Internal Revenue Service

Department of the Treasury

200024055

Washington, DC 20224

Significant Index No.
529.00-00

Contact Person:

Telephone Number:

In Reference to:
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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 provides that a savings program shall be established in such form as shall be determined by the O advisory commission and may be established as a trust to be declared by the N state treasurer. M was created by a declaration of trust. M's trust document states that the N state treasurer will serve as M's sole trustee.

M's trust document states that M was established to permit a person or persons to make contributions to accounts established for the purpose of meeting the qualified higher education expenses of the designated beneficiaries of such accounts.

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The authorizing legislation established O as an advisory commission. The authorizing legislation states that the O advisory commission was established to ensure the proper administration and management of M. The authorizing legislation states that O will consist of the following members:

(1) The N state treasurer

(2) Two members of N's house of representatives, one of whom shall be a member of the house finance committee, appointed by the speaker of the house.

(3) Two members of the N state senate, appointed by the senate president.

(4) The N state governor, or designee.

(5) Two public members, one of whom shall have business experience, appointed by the governor.

(6) One member representing the college and university system of N, appointed by the chancellor.

(7) One member of the postsecondary education commission, appointed by the members of such commission.

(8) One member representing the regional community-technical college system, appointed by the commissioner.

(9) One member representing the N college and university council, appointed by the members of the council.

(10) One member representing the Q foundation, a quasi-government state agency, appointed by the foundation.

The legislation also provides that O shall have the authority to adopt rules relating to the following:

1. The administration, management, promotion, and marketing of the savings program.

2. Maintaining the savings program in compliance with the Internal Revenue Service standards for qualified State tuition programs.

3. Application procedures and fees for participation in the savings program.

4. Start-up costs for the savings program, with any costs incurred by N for the development of the savings program reimbursed to N by the savings program.

5. (a) Phasing in the savings program and withdrawals from the savings program, so that any policies relating to early withdrawal shall not detrimentally affect investors remaining in the savings program.

   (b) Deterrents to early withdrawals and provisions for hardship withdrawals.

6. Deferred use of funds from the savings program and notification requirements of such deferral.

7. Re-enrollment in the savings program after withdrawal.

M was established to permit account owners (referred to herein as "program participants") to save for qualified higher education expenses of designated beneficiaries. The authorizing legislation provides that funds may be used for postsecondary, undergraduate and graduate education at certain eligible educational institutions. M's 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's sole activity is the administration of the N sponsored college tuition savings program. M has contracted with an independent entity (referred to herein as the "investment advisor") to provide certain administrative, marketing and investment services. The investment advisor will manage and invest the assets held on behalf of program participants and designated beneficiaries. M's trust document provides that its investment policies will be adopted by its trustee. M's trust document further provides that program participants and designated beneficiaries shall not have the power to direct the investment of any contributions or earnings on contributions. Under the terms of the investment agreement between the trustee and the investment advisor, the investment advisor 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 program participant or designated beneficiary, either at the time of initial investment or at any time thereafter. The investment guidelines require the investment advisor to implement an asset allocation

strategy 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.

M will maintain a separate account for each program participant. M's authorizing legislation provides that each prospective program participant must submit an initial application, an executed participation agreement, and accompanying fee to open an account. The application fees will be used to cover M's administrative costs. M's trust document and the authorizing legislation also requires that all contributions to an account be made in cash in whole dollar amounts.

M's trust document provides that contributions to an account may be made by check or electronic funds transfer from a bank account designated by the program participant. Program participants can elect to make monthly contributions to the account through electronic funds transfers. Each such monthly contribution must be at least x dollars. In cases where the monthly contribution election is not made, program participants are required to make an initial contribution of at least y dollars.

M's trust document states that each account established by a program participant 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. M's authorizing legislation provides that income earned from funds invested in the program shall be exempt from N's state tax on interest and dividends to the extent such amounts are used to pay qualified higher education expenses of the designated beneficiary.

M's participation agreement and program rules provide that the trustee 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 established for the benefit of the same designated beneficiary to exceed the maximum permissible investment amount. 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 expenses of the designated beneficiary. M's program rules provide that the maximum permissible investment in any calendar year is an amount equal to the N education index value determined as of the November 30th that immediately precedes the applicable calendar year, multiplied by 5. The N education index value means, as of the determination date, the average of (i) the total tuition, fees, room and board costs to attend R College (a private college located in N) as a full-time undergraduate student for a full academic year and (ii) the total tuition, fees, room and board costs to attend S (a campus of the N state university) as an in-State resident, full-time undergraduate student for a full academic year. The tuition, fees, room and board costs taken into

account will be based on the most recent report of such costs published by the institutions.

The authorizing legislation and M's trust document state that a designated beneficiary need not be a resident of N. M's trust document also provides that a program participant 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.

Under the authorizing legislation, M's trustee is required to make quarterly reports to O regarding the status of M. The authorizing legislation also requires that an account statement be issued to each program participant at least annually. The statement will include the account's beginning balance, contributions, and earnings credited to the account during the reporting period. M's trust document requires M's trustee to keep accurate and detailed accounts of all investments, receipts and disbursements and other transactions. The participation agreement provides that M, through the investment advisor described above, shall provide quarterly reports to program participants concerning the value of each account and the activity in the account, including distributions made from the account.

M's trust document prohibits 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.

