

STUDENT OPPORTUNITY SCHOLARSHIP PROGRAM

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House Bill 5404 (proposed substitute H-1)
Sponsor: Rep. Bryan Posthumus

Analysis available at
<http://www.legislature.mi.gov>

House Bill 5405 (proposed substitute H-1)
Sponsor: Rep. Phil Green

Committee: Education
Complete to 10-18-21

SUMMARY:

House Bills 5404 and 5405 would create a new act, the Student Opportunity Scholarship (SOS) Act, and a system of providing tax credits to taxpayers who contribute to scholarship-granting organizations that allocate that money to SOS-eligible students.

House Bill 5404 would create the SOS Act, which would require the Department of Treasury (“Treasury”) to establish an SOS program to give more flexibility and choice in education to Michigan residents and to address disparities in educational options available to students. It would require *scholarship-granting organizations (SGO)* to create a uniform process for determining the amount to be allocated to each *eligible student’s* SOS account with certain limitations, described below.

Scholarship-granting organization (SGO) would mean a nonprofit organization that complies with the requirements of the act and receives contributions, allocates funds, and administers SOS accounts.

Eligible student would mean a Michigan resident who is five years of age or older or is enrolled in a public or nonpublic school in kindergarten to grade 12 and who satisfies at least one of the following:

- Is a member of a household with an annual household income at the time of initial application for an SOS from an SGO of not more than 200% of the amount of household income necessary to meet the income eligibility criteria for the federal free or reduced-price lunch program.
- Is a child with a disability as defined under the Individuals with Disabilities Education Act (IDEA).
- Is a child in foster care as defined by state statute.
- Is a member of the household of an eligible student that currently has an SOS from an SGO under the new act.

Limitations on SOS accounts

Under the act, an SGO’s processes for determining the amount to be allocated to SOS accounts would have the following limitations:

- For eligible students currently *enrolled at a public school*, except nonresident students, the total SOS funds for a single school fiscal year could not exceed \$500 or, for an eligible student who is a child with a disability as defined under IDEA, \$1,100.

- For eligible students not described above (namely, students *not enrolled in a public school*), including those who intend to use the SOS funds to pay tuition, the total SOS funds for a single school fiscal year could not exceed 90% of the minimum foundation allowance for the immediately preceding state fiscal year reduced by the percentage equal to $\frac{3}{8}$ of the percentage by which the applicant's household income exceeds the applicable income eligibility criteria for the federal free or reduced-price lunch program. A qualifying child with a disability could receive up to 90% of the minimum foundation allowance for the immediately preceding state fiscal year regardless of household income.
- For eligible students *in foster care*, the SGO would have to assume that the student's parents have no income or ability to pay for educational services for the purposes of prioritizing the students and determining the amount of assistance provided under the program.

Qualifying education expenses

The funds in the SOS account could be used only to pay for the following qualifying education expenses, unless limited by the SGO, incurred for the purpose of educating an SOS student:

- Tuition or fees to attend a kindergarten to grade 12 public or nonpublic school.
- Tuition or fees for online learning programs.
- Tutoring services provided by an individual or a tutoring facility.
- Services contracted for and provided by a public school, including individual classes and extracurricular activities and programs.
- Textbooks, curricula, or other instructional materials, including any supplemental materials or associated online instruction required by either a curriculum or an education service provider.
- Computer hardware or other technological devices that are primarily used to help meet an SOS student's educational needs or educational software and applications.
- School uniforms.
- Fees for nationally standardized assessments, advanced placement examinations, examinations related to college or university admission, and tuition or fees for preparatory courses for these.
- Tuition or fees for summer education programs and specialized after-school education programs, excluding after-school child care.
- Tuition, fees, instructional materials, and examination fees for career and technical education.
- Educational services and therapies, including occupational, behavioral, physical, speech-language, and audiology therapies provided by a licensed professional.
- Tuition and fees for any of the following:
 - Enrollment in an eligible course that is offered by a postsecondary institution for postsecondary credit and that meets other requirements.
 - Enrollment in an eligible course offered by a career and technical preparation program that is offered for postsecondary credit or leads to an industry-recognized credential and that meets other requirements.
 - Participation in an authorized CTE early/middle college or CTE dual enrollment program.
- Fees for transportation paid to a fee-for-service transportation provider, or costs for mileage, for the student to travel to and from an education service provider.
- Fees for school-based athletic activities.

