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BILL ANALYSIS

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Senate Bills 640, 641, and 642 (as introduced 6-23-05)
Sponsor: Senator Buzz Thomas (S.B. 640 & 641)
Senator Bill Hardiman (S.B. 642)
Committee: Banking and Financial Institutions

Date Completed: 5-25-06

CONTENT

Senate Bill 640 would create the "Individual or Family Development Account Program Act" and Senate Bills 641 and 642 would amend the Single Business Tax (SBT) Act and the Income Tax Act, respectively, to do all of the following:

- **Establish the Individual or Family Development Account Program within the Department of Labor and Economic Growth (DLEG).**
- **Require DLEG to solicit proposals from community development organizations to administer the accounts, and specify criteria for DLEG to consider in reviewing the proposals.**
- **Provide that a proposal would have to require account holders to match contributions of a community development organization with cash or volunteer work.**
- **Allow an individual or family whose income was 200% or less of the Federal poverty level to establish a development account.**
- **Allow withdrawals from an account for postsecondary education, a first-time home purchase, major home repairs or improvements, or start-up capitalization for a small business.**
- **Specify requirements for a financial institution in which accounts were established.**
- **Exempt money deposited into or withdrawn from a development account from the income and single business taxes.**
- **Prescribe penalties, including forfeiture of account balances, for withdrawing money from a development account other than for a qualified expense.**
- **Allow a taxpayer to claim a nonrefundable SBT credit for contributions to development accounts and to the reserve fund of a community development organization.**
- **Allow a taxpayer to claim a refundable income tax credit for contributions to an individual or family development account, up to $2,500 per year; interest earned on an account; and contributions to a community development organization's reserve fund, if the taxpayer were not an account holder.**

"Community development organization" would mean a charitable organization exempt from taxation under Section 501(c)(3) of the Internal Revenue Code, approved by the DLEG Director or the Director's designee to implement the Individual or Family Development Account Program. "Reserve fund" would mean a fund created by an approved community development organization to fund the costs incurred to administer a program and to provide matching funds for money in an account.

The bills are tie-barred.

Senate Bill 640

Individual or Family Development Account Program

The bill would establish the Individual or Family Development Account Program within DLEG. The program would have to provide eligible individuals and families with an opportunity to establish accounts to be used for education, home ownership or improvements, or small business capitalization. The Department would have to solicit proposal from community development organizations to administer the accounts on a not-for-profit basis. Proposals would have to include both of the following:

-- A requirement that the individual or family account holder match contributions of a community development organization by contributing cash or volunteer work.
-- A process for including account holders in decision-making regarding the investment of money in their accounts.

In reviewing the proposals, DLEG would have to consider all of the following factors:

-- The organization's not-for-profit status.
-- The organization's fiscal accountability.
-- The organizations ability to establish and administer a reserve fund.
-- The significance and quality of proposed auxiliary services.
-- The relationship of proposed auxiliary services to the goals of the Individual or Family Development Account Program.

The Department would have to promulgate rules to implement the proposed Act.

Individual or Family Development Accounts

An individual or family whose household income was less than or equal to 200% of the Federal poverty level could establish an individual or family development account with a financial institution for the purpose of accumulating and withdrawing money for qualified expenses. The account holder could withdraw money from the account, without penalty, for any of the following qualified expenses:

-- Educational expenses for the individual account holder or any member of the family, if the account were a family development account, for postsecondary education at an eligible educational institution.
-- First-time purchase of a primary residence by the individual account holder, or any member of the family who was at least 18 years of age, a Michigan resident, and a U.S. citizen, if the account were a family development account.
-- Major repairs or improvements to a primary residence of the individual account holder, or any member of the family who was at least 18, a Michigan resident, and a U.S. citizen, if the account were a family development account.
-- Start-up capitalization of a small business for the individual account holder or any family member who was at least 18, a Michigan resident, and a U.S. citizen.

"Educational expenses" would mean tuition and fees required for the enrollment or attendance of a student who is 18 or older, a Michigan resident, and a U.S. citizen at an eligible educational institution, and expenses for fees, books, supplies, and equipment required for courses of instruction at an eligible educational institution. "Eligible educational institution" would mean a State university; a public community or junior college; a State-licensed vocational or technical education program; a State-licensed proprietary school; or an independent nonprofit college or university located in Michigan.

