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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:
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Legend:
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O=

Dear Sir or Madam:

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

The information submitted indicates that M was established pursuant to legislation enacted by the O state legislature. The authorizing legislation states that M was established for the following purposes:

> "An educated population being necessary to the social development and economic health of this state, the legislature finds and declares it to be an urgent public necessity to assist young residents of O in obtaining a higher education. Because the state's population is rapidly growing and is diverse, the state is required to use all of the higher education facilities and resources within the state, both public and private, to provide a wide variety of educational environments and instructional options and to preserve the partnership between the state and private or independent institutions of higher education. Therefore, the prepaid higher education tuition program is established to help O students attend the institution that best meets their individual needs."

The enabling legislation enacted by O's state legislature provides that M will be governed by a board of directors composed of O's state comptroller for public accounts, two members appointed by O's governor with advice and consent from the state senate, and four members appointed by the lieutenant governor, at least two of whom must be appointed from a list of persons recommended by the speaker of O's house of representatives.

The legislation authorizing M's formation also provides, in pertinent part, that M's board of directors will have the following powers with regards to the operation of the program:

(1) Adopt an official seal.

(2) Adopt rules to implement the prepaid tuition program.

(3) Sue and be sued.

(4) Enter into contracts and necessary instruments.

(5) Enter into agreements or other transactions with the United States, state agencies, including institutions of higher education, private or independent institutions of higher education, and local governments.

(6) Appear in its own behalf before governmental agencies.

(7) Contract for necessary goods and services and engage the services of private consultants, actuaries, trustees, records administrators, managers, legal counsel, and auditors for administrative or technical assistance.

(8) Solicit and accept gifts, grants, loans, and other aid from any source or participate in any other way in any government program to carry out this subchapter (prepaid tuition program).

(9) Impose administrative fees.

(10) Contract with a person to market the program.

(11) Purchase liability insurance covering the board and employees and agents of the board.

(12) Establish other policies, procedures, and eligibility criteria to implement this subchapter (prepaid tuition program).

Under M's authorizing legislation, M's board has the responsibility for preparing an annual accounting for N, which was established by O state law as a fund outside of O's state treasury. The board is required to provide a copy of this accounting to O's governor and lieutenant governor, speaker of O's house of representatives, O's legislative budget board, legislative audit committee, O's state auditor, and O's higher education coordinating board.

M's sole activity is the administration of the O state prepaid tuition program. The program is designed to enable parents, grandparents, businesses, and others to prepay college tuition at any of O's public colleges or universities. The program can also be used to pay tuition for a child electing to attend a private institution within or outside of O. At the time the contract is purchased, the beneficiary must be a resident of O, or must be the child of a parent who is a resident of O.

The enabling legislation states that the program will provide four options for prepaid educational benefits. These options include the junior college plan, the senior college plan, junior-senior college plan, and the private college plan.

The junior college plan will provide prepayment of tuition and mandatory fees for the beneficiary to attend a public junior college for a specified number of undergraduate credit hours not to exceed the typical number of hours required for a certificate or an associate degree by a public junior college. M's program rules provide that the total number of hours which may be purchased under the junior college plan is limited to 64 credit hours.

The senior college plan will provide prepayment of tuition and required fees for the beneficiary to attend a public senior college or university for a specified number of undergraduate credit hours not to exceed the typical number of hours required for a baccalaureate degree awarded by a public senior college or university. M's program rules provide that the total number of hours which may be purchased under the senior college is 128 credit hours.

The enabling legislation states that the junior-senior college plan will provide for prepayment of tuition and fees for the beneficiary to attend:

(1) a public junior college for a specified number of undergraduate credit hours not to exceed the typical number of hours required to receive a certificate or associate degree awarded by a public junior college and

(2) a public senior college or university for a specified number of credit hours not to exceed the typical number of additional hours required for a baccalaureate degree awarded by a public senior college or university.

M's program rules provide that no more than 128 credit hours may be purchased under the junior-senior college plan. This total is limited to no more than 64 credit hours for attendance at a public junior college and 64 credit hours for attendance at a public senior college or university.

M's program rules provide that its board has the authority to prescribe and change the maximum number of tuition credit hours which can be purchased under each type of plan. M's program rules also provide that the board has the authority to prescribe other limits on the amount of tuition and fees which are payable under a plan.

The private college plan will provide prepaid estimated average private tuition and required fees for the beneficiary to attend a private or independent institution of higher education for a specified number of undergraduate credit hours not to exceed the typical number or hours required for a baccalaureate degree awarded by a private or independent institution of higher education. M's program rules provide that no more than 128 credit hours may be purchased under the private college plan.

Under M's plan contract purchasers have the option of purchasing one year or two years under the junior college plan. Purchasers may purchase benefits for one, two, three, four, or five years under the senior college plan. Contract purchasers have the option of purchasing benefits for one, two, three, or four years under the private college plan. Contract purchasers may purchase benefits of four years only under the junior-senior college plan.