The bill would prohibit public or nonpublic schools from charging SOS students for tuition or any services in an amount that applies only to SOS students, from charging an SOS student tuition or for any services in an amount that differs from what it would have otherwise charged the SOS student under state law if the student were not an SOS student, or from charging tuition or for other services solely because the student is an SOS student.

SOS funds could not be refunded, rebated, or shared with a parent or SOS student in any way. Any rebate or refund for materials or services purchased with SOS funds would have to be credited directly to the student's SOS account.

Parents could make payments for the costs of educational materials and services not covered by the funds in their student's SOS account, but personal deposits into the account would not be allowed. As described in HB 5405, funds allocated to an SOS account and used for qualifying education expenses would not be taxable income to the parent or the SOS student.

Closure of an SOS account

An SOS account would remain in force unless it was closed because of a substantial misuse of funds. Any unused funds would roll over from quarter to quarter and year to year until one of the following occurs:

- The parent withdraws the SOS student from the program.
- The SGO determines the student's family income has increased beyond the eligible level.
- The student receives a high school diploma or high school equivalency certificate (or, for an SOS student with a disability, a certificate of completion for high school).
- The end of the fiscal year in which the SOS student reaches 19 years of age (or 26 years of age for an SOS student with a disability).

Upon the closure of an SOS account, any unused funds would revert to the SGO that granted the SOS and the SGO would have to allocate the unused funds to fund other SOS accounts. If the SGO were no longer operating, the funds would have to be transferred to another SGO operating in good standing with Michigan.

Awarding funding: prioritization and restrictions

The bill would require an SGO to first prioritize funding SOS accounts for students who received an SOS in the previous fiscal year, siblings of those students, and foster children living in the same household as those students. Then, for other first-time students, the SGO would have to prioritize as follows:

- A majority of funds available for other first-time applicants would be reserved for students whose household incomes rendered them eligible for the federal free or reduced-price lunch program or for children with a disability.
- The unfunded first-time applicants who do not meet the description above would be selected for funding based on a random lottery until all remaining funds were allocated.

An SGO could define and limit the educational services covered as long as the limitation was in compliance with state and federal laws affecting students with disabilities and regarding nondiscrimination. An SGO could not accept a contribution restricted for award to a particular student.

An SGO could not fund an SOS for the dependents of its board of directors, staff, or donors.

Establishing an SOS account

To establish an SOS account for an eligible student, the parent would have to submit an application to an SGO. The SGO would have to approve the application if all of the following apply:

- The SGO verifies that the student is eligible.
- Funds are available for the SOS.
- The parent signs a written agreement to use the funds only for the covered qualifying education expenses, not to establish any other SOS account for the student with any other SGO, and to comply with the rules and requirements of the SOS program.

The SGO would have to renew a student's SOS annually if funds were available, unless the student's family income had increased above the eligible level. If an eligible student became ineligible for reasons other than fraud or misuse of funds, the SGO *could* cease funding as long as the SGO complied with the following:

- The SGO immediately suspended payment of additional funds into the student's SOS account. For accounts that have been open for at least one full school fiscal year, the account would have to remain open and active for the parent to make qualifying education expenses from remaining funds. When no funds remained in the account, the SGO could close it.
- If the parent of an eligible student reapplied to the SGO and signed a new written agreement, payments into the existing open and active SOS account could resume. If it had been closed, a new SOS account could be established.
- An SGO would have to adopt policies to provide the least disruptive process for SOS students desiring to leave the program.

