Internal Revenue Service

Department of the Treasury 200030030

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:

Date: APR 28 2000

Significant Index No.
529.00-00
OP:E:EO:T3

Legend:
M=
N=

Dear Sir or Madam:

This is in response to M's request for a ruling that it is a qualified State tuition program, operating as a savings program, exempt from federal income tax under section 529 of the Internal Revenue Code (hereafter "Code").

M was established pursuant to authorizing legislation enacted by the N state legislature. The authorizing legislation indicates the following legislative intent in establishing the program:

> The legislature intends to establish the family college savings program in recognition that the general welfare and well being of the state of [N] are directly related to the educational levels and skills of its citizens. Therefore, a vital and valid public purpose of the state of [N] is served in establishment and implementation of the program that will encourage and make possible the attainment of an accessible, affordable postsecondary education by the greatest number of citizens through a savings program. The legislature further intends that the [N] commission for postsecondary education may achieve this purpose most effectively through a public-private partnership using selected financial institutions to serve as depositories for individual family college savings accounts.

163

The authorizing legislation provides that M will have an oversight committee established in the N commission for postsecondary education. The oversight committee is composed of the following members:

(1) The director of N's department of insurance or the director's designee.

(2) The director of N's department of banking or the director's designee.

(3) N's state treasurer or the treasurer's designee.

(4) The director of N's securities division of N's corporation commission or the director's designee.

(5) The president of N's board of regents or the president's designee.

(6) The executive director of N's board of directors for community colleges or the executive director's designee.

(7) The chairperson of N's board for private postsecondary education or the chairperson's designee.

(8) Three members from the general public appointed by N's governor, each of whom possesses knowledge, skill, and experience in accounting, risk management or investment management or as an actuary.

The authorizing legislation provides that the oversight committee will have the authority to recommend financial institutions for approval by the commission for postsecondary education to act as depositories and program managers of family college savings accounts. The authorizing legislation also provides that the oversight committee will have the authority to submit proposed rules to the commission for postsecondary education to assist in the implementation and administration of the program.

The authorizing legislation provides that the commission for postsecondary education will have the powers necessary to carry out and effectuate the purposes and objectives of the college savings program. Under the authorizing legislation, the commission for postsecondary education will have the following powers:

(1) Develop and implement the program in a manner consistent with the authorizing legislation through the adoption of rules, guidelines, and procedures.

(2) Retain professional services, if necessary, including accountants, auditors, consultants, and other experts.

(3) Seek rulings and other guidance from the United States Department of the Treasury and the Internal Revenue Service relating to the program.

(4) Make changes to the program required for the participants in the program to obtain the federal income tax benefits or treatment provided by section 529 of the Internal Revenue Code of 1986.

(5) Interpret, in rules, policies, guidelines and procedures, the provisions of the authorizing legislation in light of its purpose and objectives.

(6) Charge, impose, and collect administrative fees and service charges in connection with any agreement, contract, or transaction relating to the program.

(7) Select the financial institution or institutions to act as the depository and manager of the program in accordance with the authorizing legislation.

M's sole activity is the administration of the N sponsored college savings program. M will contract with independent financial institutions to receive contributions and to administer the program. The independent financial institutions will provide account owners with initial investment options and invest the contributions made by account owners. M's program rules provide that financial institutions shall not permit any account owner or designated beneficiary to change investment options after an account is opened.

M has contracted with two financial institutions: a bank and an investment company. The bank will provide account owners with the option of investing in certificates of deposit. The investment company will offer account owners a choice of mutual funds. The approach of the investment company is to assure that all families who invest have the opportunity to earn returns at a risk level with which they are comfortable and which will offer the opportunity to adequately educate their children, regardless of the time remaining until college. This is achieved by an account owner completing the application and designating, at the time the account is opened, which

mutual fund(s) are to be selected. The account owner will be able to choose from four mutual funds reflecting different risk levels. The application includes a risk tolerance section that is designed to assist the account owner in selecting the appropriate mutual funds(s) based on the amount of risk he or she is comfortable with, and the number of years before the funds are necessary to pay for educational expenses. As the designated beneficiary gets closer to the time that funds will be needed to pay qualified higher education expenses, these risk and return requirements may change. To accommodate that change, the application also allows the account owner to designate up to two time frames, based on the age of the designated beneficiary, to convert the account to a different fund with a lower risk tolerance. The account owner will make the selection at the time the account is opened, and neither the account owner nor the designated beneficiary will have the ability to subsequently select a different conversion time frame.

