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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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**Contact Person:**

**ID Number:**

**Contact Telephone:**

**Reference:**
T:EO:RA:T:3

**Legend:**
M=
N=
O=
Q=
R=
S=
x=
y=
z=

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").

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M was established pursuant to authorizing legislation enacted by the N state legislature. The authorizing legislation provides that the purpose of the legislation is as follows:

> It is hereby declared that for the benefit of the people of [N] and for the prosperity and welfare of future generations, the state should establish and maintain a college choice tuition savings program to provide our youth and their families with the fullest opportunity to afford the costs of attending institutions of higher education. It is recognized that promoting savings as one of the many tools to help families meet their higher education expenses is in the best interest of the state. It is further recognized that fostering higher education to provide well educated citizens, while assuring the ability of students to choose which institution of higher education within [N] is best for them to attend, serves the best interests of the state. Furthermore, it is the intent of this act to promote the economic development of the state by creating opportunities for a highly educated workforce.

M was established as a trust under the authorizing legislation, which states that M, shall consist of a trust account and an operating account. The trust account includes amounts received by the program from account owners pursuant to tuition savings agreements, administrative charges, fees, all other amounts received by the program from other sources, and interest and investment income earned by M. N's state comptroller shall make transfers from the trust account to the operating account for the immediate payment of obligations under tuition savings agreements, operating expenses and administrative costs of M.

The authorizing legislation provides that N's state comptroller shall serve as M's sole trustee. The authorizing legislation also provides that the comptroller, as trustee, shall invest M's assets in investments authorized by the state's retirement and social security law. The legislation further provides that the trustee may enter into contracts to provide for investment advice and management, custodial services, and other professional services for the administration and investment of the tuition savings program.

Q is an N State agency. Q's purposes are as follows: (1) to improve the post-secondary educational opportunities of eligible students through the centralized administration of N's student financial aid and loan programs; (2) to coordinate N's administrative effort in student financial aid and loan programs with those of other levels

of the government and (3) to support the administration by the federal government, other states, and institutions of post-secondary education of the federal student aid programs, established under Title IV of the Higher Education Act of 1965, as amended, or any successor legislation.

A board composed of fifteen trustees governs Q. Q's president is appointed by N's governor and serves at the pleasure of the governor. Ten of Q's trustees are appointed by N's governor with advice and consent of the N State senate. Three of Q's trustees include persons serving as the commissioner of education, the chancellor of R, and the chancellor of S. R and S are public educational institutions in the state of N.

The authorizing legislation establishing M provides that M's trustee and Q have the responsibility to implement the tuition savings program under the terms and conditions established by state statutes. Under the authorizing legislation M's trustee and Q will have the following functions in implementing the operation of the tuition savings program:

(a) develop and implement the program in a manner consistent with the authorizing legislation through rules and regulations in accordance with the state administrative procedure act;

(b) engage the services of consultants on a contract basis for rendering professional and technical assistance and advice;

(c) seek rulings and other guidance from the United States Department of the Treasury and the Internal Revenue Service relating to the program;

(d) make changes to the program required for the account owners and designated beneficiaries in the program to obtain the federal income tax benefits or treatment provided by section 529 of the Internal Revenue Code of 1986, as amended, or any similar successor legislation;

(e) charge, impose, and collect administrative fees and service charges in connection with any agreement, contract or transaction relating to the program;

(f) develop marketing plans and promotion material;

(g) establish the methods by which the funds held in such accounts are disbursed;

(h) establish the methods by which funds shall be allocated to pay administrative costs;

(i) do all things necessary and proper to carry out the purposes of the authorizing legislation.

M was established to permit account owners to save for qualified higher education expenses on behalf of designated beneficiaries. M's program rules provide that the term "qualified higher education expenses" shall have the same meaning given such term under section 529(e)(3) of the Code. M's authorizing legislation has been amended to use the term "eligible educational institution" and clarify that it means any institution of higher education defined as an eligible educational institution in section 529(e)(5) of the Code.

M's authorizing legislation provides that contributions to accounts may be made only in cash. M's program brochure requires that contributions be by check, money order, deduction from a bank account, or payroll deduction.

M's authorizing legislation provides that neither an account owner nor designated beneficiary may use any interest in a tuition savings account as security for a loan.

M's sole activity is the administration of the N sponsored college tuition savings program. O is a limited liability company created by M's trustee to serve as the investment vehicle for assets held by M. M's trustee on behalf of account owners will invest program assets through O or other investment vehicles, such as regulated investment companies. M's trustee has contracted with an independent entity (referred to herein as the "program manager") to provide certain administrative, marketing and investment services with respect to the program. The program manager will manage and invest the assets held on behalf of account owners and designated beneficiaries. M's trustee will direct M's investments. M's authorizing legislation provides that no account owner or designated beneficiary of any account shall be permitted to direct the investment of any contributions or earnings on contributions.

