DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224 200214032

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: DEC 19 2001

Contact Person:

Identification Number:

Telephone Number:

SIN# 529.00-00

T:EO:B3

Legend:

M =
State =
Trust Advisory Committee =
x =
y =

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 ("Code").

M was established pursuant to authorizing legislation enacted by the State legislature. The authorizing legislation provides that the purpose of the legislation is "to promote and enhance the affordability and accessibility of higher education for residents of the state." M was established as a trust under the authorizing legislation, which provides that the State's treasurer shall serve as M's sole trustee. The authorizing legislation provides that the State treasurer shall take any action necessary to ensure that the trust be exempt from taxation as a qualified State tuition program under section 529 of the Code ("program").

The authorizing legislation also provides, in part, that the State treasurer, on behalf of M, shall have the authority to adopt rules relating to the following:

1. receive and invest the monies in trust in any instruments, obligations, securities or property, as provided by the legislation;

2. establish consistent terms for each participation agreement, bulk deposit, coupon, or installment payments;

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3. to enter into one or more contractual agreements;

4. to obtain insurance in connection with M's property, assets, activities, or deposits or contributions to M;

5. to apply for, accept and expend gifts, grants or donations from public or private sources to enable M to carry out its objectives;

6. to adopt regulations;

7. to sue and be sued;

8. to establish one or more funds within M and maintain separate accounts for each beneficiary; and

9. to take any other action necessary to carry out the purposes of the legislation.

The Trust Advisory Committee ("Committee"), which was established pursuant to State legislation, evaluates the program and reports to the joint standing committees of the general assembly, at least annually, on M. The Committee is comprised of:

1. the treasurer as trustee;

2. the commissioner of higher education;

3. the secretary of the office of policy and management;

4. the co-chairpersons and ranking members of the joint standing committees of the general assembly having cognizance of matters relating to education and finance, revenue and bonding, or their designees;

5. one student financial aid officer and one finance officer at a public institution of higher education in the State, each appointed by the board of governors of higher education; and

6. one student financial aid officer and one finance officer at an independent institution of higher education in the State, each appointed by the State conference of independent colleges.

Under the authorizing legislation, the State treasurer also has the responsibility of preparing a financial report to the Governor on the operations of M including the

receipts, disbursements, assets, investments, and liabilities and administrative costs of the trust for the prior fiscal year. The treasurer will also make the report available to the Committee and program participants. Under the authorizing legislation, M is required to make an annual financial report to the Governor on the operations of M including the receipts, disbursements, assets, investments, and liabilities and administrative costs of M for the prior fiscal year. Additionally, the report shall be sent to the Committee, and the report shall be made available to each account owner and designated beneficiary.

M's sole activity is the administration of the State sponsored college tuition savings program. M was established to permit account owners to save for qualified higher education expenses of designated beneficiaries. M's authorizing legislation provides that qualified higher education expenses has the same meaning as defined in section 529(e)(3) of the Code and an eligible education institution has the same meaning as defined in section 529(e)(5) of the Code.

M has contracted with an independent entity (referred to herein as the "program manager") to serve as M's program manager pursuant to a contract (referred to herein as the "management contract"). Under the management contract, the program manager's responsibilities for the program include investment management, investment advice, marketing, individual account maintenance and other accounting functions, collecting contributions, processing withdrawals, providing customer services and sales, and additional administrative services related to the program. Among other things, the program manager:

1. manages the program in accordance with the qualified state tuition program requirements and regulations under section 529;

2. maintains adequate account records, segregating each account from all other accounts, and provides M with the information and data compilations necessary to permit preparation of the statements or reports required in connection with the program;

3. provides M with access to the program manager's books and records pertaining to the management contract;

4. provides M generally with copies of all regulatory filings and reports applicable to the program made by the program manager during the term of the management contract or while the program manager is holding any accounts;

5. holds all accounts that have been established pursuant to participation agreements, for the benefit of the beneficiaries.

In accordance with rules of the program (defined in the program as "program disclosure booklet" and "treasurer's regulations" and collectively referred to herein as "program rules") an account owner is required to submit a participation agreement to open an education savings account on behalf of a designated beneficiary. A designated beneficiary is not required to be a member of the family of the account owner. The program rules have no residency requirements for participation by account owners or beneficiaries. The program rules permit a change in designated beneficiaries, provided that the substitute beneficiary is a "member of the family," as that term is defined in section 529(e)(2) of the Code, of the former beneficiary.