Certification and renewal as an SGO

An organization would have to apply for initial certification or renewal as an SGO with Treasury. An initial application would have to include a copy of the SGO's incorporation documents and 501(c)(3) determination letter issued by the Internal Revenue Service (IRS), an assurance that the SGO will conduct background checks of its employees and maintain those records, and descriptions of all of the following:

- The methodology the SGO will use to determine whether the student is eligible to establish an SOS account.
- The application process.
- The methodology for establishing, funding, and managing SOS accounts.
- The process the SGO will use to approve education service providers (ESPs).
- How the SGO will inform parents of approved ESPs.
- The procedures for crediting refunds from an ESP back to a student's SOS account.

An application for renewal of certification as an SGO would have to include the following:

- Applicable IRS documentation.
- A copy of the SGO's most recent financial audit, complying with specified requirements.
- An annual report that includes the number of SOS applicants, students who received SOS funds from the SGO during the previous school fiscal year, total number of the SGO's SOS accounts, a funding breakdown, a list of the SGO's approved ESPs, and a description of how the SGO has complied with the operational requirements and responsibilities of the act. (The report would have to comply with uniform financial accounting standards, be attested to by an independent certified public accountant, and be free of material misstatements or exceptions.)

The bill would require Treasury to certify an SGO or renew an SGO's certification if the organization met the requirements listed below. Treasury would have to issue initial certifications within 60 days and renew certification within 30 days of receiving the application. For a renewal application, an SGO would have to provide proof of the following:

- At least 90% of the total annual contributions received by the SGO are allocated to SOS accounts by the end of the following calendar year or fiscal year, whichever is applicable, unless the current year's SGO contributions exceed the average of contributions received in the immediately preceding three years by more than 15%. In that event, the excess amount could be carried forward and expended for SOS accounts in equal installments over the next three years.
- The SGO maintained separate accounts for SOS funds and operating funds.
- Any interest that accrued from contributions under HB 5405 was allocated by the SGO to fund SOS accounts.
- The SGO utilized a standard application process and the application was readily available and able to be submitted online.
- The SGO included two or more ESPs in its SOS program.

Requirements for an SGO

An SGO would have to provide parents with a written explanation of the qualifying education expense for which SOS funds could be used, parents' responsibilities, and the duties of the SGO and the role of any private financial management firms or other organizations that the SGO could contact with to process SOS transactions or to maintain records for other aspects of the SOS program.

An SGO could transfer funds to another SGO if the receiving SGO required additional funds or the transferring SGO discontinued operations. If funds were transferred to meet SGO demands, no more than a combined aggregate of 10% of the SGOs total annual contribution received could be retained by the SGOs for administrative expenses. All transferred funds would have to be allocated by the receiving SGO to its account for SOS accounts. All transferred amounts would have to be separately disclosed in the receiving SGO's annual report for certification renewal.

An SGO that received funds from an SGO that was discontinuing operations would have to agree to fund its existing SOS accounts to the extent funds are available and would have to prioritize the funding of transferred SOS accounts before funding new SOS applicants.

When an SGO received a contribution for which a preapproval letter was issued, it would have to notify Treasury within 10 business days after receipt and issue a certificate of contribution to the taxpayer. An SGO could accept grants, as well as donations that were not made pursuant to a preapproval letter and are not eligible for the tax credit under HB 5405, to cover administrative costs, inform the public about the program, fund additional SOS accounts, or offer assistance outside the program. Donations not eligible for the tax credit would not be subject to the requirements of the new act.

Requirements for the Department of Treasury

By January 1 of each year, Treasury would have to publish on its publicly accessible website a list of SGOs and remove from its list the SGOs that failed to meet the requirements of the act in the previous year.

Treasury also would have to produce and publish on its website an annual report that aggregates the data from the annual reports submitted by SGOs for their certification renewal. Treasury's report could not include confidential identifying information of SOS students or SGOs.