Under the terms of a management agreement between the trustee, Q and the program manager, the program manager is required to manage M's assets in accordance with a specified set of investment guidelines that do not permit any variation in investment strategy based on the investment desires of any particular account owner or designated beneficiary. However, at the time of making each contribution to the program, an account owner may choose among four investment strategies offered by the program. (1) The program offers a managed allocation option

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that is based solely on the age of the designated beneficiary. The investment allocation will change over time, becoming less risky as the designated beneficiary nears matriculation. (2) The program offers an aggressive managed allocation option, also based on the age of the designated beneficiary, but a larger percentage of the assets are allocated to relatively more risky equity investments in the early and middle years of each designated beneficiary's life. Generally, for a designated beneficiary at a given age, the aggressive managed allocation option allocates a higher percentage of assets to equity investments than does the managed allocation option. (3) The program offers a high equity option in which 75 to 100 percent of the assets are invested in a fund of the program manager. (4) The program offers a guaranteed option in which assets will be invested mainly in an insurance contract which will guarantee principal and a minimum rate of return to M. Options (3) and (4) are not based on the age of the designated beneficiary. An account owner may allocate new contributions to an account for investment in any one or a combination of the investment options. However, once made, contributions to an account for a designated beneficiary and any earnings thereon may not be transferred by the account owner to another investment option.

M will maintain a separate account for each designated beneficiary. M's authorizing legislation and M's program brochure provide that each prospective account owner must submit an enrollment form and tuition savings agreement to establish an account. Account owners can open an account with a minimum contribution of x dollars. The minimum contribution is less if they elect to make subsequent contributions through payroll deductions.

M's authorizing legislation provides that each account established by an account owner will be maintained on behalf of a designated beneficiary. M will hold contributions and earnings on each account in trust on behalf of the designated beneficiary. M's authorizing legislation provides that contributions by an account owner to accounts are deductible in computing the account owner's N state taxable income in an amount up to z dollars in the aggregate for all accounts of the account owner in any taxable year. N state taxable income of the account owner or the designated beneficiary will not include the earnings from distributions that are made for qualified higher education expenses, or on account of the death or disability, of the designated beneficiary.

M's enrollment form and program rules provide that the trustee may accept contributions to an account only to the extent that such contributions do not cause the aggregate balance in all program accounts established for the benefit of the same

designated beneficiary to exceed the sum of four times the cost of one year of undergraduate tuition, fees, books, supplies and room and board at the most expensive educational institution eligible for the program and three times the cost of one year of graduate school tuition, fees, books, supplies, and room and board at the most expensive graduate school eligible for the program, defined in the program rules as the "maximum account balance." The maximum balance shall be determined annually. The tuition, fees, books, supplies, room and board costs taken into account in determining the maximum balance will be based on the most recent report of such costs published by the educational institutions. No additional contributions for a designated beneficiary will be permitted once the aggregate balance of all accounts within the program for that designated beneficiary reaches the maximum balance. In addition, under N state law, total contributions to all accounts held for the same designated beneficiary may not exceed y dollars. The program will retain this contribution limit, established by state law, unless the legislation requiring the limit is amended. Therefore, contributions to the program on behalf of a designated beneficiary will be limited to the lesser of the amount permitted by the maximum balance or the amount permitted by the contribution limit.

M's program rules provide that M's program manager will monitor contributions to prevent contributions to any account for a designated beneficiary when the aggregate contributions to all accounts for the designated beneficiary equal y dollars. The program rules further provide that any amount tendered as a contribution that, if accepted as a contribution, would cause aggregate contributions for any designated beneficiary to exceed the contribution limit or aggregate account balances for the benefit of any designated beneficiary to exceed the maximum balance, will not be accepted by the program manager.

The authorizing legislation provides that a designated beneficiary need not be a resident of N. M's authorizing legislation also provides that an account owner may substitute another person as the designated beneficiary of an account only if the substitute beneficiary is a member of the family, as defined in section 529(e)(2) of the Code, of the original beneficiary.

M's authorizing legislation requires that the program provide a separate accounting for each designated beneficiary. The legislation also provides that statements shall be provided for each account owner at least once each year within sixty days after the end of the twelve-month period to which they relate. The statement shall identify contributions made during a preceding twelve month period, the total contributions to the account through the end of the period, the value of the account at

the end of such period, distributions made during such period, and any other information that the trustee requires to be reported to the account owner.

The tuition savings agreement provides that account owners may direct distributions from an account to pay for qualified higher education expenses, without penalty, after the account has been open for at least 36 months. The account owner is required to provide M with a qualified withdrawal direction prior to the proposed distribution. The program brochure provides that no penalty will be assessed for the following distributions from an account: (i) distributions that are paid directly to an eligible educational institution (as that term is defined under section 529(e)(5) of the Code) to cover qualified tuition and related expenses pursuant to an invoice from the institution, (ii) distributions made pursuant to written requests that are accompanied by proof of payment that is sufficient to establish a conclusion that the distribution is to be used for qualified higher education expenses, (iii) distributions that are paid to the account owner pursuant to a distribution notice that includes documentation of the death or disability of the designated beneficiary, or (iv) distributions that are paid to the account owner pursuant to a distribution notice which includes documentation of the receipt by the designated beneficiary of a full or partial scholarship, waiver of tuition or similar benefit in an amount that is not less than the amount of the distribution. The documentation referred to in M's program rules is written third-party documentation. An account owner may request a distribution prior to submitting proof of payment of qualified higher education expenses, in which case the program manager will retain an amount sufficient to pay the penalty if proof of payment is not submitted within 90 days of the distribution. The tuition savings agreement also provides that in cases of distributions for reasons other than those stated above, including cancellation of the account, the amount of the distribution will be reduced by a penalty equal to 10 percent of the earnings portion of the distribution.

