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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

MAY - 9 2002

Significant Index No.
529.00-00

Contact Person:

ID Number:

Contact Telephone:

Reference:

T:EO:B3

Legend:
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N=
P=
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Dear Sir or Madam:

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

M was established pursuant to legislation enacted by the N State legislature. The authorizing legislation states that the purposes of the authorizing statutes are as follows:

"To assist citizens of N with the expense of college by providing an advanced payment program for tuition at a fixed and guaranteed level for public colleges and universities."

The authorizing legislation has been amended to provide that M is created as a program within the office of the N state treasurer. The N state treasurer will have fhe responsibility for developing and adopting the investment policies, guidelines, and strategies for the assets of M. The chief administrative and operating official for M is the director who is appointed and supervised by the N state treasurer. The authorizing legislation also provides that the director of M must be an N state official or employee of N.

The authorizing legislation provides that P, a nonpublic fund, was created as the repository of all money received by the N state treasurer in conjunction with the operation of M. The legislation states that P shall consist of money received from contributors, acquired from governmental and private sources, and the proceeds from the investments of the fund. The legislation further provides that the N state treasurer will direct the custody and management of P. The authorizing legislation also provides that this fund will be maintained outside of the N state treasury, separate and apart from all public money or funds of N.

The authorizing legislation provides that the N state treasurer will have the responsibility for promulgating regulations to accomplish the following:

(1) Provide for the number and types of contract plans to be offered, including both public and independent colleges and universities;

(2) Prescribe the terms and conditions of the prepaid tuition contracts, including the terms and conditions under which funds may be withdrawn or refunds made from P.

(3) Prescribe the requirements, procedures, and guidelines regarding prepaid tuition contracts.

(4) Provide for the contract contents to include, at a minimum, tuition and credit hour guarantees, beneficiary substitutions, default, withdrawal, refund, termination and penalty information, and contributor payment amounts and conditions.

(5) Provide for the receipt of advance payments.

(6) Prescribe guidelines governing [M].

(7) Provide for the charging and retention of fees for the cost of services and administration.

(8) Prescribe the investment and management policies of P.

(9) Prescribe other policies, procedures, and criteria necessary to implement and

administer [M].

Under M's authorizing legislation, M's director, or his/her designee, has the responsibility of preparing an annual financial report of M and P and submitting the report to the N state treasurer. The legislation also requires that M and P be subject to audit by the N state auditor or his/her designee. Under the authorizing legislation all of the agencies, departments, and institutions of higher learning of N are required to provide reasonable cooperation and assistance to the N state treasurer and the director of M in the implementation of the prepaid tuition program.

The amended authorizing legislation also provides that the N state treasurer has the power to establish a comprehensive investment plan indicating the investment policies for program assets. Under the authorizing legislation the N state treasurer has the power to retain the services of an investment consultant and investment managers.

The authorizing legislation provides that the director, or his/her designee, shall annually evaluate the actuarial soundness of the fund and report this information to the N state treasurer. M's master agreement, which describes the terms and conditions related to participation in M, provides that in the event that N determines P is no longer fiscally or actuarially sound, N may discontinue the program and cancel all tuition prepayment contracts. N will determine the level of refunds dependent upon available funds in P.

The authorizing legislation provides that in the event N determines that the fund should be discontinued and all prepayment contracts canceled, contributors shall be entitled to a refund of all payments made to M plus interest on the contributions from the date payment is made at the rate of four percent per annum. If P does not have sufficient money to make the refund, the deficiencies shall be paid from the general fund of the state.

The authorizing legislation provides that any accrued earnings of N prepaid tuition contracts once disbursed on behalf of an eligible beneficiary will be exempt from all taxation by the State of N and any of its subdivisions, *so* long as they are used for educational purposes in accordance with the provisions of an N prepaid tuition contract.

Program participants are required to purchase a contract to acquire tuition benefits for designated beneficiaries. M's program rules provide that purchasers or qualified beneficiaries must meet the following requirements:

(1) The purchaser (or contributor), if an individual, must be eighteen (18) years of age or older.

(2) The purchaser must designate, on the application, the social security number, the age and the educational grade level of the designated

beneficiary. The purchaser must also indicate on the application the payment plan that will be purchased under the contract.

(3) Only one designated beneficiary is allowed per tuition prepayment contract.

(4) The contributor does not have to specify at the time of application the institution of higher learning that the designated beneficiary will attend.

(5) The projected enrollment date specified on the application shall correspond to the age and/or grade of the designated beneficiary at the time of application.

(6) For each application period, a designated beneficiary is defined as an individual who is under the age of 21 on the first day of the month in which the application period begins, has not completed the 10th grade, and is a resident of N.

(7) The designated beneficiary of a tuition prepayment contract must be an N resident for at least twelve (12) months prior to a contributor's application for a tuition prepayment contract. This requirement does not apply in the case of a child born in N and under the age of one (1) on the date of application.

M's program regulations provide that, upon written request, the contributor may transfer contract benefits to a substitute-designated beneficiary. M's program rules provide that substitute beneficiaries must be members of the family of the beneficiary, as described in section 529(e)(2) of the Code.