The participation agreement provides that program participants may direct distributions from an account at any time by providing M with a distribution notice prior to the proposed distribution. The participation agreement and program rules provide 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 higher education expenses pursuant to an invoice from the institution submitted with the distribution notice, (ii) distributions made pursuant to written requests that are accompanied by written evidence of qualification, (iii) distributions that are paid to the program participant pursuant to a distribution notice that includes written third-party documentation of the death or disability of the designated beneficiary, or (iv) distributions that are paid to the program participant pursuant to a distribution notice which includes written third-party 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 program rules provide that "evidence of qualification" means (i) a bill from an eligible educational institution at which the designated beneficiary is enrolled; (ii) evidence of payment (including, but not limited to, a cancelled check) of qualified higher educational expenses to an eligible educational institution for the benefit of the designated beneficiary; (iii) evidence of payment (including, but not limited to, a cancelled check) of qualified higher educational expenses to a person other than an eligible educational institution for the benefit of the designated beneficiary and evidence that such payment is needed to satisfy requirements for attending an eligible educational institution, such as room and board, or for completing a course of study offered by the eligible educational institution; or (iv) such other evidence from persons not related to the participant or the designated beneficiary as the trustee shall determine sufficient to justify a conclusion that the distribution is to be used for qualified higher education expenses of the designated beneficiary.

The participation 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 ten percent of the earnings portion of the distribution.

M represents that M will amend its program rules to require the program participant to provide a written certification at the time of each distribution request, including the final distribution, that to the actual knowledge of the participant, all distributions previously received from the account have been used for qualified higher educational expenses; and neither the participant nor the designated beneficiary has received a refund from an eligible educational institution at any time prior to the submission of the current distribution request.

Assuming that some participants will be unable to provide this certification, M represents that M's Notice of Distribution form will also include a space where the program participant may report the amount of any prior distribution not used for qualified higher education expenses or the amount of any refund that has been received.

In addition, because this certification may not be sufficient to address the possibility that a program participant or designated beneficiary might fail to incur expenses or receive a refund after an account has been liquidated by a final distribution, M represents that M's Notice of Distribution form will include a written acknowledgment by the participant that he or she is obligated to report to M the receipt by the participant or the designated beneficiary of any refund from an eligible educational institution of an amount that justified a distribution from the account, or if

the designated beneficiary does not incur any qualified higher education expenses previously reported to M.

M also represents that in the event it determines that a ten percent of earnings penalty is applicable, i.e. because a prior distribution was not used for qualified higher education expenses or a refund was received, M will collect the penalty owed on the distribution by debiting the account or, in cases where the account has been closed or has a zero balance, M will prepare a bill for the penalty amount and attempt to collect this amount from the program participant or the designated beneficiary, as applicable. M states that it will implement this procedure as part of its normal operations.

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 O advisory commission to establish N's college savings program. M was created by a declaration of trust and M's sole trustee will be N's state treasurer. N's state treasurer will also serve on the O advisory commission, which will also include: two members of N's house of representatives, one of whom shall be a member of the house finance committee, appointed by the speaker of the house; two members of N's senate, appointed by the senate president; the N state governor, or designee; two public members, one of whom shall have business experience, appointed by the governor; one member representing the college and university system of N, appointed by the chancellor; one member of the postsecondary education commission, appointed by the members of such commission; one member representing the regional community-technical college system, appointed by the commissioner; one member representing the N college and university council, appointed by the members of the council; and one member representing the Q foundation, appointed by the foundation. The membership of the O advisory commission demonstrates N's continuing interest in the administration and management of M.

Under the authorizing legislation, the O advisory commission, which includes M's trustee, will have the authority to establish rules and regulations governing the operation of the program, including rules relating to the following: the administration, management, promotion, and marketing of the savings program; maintaining the savings program in compliance with the Internal Revenue Service standards for qualified State tuition programs; establishing application procedures and fees for participation in the savings program; start-up costs for the savings program, with any costs incurred by the state for the development of the savings program reimbursed to the state by the savings program; phasing in the savings program and withdrawals from the savings program, so that any policies relative to early withdrawal shall not detrimentally affect investors remaining in the savings program, deterrents to early withdrawals and provisions for hardship withdrawals; deferred use of funds from the savings program and notification requirements of such deferral; and re-enrollment in the savings program after withdrawal.

M will provide for the operation of a savings program as described in section 529(b)(1)(A)(ii) of the Code for the purpose of meeting the qualified higher education expenses, as defined in section 529(e)(3) of the Code, of designated beneficiaries, within the meaning of section 529(e)(1) of the Code. M was established pursuant to legislation enacted by N. The interest and dividend income on the contributions to an account are exempt from N's state tax on interest and dividends 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 N State treasurer serves as sole trustee of M and serves on the O advisory commission. 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 trust document and authorizing legislation provide that payments to the program can only be made in cash in accordance with section 529(b)(2) of the Code.

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 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 or 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 investment advisor will have the responsibility for making investment decisions and developing investment strategies for funds held by the trust. No variation in investment strategy based on the investment desires of any particular program participant or designated beneficiary is allowed, either at the time of initial investment or at any time thereafter.

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 five times the average of the cost of tuition, fees, and room and board for full-time undergraduate students who are N State residents attending R College and the S campus of the University of N for a full academic year, as determined by the institutions each year. 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(j)(3) of the Code provides that it may not be used or cited as precedent.

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

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

Sincerely yours,

/S/

Steven D. Arkin
Director, Exempt Organizations
Rulings and Agreements