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

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Contact Person:

ID Number:

Contact Telephone:

Reference:
T:EO:RA:T:3

MAR 12 2001

Legend:
M=
N=
O=

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, including proposed amendments, states that the purposes of the program are:

(1) To encourage elementary and secondary students in [N] to achieve high standards of performance and establish lifelong habits of fiscal responsibility through savings.

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(2) To encourage education and the means of education.

(3) To encourage attendance at higher education institutions.

(4) To provide families additional means of striving for higher education through the [N] family college savings plan that may be established under this article.

(5) To help provide the benefits of higher education to the people of [N].

(6) To promote the economic development of the state by creating opportunities for a more highly educated workforce.

(7) To increase employment opportunities in [N].

(8) To encourage a working partnership among the people of [N], including [N] families, and elementary and secondary schools, higher education institutions, financial institutions, and state government in furthering a greater rate of savings and greater participation in higher education.

The authorizing legislation provides that the board of directors of the N education savings authority will govern M. The authority is responsible for the management and operation of M, which is the N family college savings plan. The board of the authority is composed of the following members:

(1) The following four (4) ex-officio members or directors:
(A) The State treasurer of N.
(B) The N State superintendent of public instruction.
(C) The N State commissioner of higher education.
(D) The N State budget director.

(2) Five (5) appointed members or directors who:
(A) Are appointed by the governor of N; and
(B) Have knowledge, skill, and experience in academic, business, financial, or education fields.

The authorizing legislation also provides that the board of the authority will have all powers necessary to carry out and effectuate the purposes and objectives of M and the powers delegated by law or executive order, including the following powers:

(1) To develop and implement the education savings programs and other savings programs and services consistent with the purposes and objectives of the enabling legislation through:

(A) Rules adopted under [applicable N state law]; or
(B) Rules, guidelines, procedures, or policies established by the board and approved by the [N] higher education commission.

(2) To retain professional services including the following:

(A) Financial advisers and managers.
(B) Custodians and other fiduciaries.
(C) Investment advisers and managers.
(D) Accountants and auditors.
(E) Consultants and other experts.
(F) Actuarial services providers.
(G) Attorneys

(3) To establish minimum account deposit amounts (both initial and periodic).

(4) To employ persons, if the board chooses, and as may be necessary, and to fix the terms of their employment.

(5) To recommend legislation to the governor and general assembly [of N].

(6) To apply for designation as a tax exempt entity under the Internal Revenue Code.

(7) To adopt such rules, bylaws, procedures, guidelines, and policies as are necessary to carry out the education savings programs, and other savings programs and services and the authority's management and operations.

(8) To sue and be sued.

(9) To provide or facilitate provision of benefits and incentives for the benefit of qualified beneficiaries, account owners, contributors, or account beneficiaries as the board's resources allow or as are directed or provided for by the general assembly.

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(10) To conform the education savings programs and other savings programs to federal tax advantages or incentives, as in existence periodically, to the extent consistent with purposes and objectives of this article.

(11) To interpret, in rules, policies, guidelines, and procedures, the provisions of this article broadly in light of the purposes and objectives of this article.

(12) To charge, impose, and collect administrative fees and service charges in connection with any agreement, contract, or transaction under an education savings program or other savings program or services.

(13) To have perpetual succession.

Under the authorizing legislation, the board of the authority also has the responsibility of preparing an annual report regarding the status of M and transmitting the report to N's governor and general assembly. M will also make the report available to designated beneficiaries, account owners, and members of the general public upon request.

M's sole activity is the administration of the N sponsored college savings program. M was established to permit account owners to save for qualified higher education expenses of designated beneficiaries. The authorizing legislation provides that individual accounts and all earnings or interest on accounts are exempt from taxation in N to the extent that those amounts, earnings, and interest are exempt from federal taxation under federal law.

M's program procedures and operations (referred to as "program rules") provide that the terms "qualified higher education expenses" and "eligible educational institution" shall have the same meaning given such terms under sections 529(e)(3) and (5) of the Code. M also has a procedures manual that explains the program rules to account owners and designated beneficiaries.

The N education savings authority has contracted with an independent entity to serve as M's program administrator. M's program rules provide that the program administrator will perform the following functions:

(1) Generally administer and carry out the program according to the directions and policies of the board.