Contract purchasers also have the option of purchasing a supplemental contract for one year of additional benefits under the senior college plan where the purchaser has previously paid for a four year plan. The supplemental contract provides an additional 32 credit hours over and above the 128 hours available under the senior college plan for a maximum of 160 credit hours.

A beneficiary may use any unused undergraduate credit hours to pay the cost of graduate or professional school. M's program rules provide that in such a case the amount paid to the graduate or professional school is equal to the average public charges (if the beneficiary's contract is a public plan contract) or the average private charges (if the contract is a private plan contract) for the year in which the payment is made to the graduate or professional school.

M will provide benefit payments on behalf of the beneficiary directly to the college or university located in O upon enrollment of the beneficiary. M states that a contract for a public plan may be used to pay the actual charges at a private college. M's program rules also permit a contract purchaser, before commencement of benefits, to convert the contract from one plan to another. Payments for attendance at a private college for a year where the original contract provided for a public college will be limited to the average public college charges for that year. M will not pay charges in excess of the average public college charges for attendance at a private college.

M will provide benefit payments under a private college plan in cases where the beneficiary attends a public college. M will pay the actual charges of the public college attended by the beneficiary. M states that in cases where the average private charges for a year exceed the actual expenses charged to a beneficiary for that year by the public college, the excess will be paid or refunded to the contract purchaser, subject to a regular penalty. M's program rules indicate that the regular penalty is equal to 10 percent of the amount refunded.

M's program rules and master agreement provide that in cases where the beneficiary attends an institution located outside of O, M will pay the lesser of the actual charges of the institution attended by the beneficiary or the average public college plan charges or private college plan charges, whichever is applicable, for the academic year for the type of plan chosen under the contract. M will make payments to institutions located outside of O only in cases where the board has received a supporting statement of charges from the out of state institution.

M will provide contracts to purchasers at a price predetermined at the time of purchase. M states that the price of the contract under each type of plan will be determined actuarially by the board of directors after considering such factors as the number of years selected for benefits and whether the program selected is a junior college plan, senior college plan, junior-senior college plan, or private college plan.

The enabling legislation provides that payments of the purchase price of a prepaid tuition contract may be made in lump sum or installment payments. M's general rules require that payments for prepaid tuition contracts be made in cash.

Payments made by contract purchasers under M's program are deposited into N, which, as stated previously, was established by O state law as a fund outside of O's state treasury. Funds deposited into N will belong to the state of O and will include payments made by contract purchasers as well as earnings on such payments.

The authorizing legislation provides that a program participant is required to purchase a contract to acquire tuition benefits for a designated beneficiary. M's program rules provide that the beneficiary of a prepaid tuition contract must be a person younger than 18 years of age or 18 years of age or older and enrolled in high school at the time the purchaser enters into the contract, who has not graduated from high school nor obtained high school equivalency certification, and is either:

(1) a resident of the state of O; or

(2) a non-resident who is the child of a parent who is a resident of the state of O at the time the parent enters into the contract.

Under the enabling legislation the purchaser of a prepaid tuition contract may designate a new beneficiary in place of the original beneficiary. M's general rules and enabling legislation require the substitute beneficiary to be a member of the family of the original beneficiary who meets the requirements of section 529 of the Code on the date the designation is changed.

M's enabling legislation also provides that the terms of a prepaid tuition contract shall be based on an actuarial analysis of:

(1) the rates of increase of:

   (A) tuition and required fees at institutions of higher education; or
   (B) estimated average private tuition and required fees;

(2) expected investment return;

(3) estimated administrative costs; and

(4) the period between the date the contract is entered into and the date the beneficiary is projected to graduate from high school.

M's enabling legislation requires that prepaid tuition contracts contain the following information:

(1) specify the amount and number of payments required from the purchaser on behalf of the beneficiary;

(2) specify the terms under which the purchaser shall make payments, including the date on which each payment is due;

(3) specify the consequences of default;

(4) specify the name and date of birth of the beneficiary of the contract and terms under which another person may be substituted as the beneficiary;

(5) specify the number of credit hours contracted by the purchaser;

(6) specify the type of plan toward which the contracted credit hours shall be applied;

(7) contain an assumption of a contractual obligation by the board to the beneficiary to provide for a specified number of credit hours of undergraduate instruction at a public institution of higher education or private or independent institutions of higher education, not to exceed the typical number of credit hours required for the degree that corresponds to the plan purchased on behalf of the beneficiary;

(8) specify the date the beneficiary is projected to graduate from high school;

(9) contain any provisions the board considers necessary or appropriate.

The authorizing legislation also requires the board to provide annual account information for contract purchasers. This information will include the following:

(1) the amount paid by the purchaser under the prepaid tuition contract;

(2) the number of credit hours originally covered under the contract;

(3) the number of credit hours remaining under the contract; and

(4) any other information the board determines by rule is necessary and appropriate.