Treasury could conduct or contract for an additional audit or financial review of an SGO and, in the case of a violation, would have to send written notice of the violation to the SGO. The SGO would then have 60 days to correct the violation before Treasury could revoke its certification. An SGO could appeal a revocation under the procedures set out for taxpayers. If the SGO does not file a timely appeal to a revocation, it would have to continue administering existing SOS funds, cease to accept further funds for SOS accounts, and refund funds received after the date of revocation.

Payment system for SOS accounts

Each SGO would have to implement a commercially viable, cost-effective, and parent-friendly system for payment of qualifying education expenses from SOS accounts to ESPs. The system would have to provide flexibility and could not rely exclusively on reimbursing parents for out-of-pocket qualifying education expenses. An SGO could contract with a private financial management firm or other organization to develop the system and to maintain records and process transactions of the SOS accounts.

As long as funding is available, an SGO would have to continue making payments into an SOS account until the student is withdrawn from the program, the family is no longer eligible, there was misuse of funds, the student receives a high school diploma or high school equivalency certificate (or, for a student with a disability, a certificate of completion for high school), or the student ages out of the program.

Each SGO would have to establish a process for approving ESPs and could do so on its own initiative or at the request of parents or prospective ESPs.

Limitations and right of intervention

Nothing in the act could be considered to limit the independence of ESPs, to make actions by ESPs the actions of the state, to expand the regulatory of the state or public or nonpublic schools to impose additional regulation of ESPs beyond those necessary to enforce the requirements of the SOS program. An ESP that accepted payment from an SOS account would not be an agent of the state. An ESP could not be required to alter its creed, practices, admissions policy, or curriculum in order to accept payments from an SOS account.

If any part of the act were challenged in state court as violating either the state or federal constitution, parents of students who would meet the criteria for being eligible students could intervene as of right in the lawsuit for the purpose of defending the program's constitutionality.

House Bill 5405 would amend the Income Tax Act to allow contributions to SOS accounts to be deductible from a taxpayer's taxable income.

The bill would add an adjustment to section 30 of the act, which describes additions and deductions to a taxpayer's taxable income, to deduct, to the extent included in adjusted gross income, funds allocated during the tax year to an SOS account and used for qualifying education expenses of an SOS student.

Additionally, the bill would add two sections to the act—one to Part 1, which deals with the individual income tax, and one to Part 2, which addresses the corporate income tax. Both would provide that, generally, for tax years beginning on or after January 1, 2022, a taxpayer could claim up to 100% of the contributions made to SGO organizations certified by Treasury and participating in the SOS program against the taxpayer's tax liability for that tax year. A member of a flow-through entity that qualifies for the credit could claim the credit against the member's tax liability based on the member's distributive share of business income.

If the taxpayer claimed a deduction for these same contributions on his or her federal tax return for the same tax year, the deduction could not exceed the total contributions made less the credit certified and allowed to be claimed.

Preapproval for the credit

To be eligible for the credit, before making a contribution to an SGO, a person or an SGO acting on behalf of that person would have to submit an application and contribution plan for preapproval of the credit. The application and contribution plan would have to include the total amount of proposed contributions, the applicable tax year or years, whether the contributions would be in cash or marketable securities, and the name of the receiving SGO.

Applications would be considered in the order received by Treasury and would have to be approved or denied within 10 days of receipt. Treasury would issue preapproval letters for approved applications, including the maximum amount of the credit reserved. If an application were denied, the applicant could file an appeal as specified by Treasury or reapply for the same contribution plan or another contribution plan, or both.

The total credits reserved under preapproval letters for contribution plans approved under the personal income tax and corporate income tax provisions could not exceed \$500.0 million for any state fiscal year. However, if the total aggregate amount of tax credits approved for a fiscal year were 90% or more of the maximum amount available, the total aggregate amount of the next fiscal year would increase by 20%. Treasury would have to publish on its website when the amount is increased.