The authorizing legislation provides for the operation of a college savings program for the payment of tuition, fees, books, supplies, room and board, and equipment required for enrollment or attendance of a designated beneficiary at an eligible educational institution. Under the program rules, the term "eligible educational institution" has the same meaning as in section 529(e)(5) of the Code.

Account owners are required to complete an application in order to participate in the college savings program and provide benefits for designated beneficiaries. The authorizing legislation provides that account owners are required to complete an application containing the following information:

(1) The name, address, and social security number or employer identification number of the contributor.

(2) The name, address, and social security number of the account owner if the account owner is not the contributor.

(3) The name, address, and social security number of the designated beneficiary.

The authorizing legislation provides that account owners must also pay a one-time application fee established by the commission for postsecondary education and make a minimum initial contribution to the account. The authorizing legislation also provides that contributions to an account must be made in cash.

The authorizing legislation further provides that neither an account owner nor a designated beneficiary may use an interest in a college savings account as security for a loan.

Designated beneficiaries are not required to be members of the family of the account owner or to be residents of N. Substitute beneficiaries must be "members of the family", as defined in section 529(e)(2) of the Code, of the former designated beneficiary.

The authorizing legislation and M's program rules provide that participating financial institutions will maintain a separate account for each designated beneficiary and provide quarterly reports showing all activity during the quarter including the beginning balance, interest, dividends or earnings on the account, distributions from the account, and the ending balance of the account.

M's program rules also state that there is no limit on the number of accounts that may be opened for one beneficiary by different account owners. However, M's program rules provide that contributions may not be made to any account in M's program for a designated beneficiary if the aggregate balance of all accounts for that designated beneficiary exceeds the lesser of:

(1) The product (rounded down to the nearest multiple of ($1,000)) of 7 and the average one year's undergraduate tuition, fees, room and board at independent four year educational institutions as measured and last published by the College Board's Independent College 500 Index; or

(2) The cost in current dollars of qualified higher education expenses the account owner reasonably anticipates the designated beneficiary will incur.

M will maintain a database using designated beneficiaries' social security numbers to aggregate multiple accounts for the same beneficiary and to ensure that additional contributions are not made on behalf of a beneficiary once the account balance limit is reached.

Except as provided below, M's program rules require that distributions which are not used to pay qualified higher education expenses (as defined in section 529(e)(3) of the Code) of the designated beneficiary are subject to a penalty equal to ten percent of that portion of the distribution that constitutes earnings.

M's program rules provide that distributions based on the death or disability of the designated beneficiary, or receipt by the designated beneficiary of a scholarship may be made without a penalty if written third party substantiation is provided. In the case of a scholarship, the distribution may not exceed the amount of the scholarship.

M's program rules provide that a distribution will be treated as used to pay qualified higher education expenses of the designated beneficiary if the distribution is paid directly to the eligible educational institution, or the distribution is made in the form of a check payable to both the designated beneficiary and the eligible educational institution. A distribution may also be made, without imposition of a penalty, as a reimbursement of qualified higher education expenses of the designated beneficiary if the account owner provides written, third party substantiation showing qualified higher education expenses that the designated beneficiary has already paid. M's program rules provide that if an account owner certifies that a distribution for qualified higher educational expenses is needed but does not provide the required substantiation to show that the distribution is a reimbursement of qualified higher education expenses paid prior to the time the certification is made, the distribution is limited so that the balance remaining in the account is sufficient to pay the ten percent of earnings penalty. If the required substantiation that the distribution was actually expended for qualified higher educational expenses is not provided within 30 days, the penalty is imposed and is withdrawn from the account.