M will provide refunds to contract purchasers or their designees upon termination or withdrawal from the program. In case of death or disability of the beneficiary, the contract may be terminated by the contract purchaser without a penalty on the earnings from the amounts paid under the contract. If a contract beneficiary receives a scholarship, the amount of the scholarship will be refunded to the contract purchaser, without a penalty on the earnings portion of the amount refunded.

In general, M will provide refund or termination payments equivalent to the present lump sum actuarial value as of the date of the termination of the average amount of tuition or the estimated amount of private tuition and required fees of junior college plans, junior/senior college plans, and senior college plans or the estimated amount of private tuition and required fees for private college plans, less a required penalty, a cancellation fee, and other required fees. M represents that in such cases the penalty imposed on termination will constitute ten percent on the earnings component of the amounts refunded.

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 pay for the requisite number of credit hours for a baccalaureate degree, an associate degree, or the number of years selected under the contract. M's recordkeeping system will not allow, in any enrollment period, the purchase of any benefits, which when added to the number of credits previously contracted for on behalf of a designated beneficiary, results in an excess of the number of credit hours necessary to obtain a four year baccalaureate degree (or in the case of a five year plan, to complete five years).

M's board is required to furnish to each purchaser an annual statement showing the amount paid by the purchaser under the prepaid tuition contract, the number of credit hours originally covered by the contract, and the number of credit hours remaining under the contract.

M's enabling legislation provides that investment powers will be vested in its board of directors. M's general rules state that contract purchasers and designated beneficiaries shall not have the power to direct the investment of any contribution or earnings on any contribution. M's master agreement also provides that contract purchasers and designated beneficiaries shall not have the power to use the contract as security for a loan.

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 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 O. M's enabling legislation sets forth details on the four types of prepaid plans and the terms to be included in the tuition contracts. M's board of directors will include O's state comptroller for public accounts, two members appointed by O's governor with advice and consent from O's state senate, and four members appointed by O's lieutenant governor with input from the speaker of O's house of representatives. Under M's authorizing legislation the board will have the power to establish rules and regulations governing the operation of the program, including residency requirements for designated beneficiaries, investment decisions regarding program assets, eligibility requirements for participation in the program, terms and conditions for withdrawals and refunds from the program, and applicable administrative fees and charges upon withdrawal. O has demonstrated that it sets the terms and conditions of the program and is actively involved on an ongoing basis in the administration of M.

M will provide for the prepayment of tuition expenses and mandatory fees only at accredited postsecondary institutions for designated beneficiaries as described in section 529(b)(1)(A) of the Code. Program participants are required to purchase a contract to receive tuition benefits for designated beneficiaries under the program. M requires that payments to the program be made only in cash as required by section 529(b)(2) of the Code.

M will provide refunds upon termination of the contract in accordance with the general rules and procedures of its program. In general, M will provide refund or termination payments equivalent to the present actuarial value of the original contract less a penalty of ten percent on the earnings portion of the amount refunded. The refunds may be paid in semi-annual installments, and no interest accrues after the refund is requested. In addition, the program will impose a cancellation fee, except in the case of death or disability of the beneficiary. The expected rate of return on amounts refunded on contracts terminated for designated beneficiaries electing not to go to college is sufficiently low to discourage individuals who do not intend their funds to be used to pay for higher education from investing in an advance tuition contract with M to obtain deferral for federal income tax purposes. Based upon these facts and circumstances, the penalty imposed by M on refunds is a more than deminimis penalty as required by section 529(b)(3) of the Code.

M's board is responsible for preparing an annual accounting for the trust. A copy of this accounting is required by O's legislature to be provided to contract purchasers on request. Further, M maintains a separate account for each qualified beneficiary and will provide annual reports showing account activity for the period in accordance with section 529(b)(4) of the Code.

M's general rules and program procedures prohibit account owners and designated beneficiaries from directing the investment of contributions and earnings in the account. The authorizing legislation and M's general rules and program procedures provide that its investment powers are vested exclusively in its board of directors. Therefore, contract purchasers and designated beneficiaries will not have the power to direct the investment of earnings or contributions to the program as required by section 529(b)(5) of the Code.

M's general rules and master agreement prohibit account owners or qualified beneficiaries from using the prepaid tuition contract as security for a loan as required by section 529(b)(6) of the Code.

M's program procedures will limit the total contributions or contract payments to an amount required to prepay tuition for the number of credit hours required for a baccalaureate degree or an associate degree as determined by the type of plan selected by the contract purchaser and the number of years selected for coverage by the contract purchaser. M's recordkeeping system ensures that M will not allow the purchase of any credit hour which, when added to credit hours previously contracted for the beneficiary, will provide the beneficiary with more than the number of credit hours necessary for a four-year baccalaureate degree. Thus, M's program provides adequate safeguards to prevent contributions on behalf of the designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the 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,

(signed) Marcus S. Owens

Marcus S. Owens
Director, Exempt Organizations
Division