A taxpayer could agree to a multiyear contribution plan for up to four years.

If the credit allowed for the tax year and any unused carryover of the credit exceeded the taxpayer's tax liability for the tax year, the portion exceeding the tax liability would not be refunded but could be carried forward to offset tax liability for up to five years or until used up, whichever occurred first.

A taxpayer who receives a preapproval letter would have to make the preapproved contribution to the SGO within 15 business days of the preapproval letter of June 30 of the applicable fiscal year, whichever was earlier. If the preapproved contribution was in marketable securities, the SGO would have to monetize the securities within five business days of receipt and notify Treasury within 10 business days of the monetization. If the monetized value was less than the proposed contribution in the preapproval letter, the taxpayer would have to make up the difference in cash.

The taxpayer could not claim a credit for more than the amount in the preapproval letter. A taxpayer would have to attach a copy of the certificate of contribution to the taxpayer's annual income tax return.

An SGO would have to notify Treasury and issue a certificate of contribution to the taxpayer within 10 business days after receipt of a preapproved contribution.

Requirements for the Department of Treasury

Treasury would have to include on its website the current amount of total credit applications pending verification, the amount of total credits allocated to date, and the remaining credit available to taxpayers making contributions to SGOs. Upon notification that a contribution has been made and certificate of contribution has been issued, Treasury would have to update the website accordingly.

By November 1, 2023, and yearly thereafter, Treasury would have to submit a report to the legislature concerning the administration, operation, and financial impact of the SOS program and corresponding credits. The report would have to include the following:

- The number of applications received and total amount of proposed contributions seeking a credit.
- The number of preapproval letters issued and amount of credits preapproved.
- The number of certificates of contribution issued and amount of credits claimed.
- The amount of credits authorized in preapproval letters that were not claimed or that were claimed but carried forward.
- The number of SOS accounts opened and the total amount awarded by SGOs to SOS students and reported by household income range intervals of \$5,000.
- The number of SOS accounts opened and total amount awarded by SGOs to SOS students, disaggregated by qualifying characteristics.
- Any other information that may be necessary to the legislature in determining that the purposes of the SOS program and corresponding tax credits are being fulfilled.

MCL 206.30 and 206.697 and proposed MCL 206.279 and 206.679

FISCAL IMPACT:

House Bill 5404 would have an indeterminate fiscal impact on local school districts, intermediate school districts (ISDs), and public school academies (PSAs) depending on how parents spend funds from their students' SOS accounts. A district, ISD, or PSA would incur a revenue loss if an SOS student who would otherwise have enrolled in the district, ISD, or PSA uses SOS funding to enroll in a nonpublic school. A district, ISD, or PSA may realize a revenue increase if a student uses SOS funding for public school tuition, extracurricular programs, or other expense that would result in the district, ISD, or PSA receiving SOS funding as an education service provider.

As written, HB 5405 would reduce both individual and corporate income tax revenue by an unknown, but potentially significant, amount.

Although the provisions of the bill allow for a credit equal to a taxpayer's donation to one or more scholarship granting organizations and the total amount of combined individual and

corporate income tax credits in any tax year is generally capped at \$500.0 million (with exceptions to exceed that cap), annual credits could technically exceed \$500.0 million. In addition, because the credits are not refundable, any amount not used by a taxpayer in the year in which the donation is made can be carried forward for up to five years.

All corporate income tax revenue accrues to the general fund (GF/GP), so any credits claimed by C corporations would reduce GF/GP revenue. With respect to the individual income tax, to the extent that a credit results in or increases a taxpayer's refund, the impact would reduce GF/GP revenue. However, if a taxpayer reduces quarterly or annual payments in anticipation of receiving a credit, roughly 23.8% of the revenue loss would be borne by the School Aid Fund, with the remainder reducing GF/GP revenue.

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■ This analysis was prepared by nonpartisan House Fiscal Agency staff for use by House members in their deliberations and does not constitute an official statement of legislative intent.