(2) Post contributions to accounts within seven (7) business days following verification that such contributions consist of fully collected funds and allocate investment earnings to accounts quarterly.

(3) Collect all administrative fees, either directly from account owners or accounts, and deposit them into the administrative account in the name of [M] and disburse such funds at such times and in such amounts to [M] as reasonably directed by the authority.

(4) Provide the authority and all appropriate governmental and regulatory agencies all reports and information as may be required or deemed necessary to obtain tax advantages available under state or federal laws.

(5) Provide regular reports at least quarterly to each account owner showing all contributions, withdrawals, and earnings posted to each account during the previous reporting period.

(6) Upon request, provide a copy of the annual report and audited financial statements prepared for the governor and general assembly [of N] to an account owner or beneficiary.

(7) Provide reports at least quarterly to the authority, containing such information as requested by the authority, within seven (7) business days following the end of the quarter.

(8) Comply with terms and conditions of the contract with the authority.

(9) Comply with all laws, rules, regulations, and policies applicable to the program.

An account owner is required to submit an application and execute an adoption 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. A designated beneficiary may be a resident of any state. M's 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.

M's program rules provide that M will maintain a separate account for each designated beneficiary. Account owners will receive a statement each calendar quarter containing beginning and ending account balances, and total contributions, distributions and earnings for the quarter.

M's program rules state that there is no limit on the number of accounts that may be opened for one designated beneficiary by different account owners. However, the program rules provide that the total of all account balances (total contributions and earnings thereon) held on behalf of a designated beneficiary may not exceed the amount necessary to pay for four years of qualified higher education expenses at O, a private university in the state of N. Currently, this amount is $114,548. The program rules provide that the board of the authority may increase the number of years used in this calculation from four to a maximum of five. M will maintain records to ensure that contributions cannot be made to any account, which would result in the total of all account balances held on behalf of a designated beneficiary to exceed $114,548 (including accrued earnings up through the date of contribution).

M's program rules state that contributions must be made in cash only. The rules provide that payment options include such methods as payroll deductions and electronic funds transfer.

M's program rules provide that funds held by the program shall not be used by account owners or designated beneficiaries as security for a loan.

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 the portion of the distribution that constitutes earnings. In the event an account is cancelled for reasons other than those stated below, the program will charge a cancellation fee of $25.00.

The program rules and procedures manual provide that refunds will be made, without penalty, in the event of the death or disability of the designated beneficiary, or receipt by the designated beneficiary of a full or partial scholarship, or an allowance or payment 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 refund. Before the refund is made, an account owner must provide the program administrator with (as applicable) a copy of the designated beneficiary's death certificate or other proof of death acceptable under state law; a written certification from a qualified and licensed physician concerning the disability of the designated beneficiary; or, written third party verification of receipt by the designated beneficiary of a scholarship (or allowance or payment described in section 135(d)(1)(B) or (C)) and the amount of the scholarship, allowance, or payment.

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M's program rules provide that in order to receive a distribution of funds for qualified higher education expenses, the account owner must submit a Distribution Authorization Form to M at least 30 days prior to the designated beneficiary's enrollment at an educational institution, to allow time for the program to confirm that the intended educational institution is an eligible education institution described in section 529(e)(5) of the Code. Invoices from eligible educational institutions for tuition, required fees and room and board must be forwarded, along with an Expense Form, to the program administrator for payment directly to the educational institution. Distributions to pay other qualified higher education expenses are made on a reimbursement basis. For reimbursement of these expenses, legible copies of receipts and proof of payment must be sent to the program administrator along with an Expense Form. At the end of each calendar year for which there was a distribution, the designated beneficiary must certify in a manner specified by the program that the designated beneficiary was enrolled and attended school for the preceding term, and the full amount of any refunds attributable to any prior distributions. If the certification required by the program is not received, the program will consider the distributions for that term to be distributions subject to the penalty, and shall levy the penalty of ten percent of earnings against the remaining balance in the account. If a requested distribution would exhaust the balance in the account, the program will withhold the amount necessary to pay the penalty. On presentation of the certification, the program will distribute the withheld amount to the designated beneficiary, assuming no refunds were received.

