate accounting for each student.

Opening and contributing to an account

To open an account, a parent must enter into a program agreement that includes the name, address, and social security number of the parent and student, as well as any other information that the state treasurer or program manager considers necessary for the enrollment of the student and related to the eligible services.

Any individual or entity may make contributions to an account. Those contributions must be made in cash, by check, by credit card, or by any similar method as approved by the state treasurer, but may not be property.

Under the bill, an account owner would be responsible for the payment of eligible services and any postsecondary education expenses. Distributions from an account to pay for eligible services would be paid directly to the public school or other organization providing eligible services. Distributions for postsecondary education expenses may be paid to the account owner or postsecondary institution. (Payments may be made electronically).

The bill would prohibit Treasury or MDE from imposing any additional requirements on an account other than those established under the program agreement and the proposed Part 2.

Transfer of excess funds

Once a student graduates from a public school, an account owner may transfer funds back to the E-MESP fund or utilize the remaining funds to pay for postsecondary education expenses. Upon the death of a student, the money in the account would be transferred back to the account owner or, upon written request of the account owner, deposited into the E-MESP fund.

Role of an account owner

An account owner may select among different investment strategies designed by a program manager, but may not otherwise direct the investment of any contributions to an account or the earnings on an account. The program may allow 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.

Interest in an account may not serve as security for a loan

An interest in an E-MESP account may not be used by an account owner to secure a loan. Any pledge of interest in an account has no force or effect.

Senate Bill 547

Senate Bill 547 would designate the current Michigan Education Savings Program Act as Part 1 of the Act. (The proposals in SBs 544, 545, and 546 would serve as Part 2).

Senate Bill 548

Senate Bill 548 would create a Section 1210 in the Revised School Code to require provision of certain information to MDE and Treasury in order for districts to be eligible for E-MESP funds under the proposed Part 2. It would require a school district's or ISD's board, or a PSA's board of directors, to submit, no later than March 1, 2018 and thereafter at least six months before the beginning of the school year, all of the following:

- A complete listing of all services to be provided to students by the district, ISD, or PSA, broken down by subject-specific core instructional courses and services, noncore instructional courses and services, extracurricular activities, support activities, costs and fees, and course materials. The board or board of directors, or its designee, must map each of the services to the funding source for the service.
- A breakdown of the direct costs and fully burdened costs to the school district, ISD, or PSA for providing each of those services.
- Any other information requested by Treasury related to services provided to pupils by the district, ISD, or PSA.

MDE and a district, ISD, or PSA that is eligible to receive funds from the accounts must ensure that parents have access to information on the direct costs and fully burdened costs of each service. At least six months before each school year, each district, ISD, or PSA that is eligible to receive funds must provide parents with clear information on what services are available from the district, ISD, or PSA.

House Bill 5428

House Bill 5428 would amend the tax implications of education savings accounts (ESAs) in the Income Tax Act. The Act provides that taxable income for a person other than a corporation, estate, or trust is that person's adjusted gross income as defined in the federal Internal Revenue Code, subject to certain adjustments.

Currently, the Income Tax Act allows the following deductions regarding ESAs (in other words, the following categories are generally tax-exempt):

- Contributions, minus qualified withdrawals, not to exceed a total deduction of $5,000 for a single return or $10,000 for a joint return per tax year.
- Interest earned on those contributions if the contributions were deductible.
- Distributions that are qualified withdrawals.

The bill would extend those deductions to the proposed Part 2 beginning in the 2018 tax year and for each tax year thereafter.

Additionally, the bill would also require that money withdrawn from an account be added to taxable income if the withdrawal was not a qualified withdrawal.

As defined in SB 544, a ***qualified withdrawal*** is a distribution that is not subject to a penalty under Part 2 of the MESP Act or taxation under the Income Tax Act, and that meets any of the following:

- A withdrawal from an account to pay for eligible services provided by a public school or any other organization to the student or to pay for postsecondary education expenses incurred after the account is established.
- A transfer of funds due to the termination of the management contract.
- A transfer of funds upon the student's graduation or death.

Tie-bars

SBs 545 through 548 and HB 5428 are tie-barred to SB 544, meaning that they could not take effect unless SB 544 were also enacted. SB 548 is also tie-barred to HB 5428.