A financial institution in which an account was established would have to do all of the following:

-- Keep the account in the name of both the account holder and the administrator of the community development organization that administered the account.
-- Permit deposits to be made to the account by the account holder or by a contributor on behalf of an account holder.
-- Provide that the accounts would earn the market rate of interest.
-- Permit the account holder to withdraw money from the account for any of the qualified expenses detailed above.

Deposits made by a contributor could include money to match the account holder's deposits.

Up to $2,500 in deposits to an account in a tax year would be exempt from taxation for that tax year. Up to $5,000 total in an account would be exempt from taxation. Accumulated interest earned on an account would not be included for purposes of these caps.

If a contribution to an account would cause the account balance to exceed the maximum total for a tax year or the maximum balance of an account, the financial institution would have to notify the account holder or other contributor and the administrator of the community development organization that administered the account that making the deposit would cause the account balance to exceed the statutory maximums. Deposits that exceeded the maximums would have to be returned to the contributor who made the contribution or returned on a pro rata basis among multiple contributors.

Tax Exemption

Money deposited in or withdrawn from an individual or family development account by an account holder would be exempt from taxation under the Income Tax Act and the SBT Act. Interest earned by a family development account also would be exempt from the income tax.

A contributor could deduct the amount of contributions made to accounts from the taxpayer's tax base as determined under the SBT Act.

The administrator of a community development organization that administered an account, with the cooperation of the participating financial institutions, would have to submit to DLEG the names of contributors and the total amount that each contributed to a family development account reserve fund for each tax year. The DLEG Director would have to determine the date by which the information would have to be submitted. The Department would have to submit to the Department of Treasury a verification of qualified tax credits claimed pursuant to the proposed Act.

Penalties

Money withdrawn during a tax year from an account, by an account holder, that was not withdrawn for a qualified expense under the proposed Act would be subject to a penalty of 15% of the amount withdrawn, for the first time an account holder withdrew money other than for a qualified expense. The second time an account holder withdrew money other than for a qualified expense, the account holder would be subject to a 15% penalty and the account would have to be closed and the money in it forfeited. Penalties and money forfeited by an account holder would have to be deposited in the individual or family development account reserve fund of the community development organization that administered the account.

Other Provisions

Interest Distribution. Interest earned on an account would have to be distributed proportionately to the account holder and other contributors, based on the individual contributions of each.

Contingent Beneficiary. An account holder would have to name at least one contingent beneficiary at the time the account was established and could change beneficiaries at any time. In the event of an account holder's death, the account would have to be transferred to a contingent beneficiary. If the named beneficiary were deceased or otherwise could not accept the transfer, the money would have to be transferred to the beneficiary's estate.

Senate Bill 641

Under the bill, for tax years beginning after December 31, 2005, a taxpayer could claim an SBT credit equal to the total of the following amounts:

-- Contributions the taxpayer made in the tax year to an individual or family development account, not to exceed the maximum allowable contribution under the proposed Individual or Family Development Account Program Act.
-- Contributions made in the tax year to the reserve fund of a community development organization pursuant to the proposed Act, if the taxpayer were not an account holder.

If the credit allowed under the bill and any unused carryforward of the credit exceeded the taxpayer's tax liability for the tax year, the excess could not be refunded, but could be carried forward as an offset to the tax liability in subsequent tax years for 10 tax

years or until the excess credit was used up, whichever occurred first.

A taxpayer could irrevocably assign all or a portion of a credit allowed under the bill. A taxpayer could claim a portion of a credit and assign the remaining credit amount. An assignee could not subsequently assign a credit or any portion of a credit. The credit assignment would have to be made on a form prescribed by the Department of Treasury. The taxpayer would have to send a copy of the completed assignment form to the Department in the tax year in which the assignment was made. An assignee would have to attach a copy of the completed assignment form to its annual return for the tax year in which the assignment was made and the assignee first claimed a credit, which would have to be the same tax year.