M's program rules provide that, before treating any distribution as made for qualified higher education expenses based on substantiation provided, the financial institution maintaining the account shall review the substantiation to confirm that substantiation is provided for the amount of a distribution that the account owner or the designated beneficiary asserts is a qualified distribution, that the substantiation complies with the program rules, and in the case of a distribution to pay qualified higher education expenses, that the substantiated expenditures are of a nature and in amounts that can be treated as qualified higher education expenses. The financial institution may seek additional information from the account owner, the designated beneficiary, or the higher educational institution before approving or rejecting substantiation, and the financial institution may seek guidance from staff of the commission for postsecondary education. The program rules provide procedures for the account owner to appeal an initial determination that the substantiation provided is inadequate.

M's program rules state that if a qualified distribution is made from an account in any calendar year, then within 60 days after the end of such year and within 60 days after the end of the following year, any designated beneficiary or account owner who

receives a partial or total refund from the eligible educational institution shall provide to the financial institution a signed statement identifying the amount of the refund. In addition, the designated beneficiary or account owner shall provide an explanation as to what portion, if any, of the refund is allocable to a qualified distribution. If all or a portion of a refund is allocable to a qualified distribution, the designated beneficiary or the account owner may provide the financial institution with written, third party substantiation of qualified higher education expenses of the designated beneficiary for which the refund was used, or substantiation that the refund was made by reason of a scholarship received by the designated beneficiary, or the death or disability of the designated beneficiary. To the extent that a refund was not used to pay qualified higher education expenses or made on account of a scholarship or the death or disability of the designated beneficiary, the refund will be considered a nonqualifying distribution subject to the ten- percent of earnings penalty. The program shall withdraw the penalty from the account in a manner consistent with the final regulations under section 529 of the Code. If sufficient funds are not available in the account, the program will prepare a bill for the penalty amount and attempt to collect this amount from the account owner or the designated beneficiary, as applicable. M's distribution form will inform designated beneficiaries and account owners of their obligation to report any refunds received from eligible educational institutions.

Section 529(a) of the Code provides for the exemption from federal income tax of qualified State tuition programs.

Section 529(b)(1) of the Code provides that the term 'qualified State tuition program' means a program established and maintained by a State or agency or instrumentality thereof-

(A) Under which a person-

(i) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or

(ii) may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account, and

(B) which meets the other requirements of this subsection.

Section 529(b)(2) of the Code provides that a program shall not be treated as a qualified State tuition program unless it provides that purchases or contributions may only be made in cash.

Section 529(b)(3) of the Code provides that a program shall not be treated as a qualified State tuition program unless it imposes a more than de minimis penalty on any refund of earnings from the account which are not-

(A) used for qualified higher education expenses of the designated beneficiary,

(B) made on account of the death or disability of the designated beneficiary, or

(C) made on account of scholarship (or allowance or payment described in section 135(d)(1)(B) or (C)) received by the designated beneficiary to the extent the amount of the refund does not exceed the amount of the scholarship, allowance, or payment.

Section 529(b)(4) of the Code provides that a program shall not be treated as a qualified State tuition program unless it provides separate accounting for each designated beneficiary.

Section 529(b)(5) of the Code provides that a program shall not be treated as a qualified State tuition program unless it provides that any contributor to, or designated beneficiary under, such program may not directly or indirectly direct the investment of any contributions to the program (or any earnings thereon).

Section 529(b)(6) of the Code provides that a program shall not be treated as a qualified State tuition program if it allows any interest in the program or any portion thereof to be used as security for a loan.

Section 529(b)(7) of the Code provides that a program shall not be treated as a qualified State tuition program unless it provides adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary.

M was established pursuant to authorizing legislation passed by N's state legislature, which authorized the establishment of a college savings program. M will be governed by an oversight committee established in the N commission for postsecondary education. The oversight committee will include the following individuals (or their designees): N's state treasurer, N's director of the department of insurance,

N's director of the department of banking, N's director of the securities division of N's corporation commission, the president of N's board of regents, the executive director of the state board of directors for community colleges, and the chairperson of N's board for private postsecondary education. In addition, the oversight committee will include three members of the general public with skill and experience in accounting, risk management, or investment management or as an actuary. These members from N's public and educational sectors demonstrate N's active involvement in the administration and management of M.

M will provide for the operation of a savings program as described in section 529(b)(1)(A)(ii) of the Code for the purpose of meeting the qualified higher education expenses, as defined in section 529 (e)(3) of the Code, of designated beneficiaries, within the meaning of section 529(e)(1) of the Code. M was established pursuant to legislation enacted by N.