BACKGROUND:

Public Act 161 of 2000 (SB 599) created the Michigan Education Savings Program Act. That Act authorized the creation of tax-advantaged savings accounts for postsecondary education expenses. Public Acts 162 and 163 of 2000 (HBs 5653 and 5654) made complementary changes to the Income Tax Act.[1]

[1] House Legislative Analysis Section and House Fiscal Agency analysis of PAs 161, 162, and 163 of 2000. http://www.legislature.mi.gov/documents/1999-2000/billanalysis/House/pdf/1999-HLA-5653-B.pdf

Federal tax law allows individual states to establish state-sponsored college savings plan programs under which people can make contributions to special tax-deferred savings accounts. Earnings accumulate tax-free and are distributed to the beneficiary to pay expenses associated with postsecondary education, such as tuition and fees, room and board, and books. Withdrawals for education expenses are taxable at the federal level, but at the student's (presumably lower) tax rate; some states exempt contributions, earnings, and withdrawals from state income taxes. These plans are sometimes referred to as 529 plans because they are authorized in Section 529 of the federal Internal Revenue Code. (The same section also authorizes states to establish tuition prepayment plans, like Michigan's MET program.)

The bills would extend some of these benefits to other educational expenses in addition to postsecondary education expenses, as long as they meet MDE's definition of "eligible services."

FISCAL IMPACT:

The bills would create indeterminate state and local costs and reduce state income tax revenues.

State Revenues

House Bill 5428 would reduce General Fund and School Aid Fund revenues by an unknown amount. The current postsecondary education savings plans (MESP and Michigan Education Trust (MET)) are expected to reduce state revenues by $14.2 million in FY 2017-18. The magnitude of the fiscal impact under this bill package would depend on the number of taxpayers and the amounts contributed or withdrawn on an annual basis. Individual deductions are calculated as contributions less qualified expenditures in any given year, but cannot be less than zero. For third-party contributors to accounts, the entire contribution would likely be deductible.

Because of the way the deduction is calculated, account owners would have an incentive to make contributions in years prior to any planned qualified expenditures. Therefore, the reduction in revenues would likely be greatest in the years immediately following enactment and then revert to a lower annual revenue reduction as qualified expenditures begin to offset contributions. Additionally, the E-MESP would affect a larger number of taxpayers and cover a wider array of expenses than the current education savings plans (MESP and MET), so the annual reduction in state revenues is likely to exceed the $14.2 million by which the current education savings plans are expected to reduce revenues in FY 2017-18.

Senate Bill 546 provides that upon the death of a student who is a beneficiary of an account, the account shall be closed and all funds shall be transferred back to the account owner. However, an account owner could elect to deposit the remaining funds in the Enhanced Michigan Education Savings Program Fund, which, if chosen, would increase revenues to the fund.

State Costs

The bills could increase certain costs related to administration, oversight, and review of any contract entered into to perform the investment services required under the provisions of SB 544. The magnitude of the direct costs to the Department of Treasury is unknown, but expected to be minimal.

Costs of managing investments, auditing financial reports, compiling reports, and other clerical and administrative services would be covered through various investment fees charged by the program manager Treasury contracted with to run the E-MESP. Treasury currently has a contract for the MESP with a total cost of $76.0 million over the term of the contract (2012 through 2020) paid for with investment fees and charges. The E-MESP would effectively mirror MESP as it relates to its financing structure. Presumably, the cost of the contract would depend on the number of accounts created, the asset size of the accounts, and the fees charged by the program manager.

MDE would incur additional costs in determining which services, courses, materials, and other fees and costs offered by each public school are eligible services that may be purchased using an E-MESP account and in separating services into designated categories. These would include one-time administrative costs to prescribe the form and matter for the data collected from school districts, ISDs, and PSAs and ongoing costs, including at least one FTE position to continue this work as services change and in collecting yearly district reports. MDE would also be responsible for identifying other eligible organizations that could provide services.

MDE and Treasury would incur administrative costs to collect and process E-MESP service plans for each eligible school district, ISD, and PSA.

It is unclear whether the administrative fees and service fees, capped at 2.0% of the average daily net assets of the account, could be used to offset non-contract related administrative costs of Treasury and MDE.

Local Costs

School districts, ISDs, and PSAs would incur additional operational and administrative costs to do the following:

- Annually provide a report to MDE and Treasury of the complete categorized listing of all services provided to pupils, including the funding source for the service, costs for providing the service, and any other information requested by MDE or Treasury.
- Ensure that parents have access to information on the cost of each service.
- Provide parents with clear information for available services for each year.

There would be significant one-time cost increases to initially categorize and determine the cost of all of the services they provide on a per pupil basis, since they do not currently do this. There would also be ongoing costs to annually update that information and to provide parents with the requisite information concerning services.

School districts, ISDs, and PSAs could receive additional E-MESP revenue for services provided; however, this revenue would be for the cost of the service, so there is likely to be no net revenue change unless they intend to start charging for services which are currently provided to students at no cost.

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