The program rules provide that M shall maintain a separate account for each designated beneficiary. The program rules also require that the program manager maintains separate records for each account and issue quarterly and annual statements to program participants. The statements will include the account's beginning balance, aggregate contributions year-to-date, withdrawals, earnings credited to the account during the reporting period, and total value of the account at the end of the period.

The program rules do not impose a limit on the number of accounts that may be opened for one designated beneficiary by different account owners. Contributions may not be made to any account for a designated beneficiary if the aggregate balance of all accounts in the program for that designated beneficiary exceeds the product of one year of qualified higher education expenses (as defined in section 529(e) of the Code) at the most expensive undergraduate educational institution eligible for the program multiplied by seven years (defined in the program as the "account balance limit on contributions"). Additional contributions for a designated beneficiary shall not be permitted if at the time of the contribution the aggregate balance of all accounts within the program for that designated beneficiary has reached the account balance limit on contributions.

M's program rules provide that M may accept contributions to an account only to the extent that such contributions do not cause the amount invested in the aggregate in all accounts, contributions and earnings, established for the benefit of the same designated beneficiary to exceed the account balance limit on contributions. This limitation is reasonably constructed to ensure that contributions shall not exceed the amount that is estimated to be necessary to provide for the qualified higher education expense of the designated beneficiary. The program rules further provide that contributions for any beneficiary will not be accepted if the amount of the contribution

would cause the aggregate in all accounts held for that beneficiary to exceed the account balance limit on contributions.

M's authorizing legislation provides that contributions to accounts may be made only in cash. M's program rules further provide that contributions to an account may be made by check, money order, automatic contribution plan, payroll deduction, electronic funds transfer (including telephone purchase option) from a bank account designated by the account owner, or a transfer from another qualified State tuition program.

M's program rules prohibit the use by any program participant or the designated beneficiary of any interest in the savings program or any portion of such interest as security for a loan. The participation agreement confirms this prohibition.

Under the terms of a management agreement between the trustee and the program manager, the program manager is required to manage trust 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 a contribution to the program, an account owner may choose among three investment strategies offered by the program. (1) The program offers a managed allocation option that is based solely on the age of the designated beneficiary. The investment allocation may change over time, becoming less risky as the designated beneficiary nears matriculation. (2) The program offers a high equity option in which 75 to 100 percent of the assets are invested in a particular fund of the program manager. (3) The program offers a principal plus interest option where the program allocates contributions to a money market fund, but will subsequently allocate such assets to a funding agreement issued by an affiliate of the program manager to the trust. The funding agreement provides for a guarantee to the trust of all principal and a minimum rate of return of three percent (3%) per annum and offers the opportunity for additional returns. Options (2) and (3) 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.

An account owner may choose a different investment option, or options, once per calendar year without changing the designated beneficiary, and at the time that the designated beneficiary of an account is changed to a new beneficiary. The selection of a new investment option at the same time as a change in beneficiary may occur through three different procedures: (1) the account owner may withdraw money from an existing account and, within 60 days of the withdrawal, make a deposit to a different account with a new beneficiary, (2) the account owner may request that money in an existing account be transferred directly to a different account with a new beneficiary, or (3) the account owner may request that the designated beneficiary for the account be

changed to a new beneficiary. In each case described above, when there is a change in beneficiary, the new beneficiary must be a member of the family of the old beneficiary, within the meaning of section 529(e)(2) of the Code.

M's program rules provide that each prospective account owner must submit a participation agreement to establish an account. Account owners can elect to make periodic contributions to the account through electronic funds transfers. Each such periodic contribution must be at least x dollars. In cases where the periodic contribution election is not made, program participants are required to make an initial minimum contribution of at least y dollars.

Each account established by an account owner will be maintained on behalf of a designated beneficiary. Contributions and earnings on each account will be held in trust by M on behalf of the designated beneficiary. Earnings from investment in an account are exempt from State income tax if used to pay for the qualified higher education expenses of a designated beneficiary.