The authorizing legislation provides that M's investment policies will be established and implemented by the board of the authority. M permits account owners a choice of two investment strategies. Under the first strategy, contributions are invested on a program-wide basis in one of four mutual fund portfolios based upon the age of the designated beneficiary. The investment allocations among money market funds, bonds, and stocks in the age-banded portfolios are determined by the board of the authority with the assistance of professional financial and investment consultants. Under the second strategy, the account owner may choose to invest contributions to the account in up to four different mutual funds, consisting of two equity funds, a bond fund, and a bond market index fund. The board of the authority determines the assets and allocations in these funds with the assistance of professional financial and investment consultants. Once contributions are invested in a specific option they may not be moved to a different fund. Funds previously invested cannot be invested in new options. Under this second strategy, account owners may vary the percentage of contributions going into each fund once per quarter by submitting an Investment Selection Form. The Form must be received by the program no later than the 15th day of the month preceding the calendar quarter in which the election is to be effective. Changes apply only to new contributions received after the effective date of the new investment selection.

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 provides that M is governed by the board of directors of the N education savings authority. The authority is responsible for the management and operation of M. The board of directors includes the N State treasurer, the N State superintendent of public instruction, the N State commissioner of higher education, the N State budget director, and five members, appointed by the governor of N, who have knowledge, skills, and experience in the academic, business, financial, or education fields. These board members from N's public and educational sectors demonstrate N's active involvement in the administration and management of M.

The authorizing legislation grants the board of the authority the powers necessary to carry out and effectuate the purposes and objectives of the education savings program including the power to: adopt rules, bylaws, procedures, guidelines and policies necessary to carry out the purposes and objectives of the program; retain professional services; establish minimum account deposit amounts; employ persons; recommend legislation; seek rulings relating to qualification of the program and make any changes to the program required to qualify under section 529 of the Code; to sue and be sued; to facilitate provision of benefits and incentives of participants in the program; to charge, impose, and collect administrative fees; and to have perpetual succession. The board also has the responsibility of preparing an annual report regarding the status of M and transmitting the report to N's governor and general assembly. M will also make the report available to designated beneficiaries, account owners, and members of the general public upon request. 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 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's program rules provide that contributions to the plan can only be made in cash pursuant to section 529(b)(2) 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 (or certain other educational assistance), 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. Under the program, distributions for qualified higher education expenses are made directly to eligible educational institutions or to account owners and designated beneficiaries for reimbursement of expenses previously paid, for which the account owner or the designated beneficiary submits proof of payment. If a requested distribution would exhaust the balance in the account, the program will withhold the amount necessary to pay the penalty. On presentation of a certification verifying that the designated beneficiary was enrolled and attended school for the academic period for which the distribution was made and no refunds were received, the program will distribute the withheld amount to the designated beneficiary. 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 provide reports to the account owner each calendar quarter showing account activity for the relevant period pursuant to section 529(b)(4) of the Code. Account information will include the amounts contributed to each account, earnings on the contributions, distributions from the account, and the account balance.

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 plan pursuant to section 529(b)(5) of the Code. The program offers two investment strategies. Under the first strategy, contributions are invested on a program-wide basis in one of four mutual fund portfolios based upon the age of the designated beneficiary. The board of the authority determines the allocations among money market funds, bonds, and stocks in the age-banded portfolios with the assistance of professional financial and investment consultants. Under the second strategy, the account owner may choose to invest contributions in up to four different mutual funds, consisting of two equity funds, a bond fund, and a bond market index fund. The board of the authority determines the assets and allocations in these funds with the assistance of professional financial and investment consultants. Under this second strategy, account owners are permitted to change the investment selection quarterly, provided that changes apply only to subsequent contributions. Amounts previously invested cannot be moved from one mutual fund to a different fund. The ability to select, 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 and designated beneficiaries to use the account as security for a loan pursuant to section 529(b)(6) of the Code.

The board of the authority has determined that the amount necessary to provide for the qualified higher education expenses of a designated beneficiary may not exceed the amount needed to pay for four years of qualified higher education expenses at O, a private university in the state of N. Contributions cannot be made to any account which would result in the total of all account balances (total contributions and earnings thereon) held on behalf of a designated beneficiary to exceed the program limit of $114,548, which is the amount currently needed to pay for four years of qualified higher education expenses at O. 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 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 yours,

/S/

Director, Exempt Organizations
Rulings and Agreements

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