N has established that it sets the terms and conditions of the program and is actively involved on an ongoing basis in the administration of the program.

M's program rules provide that contributions to the program can only be made in cash as required by section 529(b)(2) of the Code.

Pursuant to the authorizing legislation, the commission for postsecondary education will have the power to establish rules and regulations governing the operation of the program, including the administration, management, promotion, and marketing of the savings program; to maintain the tuition savings program in compliance with the Internal Revenue Service standards for qualified State tuition programs; to establish application procedures and fees for participation in the savings program, and withdrawals from the savings program within the scope of section 529(b)(3) of the Code.

M will administer the program in a manner that verifies distributions and imposes and collects penalties. If a distribution from any account is not used exclusively for qualified higher education expenses of the designated beneficiary, the amount of the distribution will be reduced by a penalty equal to ten percent of the earnings portion of the distribution. M's program rules implement practices and procedures to identify whether a distribution is subject to a penalty and to collect any penalty that is due.

In the case of any distribution other than a distribution used exclusively for the payment of qualified higher education expenses, or made on account of the death or disability of the designated beneficiary, or the receipt by the designated beneficiary of a

scholarship in an amount that is not less than the amount of the distribution, the amount of the distribution will be reduced by a penalty equal to ten percent of the earnings portion of the distribution. The amount of the penalty is sufficient to discourage individuals who do not intend to save for higher education expenses from investing in an account with M in order to obtain deferral of income for federal income tax purposes. M will implement as part of its normal operations a procedure to collect the penalty amount where the account owner or the designated beneficiary has received a refund from an eligible educational institution, unless the account owner or the designated beneficiary provides substantiation that the refund has been used to pay other qualified higher education expenses of the designated beneficiary (or was made on account of death, disability, or receipt of a scholarship). Therefore, M will impose more than a de minimis penalty on refunds of earnings, as described in section 529(b)(3) of the Code.

M will maintain a separate account for each designated beneficiary and will provide reports at least annually showing account activity for the relevant period pursuant to section 529(b)(4) of the Code. The reports will include all account activity including the beginning and ending balances, interest, dividends or earnings, and distributions.

M's program rules provide that account owners and designated beneficiaries will not have the power to directly or indirectly direct the investment of earnings or contributions to the program pursuant to section 529(b)(5) of the Code. At the time of opening an account, account owners have the option of selecting from among different investment options, such as certificates of deposit and mutual funds having different risk levels. Depending on their initial investment selection, account owners may have the option during the initial application process to designate up to two other mutual funds, having a lower risk than the initial investment selection, to which the account will be automatically transferred in specified future years. The automatic transfer will be limited to two occasions or time frames generally based on the age of the designated beneficiary. After an account is established, neither the account owner nor the designated beneficiary may change the investment selections or the timing of the automatic transfers. The ability to select, at the time of opening an account, from among various investment options offered by the program and to specify subsequent automatic transfers does not constitute the power to directly or indirectly direct investments as described in section 529(b)(5).

The authorizing legislation does not permit the account owners and designated beneficiaries to use any interest in the account as security for a loan pursuant to section 529(b)(6) of the Code.

M's program rules will limit the total contributions for each designated beneficiary by providing that contributions may not be made to any account for a designated beneficiary if the aggregate balance of all accounts for that designated beneficiary exceeds the lesser of seven times the average undergraduate tuition, fees, and room and board at independent four year educational institutions, or the cost in current dollar of the designated beneficiary's reasonably anticipated qualified higher education expenses. M will maintain records to ensure that the amounts paid or contributed on behalf of each designated beneficiary are not in excess of the funds required to meet the qualified higher education expenses of the designated beneficiary, in accordance with section 529(b)(7) of the Code.

Based on the above, we rule that M meets the requirements for exemption from federal income tax as a qualified state tuition program described in section 529 of the Code.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

There are no final regulations for section 529 of the Code. Please be advised that the validity of this ruling may be affected by the issuance of final regulations as well as any transitional rules contained therein.

Because this letter could help resolve any future questions about M's exempt status, please keep a copy of this ruling in the organization's permanent records.

Sincerely yours,

/s/

Steven D. Arkin
Director, Exempt Organizations
Rulings and Agreements