Senate Bill 642

Under the bill, for tax years beginning after December 31, 2005, a taxpayer could claim a credit against the income tax equal to the total of the following amounts:

-- Contributions the taxpayer made in the tax year to an individual or family development account, if the taxpayer were the account holder for that account, not to exceed $2,500 per tax year.
-- Interest earned in the tax year on money in an individual or family development account established by the taxpayer.
-- Contributions made in the tax year to a community development organization's reserve fund pursuant to the proposed Individual or Family Development Account Program Act, if the taxpayer were not an account holder.

If the amount of the income tax credit allowed under the bill exceeded the taxpayer's tax liability for the tax year, the excess portion would have to be refunded.

Proposed MCL 208.35d (S.B. 641)
Proposed MCL 206.272 (S.B. 642)

Legislative Analyst: Patrick Affholter

FISCAL IMPACT

The Michigan State Housing Development Authority in DLEG already administers similar programs so the cost of these additional administrative responsibilities would be minimal.

The bills would reduce single business tax and individual income tax revenue by an unknown and potentially significant amount. During 2003, approximately 2.9 million individuals in Michigan, living in 675,000 families, resided in households with incomes of 200% of poverty or less. If a single account were created for each of 10% of the individuals (and no family accounts were created) and each account received an average contribution of $1,000 (rather than the $2,500 allowed by the bills) per year, the bills would reduce State revenue by $290.0 million per year. If participation rates and/or average contribution amounts were higher, then the fiscal impact would be greater. It is unknown how the fiscal impact would be divided between the SBT and the individual income tax, but a portion of the individual income tax impact also would be expected to reduce School Aid Fund revenue. The remaining impact would reduce General Fund revenue.

The impact of the bills likely would be substantially higher because of a number of factors relating to the way the accounts and the credits are structured in the bills. Examples of these provisions include: 1) The bills would allow multiple accounts to be established for any given individual, and such an individual also could be covered by a family account, and there also could be multiple family accounts covering the same family; 2) deposits to accounts and reserve funds would be cost-free to contributors because the contributions would be 100% reimbursed through tax credits; 3) contributions from sole proprietorships would appear to qualify for double credits, one under the SBT and another under the individual income tax; 4) the penalty provisions for unauthorized withdrawals are not substantial (for example, if an account holder had received deposits in exchange for volunteer work, the account holder still would receive 85% of the money, plus all contributors still would have received 100% of the tax benefit associated with the deposits) and some aspects could be easily circumvented (for example, an account holder could make sure the second withdrawal depleted the account so that no money reverted to contributors when the account was closed; also, closing an account due to unauthorized withdrawals would not

prevent an individual from opening another account); 5) the income conditions for opening an account would depend only upon income at the time the account was opened—once an individual (for example, while a student) opened an account, the account would be available to him or her in perpetuity—even if the person's income (for example, after graduation) rose substantially above 200% of poverty; 6) the provisions for withdrawals to cover the start-up capitalization (a term not defined in the bills) of a small business would appear to provide enough leeway that many individuals could use the withdrawals to fund many ordinary purchases; and 7) Senate Bill 640 would exempt contributions from taxation, while the other two bills would provide credits for the contributions, thus providing both a credit and an exemption for the same contribution.

A few provisions could reduce participation, although these incentives would not be likely to outweigh the substantial incentives for participation to be high. Examples of these provisions include: 1) While account holders could include resident aliens, a withdrawal could be used to cover the expenses of a resident alien only if it were to cover educational expenses; other qualified withdrawals could not be spent for the benefit of a resident alien; 2) community development organizations would not be subject to any minimum or maximum contribution rates, matching rates, or amounts and would face no restrictions upon their use of reserve funds (nor are there any conditions placed upon what would constitute volunteer work equivalent to contributions); 3) market rate of interest is not defined; 4) community development organizations would be required to make account holders provide matching contributions to match deposits from the organization, but there is no requirement that the organization make contributions to any accounts; and 5) there are no restrictions upon beneficiaries, so beneficiaries could include individuals who would not be eligible to establish an account (for example, a lower-income elderly person establishing an account for a well-off child or grandchild) as well as entities that are not natural persons (such as a business or trust).

This estimate is preliminary and will be revised as new information becomes available.

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