The program rules 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 educational expense, (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 as described in section 135(d)(1)(B) or (C) of the Code in an amount that is not less than the amount of the distribution. The documentation referred to in the program rules is written third-party documentation. An account owner may request a distribution prior to submitting proof of payment of qualified higher education expense, in which case the program manager will retain an amount sufficient to pay the penalty, set aside this amount, and then if proof of payment is not submitted within 90 days of the distribution, the program retains the penalty. The program rules and participation agreement provide that in cases of distribution for reasons other than those stated above the amount of the distribution will be reduced by a penalty equal to ten percent of the earnings portion of the distribution. If a penalty is due but insufficient funds remain in an account or an account is closed, M will prepare a bill for the unpaid penalty amount and collect this from the account owner or the beneficiary.

M's program rules include a certification, on its qualified withdrawal form, to advise the program if either the account owner or the designated beneficiary receive a refund from an eligible educational institution at the end of each year in which a distribution for a qualified higher education expense was made and at the end of the next year.

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 a scholarship (or allowance or payment described in section 135(d)(1)(B) or (C)) of the Code 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.

Notice 2001-55, IRB 2001-39 (Sept. 24, 2001) provides that a program does not violate section 529(b)(5) of the Code if it permits a change in the investment strategy selected for an account once per calendar year, and upon a change in the designated beneficiary of the account. The Notice provides that, to qualify under this special rule, a program must allow participants to select only from among broad-based investment strategies designed exclusively by the program. In addition, the program must establish procedures and maintain records to prevent a change in investment options from occurring more frequently than once per calendar year or upon a change in the designated beneficiary of the account. The Notice provides that section 529 programs and their participants may rely on the Notice pending the issuance of final regulations under section 529 of the Code.

M was established as a trust pursuant to legislation enacted by the State legislature. Under the authorizing legislation, M's Trustee, the State treasurer, will have the authority to establish rules and regulations governing the operation of the program. M's sole trustee is the State treasurer. The State's treasurer will also serve on the Committee, which will evaluate the program and report on the program annually to the joint standing committees of the State's general assembly. The Committee members include: the commissioner of higher education; the secretary of the office of policy and management; the co-chairpersons and ranking members of the joint standing committees of the general assembly having cognizance of matters relating to education and finance, revenue and bonding, or their designees; one student financial aid officer and one finance officer at a public institution of higher education in the State, each

appointed by the board of governors of higher education; one student financial aid officer and one finance officer at an independent institution of higher education in the State, each appointed by the State conference of independent colleges. The membership of the Committee and the role of the State treasurer demonstrate the State's continuing interest 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. The interest and dividend income on the contributions to an account are exempt from the State's income tax to the extent used to pay qualified higher education expenses of the designated beneficiary, thereby giving the State a financial stake in the program. As noted above, the State treasurer serves as sole trustee of M and serves on the Committee that is responsible for evaluating and reporting on the program. The State 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 rules further provide that payment may be made by check, money order, automatic contribution plan, payroll deduction, electronic funds transfer (including telephone purchase option) from a bank account designated by the account owner, or a transfer from another qualified State tuition program.

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, tuition waiver or similar benefit as provided in section 135(d)(1)(B) or (C) of the Code 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 program participant or the 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 required by section 529(b)(3) of the Code.

M will maintain a separate account for each designated beneficiary and will provide reports to the program participants 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 program rules ensure that program participants 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 and program manager will have the responsibility for making investment decisions and developing investment strategies for funds held by the trust. 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. M also permits an account owner to change investment strategy selected for a designated beneficiary once per calendar year without changing the designated beneficiary, and upon a change in the designated beneficiary of the account. The ability to select, prior to making a contribution, from among various investment options offered by the program, or to change investment options offered by the program once per calendar year without changing the designated beneficiary, and when there is a change in the designated beneficiary, does not constitute the power to directly or indirectly direct investments as described in section 529(b)(5).

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

M's program rules limit contributions so that the total investment in all accounts for a designated beneficiary does not exceed seven times the cost of tuition, fees, and room and board at the most expensive undergraduate educational institution eligible for the program. M will maintain records to ensure that the amounts 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.

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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,

(signed) Robert C Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3