M's program brochure and its qualified withdrawal form require the account owner and the designated beneficiary to report to the program the amount of any refunds received from eligible educational institutions at the end of each year in which a distribution for qualified higher education expenses was made and at the end of the next year.

The program legislation provides that if a distribution was subject to a penalty and the penalty was not withheld from a withdrawal or the amount withheld is less than the amount required to be withheld, the account owner must pay the unpaid portion of the penalty to the program manager at the same time that the account owner files the earlier of the account owner's state or federal income tax return for the taxable year of

the withdrawal or if the account owner does not file such return, the due date for such returns, but in any event on or before the due date for such return taking into account any authorized extensions.

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 legislation enacted by N's state legislature, which authorized the establishment of N's college tuition savings program. M was established as a trust under the authorizing legislation, which also designated N's state comptroller as M's sole trustee. N's state comptroller and Q, an agency of N State government, have the responsibility of implementing and managing the operation of the tuition savings program. Q's purposes include improving the post secondary educational opportunities of eligible students through the centralized administration of N's student financial aid and loan programs. N's governor appoints Q's president. N's governor with advice and consent of the N State senate appoints ten of Q's trustees. Q's governing body also includes the N commissioner of education, the chancellor of R, and the chancellor of S. The membership of Q's governing body and the role of N's comptroller as trustee of M demonstrates N's continuing interest in the administration and management of M.

Under the authorizing legislation, M's trustee and Q 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 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.

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. Account owners are required to complete an application, execute a tuition savings agreement, and invest in the program on behalf of designated beneficiaries to participate in the program. Contributions made by an account owner to accounts are deductible in computing the account owner's N state taxable income in an amount up to z dollars in the aggregate for all accounts of the account owner in any taxable year. N state taxable income of the account owner or the designated beneficiary will not include earnings from distributions that are made for qualified higher education expenses, or on account of the death or disability, of the designated beneficiary. These state income tax provisions give the state a financial stake in the program. As noted above, the N State comptroller serves as sole trustee of M and, along with Q, has the responsibility of implementing the tuition savings program. N has demonstrated 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 authorizing legislation provides that payments to the program can only be made in cash in accordance with section 529(b)(2) of the Code. M's program brochure requires that contributions be by check, money order, deduction from a bank account, or payroll deduction.

In the case of any distribution other than a distribution used exclusively for the payment of qualified higher education expenses paid after an account has been opened for 36 months, or made on account of the death or disability of the designated beneficiary, or the receipt by the designated beneficiary of a scholarship, tuition waiver or similar benefit 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 10% 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 has implemented as part of its normal operations a procedure to collect the penalty amount where the account owner or designated beneficiary has received a refund and distributions have not been used for qualified higher education expenses. 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 to the account owners at least annually showing account activity for the relevant period pursuant to section 529(b)(4) of the Code. The reports will include the value of each account and the activity in the account, including distributions made from the account.

M's authorizing legislation and program rules ensure that account owners and designated beneficiaries will not have the power directly or indirectly to direct the investment of earnings or contributions to the program pursuant to section 529(b)(5) of the Code. M's trustee will have the responsibility for making investment decisions and developing investment strategies for funds held by the trust and M's trustee and Q have hired a program manager to assist with the investment decisions. At the time of making a contribution to the program, account owners have the option of selecting from among different investment options offered by the program, having different risk levels. However, once made, contributions to an account for a designated beneficiary and any earnings thereon may not be transferred by the account owner to another investment option. The ability to select, prior to making a contribution, from among various investment options offered by the program does not constitute the power to directly or indirectly direct investments as described in section 529(b)(5).

M's program rules do not permit the account owners or designated beneficiaries to use the account as security for a loan pursuant to section 529(b)(6) of the Code. Amounts contributed to the program will be held in trust for the benefit of designated beneficiaries.

M's program rules limit contributions so that (1) the total contributions to all accounts for a designated beneficiary do not exceed y dollars and (2) no additional contributions may be made on behalf of a designated beneficiary once the aggregate balance of all accounts for that designated beneficiary reaches the sum of four times the cost of one year of undergraduate tuition, books, supplies, fees, and room and board for a full-time undergraduate student attending the most expensive educational institution eligible for the program and three times the cost of one year of graduate school tuition, books, supplies, fees, and room and board at the most expensive graduate school eligible for the program. 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 beneficiary pursuant to 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(k)(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 T. Miller
Director, Exempt Organizations