M's sole activity is the operation of N's prepaid college tuition program. The program provides for the prepayment of tuition and mandatory fees for students attending public and private or independent colleges and universities in the state as well as institutions outside of the state. M's authorizing legislation and program regulations provide that the term "college or university" means a state-chartered public educational institution of higher learning located in N. M's authorizing legislation provides that the term "independent institution of higher education" means any independent eleemosynary junior or senior college in N whose campus and headquarters are located within N and which is accredited by *S*, a regional accreditation board. M's definition is not as broad as the definition of eligible educational institution described in section 529(e)(5) of the Code, but does not include any institution that does not meet section 529(e)(5).

The enabling legislation provides that the program will offer the following prepaid tuition contracts to obtain benefits for designated beneficiaries: (1) four-year plan (2) two-year plan.

M's program rules provide that a tuition prepayment contract under the four-year plan will provide payment of in-state tuition for not more than four years, or the equivalent number of credit hours. A tuition prepayment contract under the two-year plan will provide payment of in-state tuition for not more than two years, or the equivalent number of credit hours. M's program rules provide that in no event will the total amount paid by the program exceed the cost for a full time, in-state resident student to attend eight semesters at a college or university.

M's program rules further provide that a single individual may be named as the designated beneficiary in up to two (2) tuition prepayment contracts provided both of the contracts naming the designated beneficiary are for the two year benefit option plan. Under no circumstances may a single individual be named as a designated beneficiary on more than one tuition prepayment contract when one of the contracts purchased on behalf of the designated beneficiary provides for the full four years of contract beriefits. In the event tuition prepayment contracts are processed with combined benefits extending beyond four years for the same designated beneficiary, the contract processed first shall be deemed valid and the remaining tuition prepayment contract(s) shall be deemed canceled.

M's program regulations provide that the tuition prepayment contract will not provide for benefits associated with graduate programs. Benefit payments may only be applied toward the attainment of an undergraduate degree. M's program rules provide that the program will not make payments toward expenses of books, non-mandatory fees, dormitory expenses, or other housing. M will maintain a system to ensure that the program rejects contributions in excess of the amount required for four years of tuition at a public institution in N.

M will offer prepaid tuition contracts to purchasers at a price predetermined at the time of purchase. The contract price will depend on the type of plan selected, projected enrollment year, and the number of years elapsing before the beneficiary starts to attend a college or university.

Under M's program rules contract purchasers will be permitted to make payments under one of three different payment options. Contract purchasers can elect to pay the cost of the contract in lump sum. monthly payments over forty-eight (48) months, or continuous monthly payments beginning on the date prescribed in the contract and continuing on a monthly basis until not later than July 1 of the year immediately preceding the projected enrollment date of the designated beneficiary.

M's program rules provide that the term "contributor" (purchaser) means a person who makes or is obligated to make advance payments in accordance with a tuition prepayment contract. or, in the event of multiple individual contributors, the primary party responsible for contract obligations.' Under the authorizing legislation the purchaser is the owner of the contract. Payments for contracts that are not paid in full at the time-of application may be made using a coupon book, automatic deductions from the purchaser's bank account, or payroll deductions.

Tuition benefits under M's program will be transferable to private and out-of-state schools. M's master agreement provides that if a qualified beneficiary enrolls in any regionally accredited private college or an out-of-state regionally accredited private college, M will pay directly to the institution an amount up to, but not in excess of the average tuition, less an administrative fee, of public colleges or universities in N. The qualified beneficiary will be responsible for paying any tuition or fees in excess of the amount transferred.

The program rules require **M** to maintain a separate account for each qualified beneficiary and provide account information annually. Account information will include the amount paid under the contract, the number of years originally covered under the contract. and the number of years remaining on the contract.

The authorizing legislation provides that the earnings in the fund or a portion of the fund may not be used as security for a loan and that an attempt to use the fund, a contract, or a portion of either as security for a loan is void. M's program rules and master agreement also prohibit contract purchasers or designated beneficiaries from using the contract as security for a loan.

M s program rules and master agreement prohibit contract purchasers or beneficiaries from directly or indirectly directing investment of contributions or earnings.

Section 529(a) of the Code provides for the exemption from federal income tax of qualified tuition programs.

Section 529(b)(1) of the Code provides that the term 'qualified tuition program' means a program established and maintained by a State or agency or instrumentality thereof or by one or more eligible educational institutions -

(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 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 tuition program unless it provides separate accounting for each designated beneficiary.

Section 529(b)(4) of the Code provides that a program shall not be treated as a qualified 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)(5) of the Code provides that a program shall not be treated as a qualified 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)(6) of the Code provides that a program shall not be treated as a qualified 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 legislative bodies. The N state treasurer has the authority to establish all rules and regulations governing M's operations. The enabling legislation and M's program rules provide the terms and conditions for the operation **of** the program, including who may purchase prepaid tuition contracts, who may be designated as a beneficiary of the program, the types of benefits the program provides, and the applicable penalties for withdrawal.

M will provide for the prepayment of tuition expenses and mandatory fees only at accredited postsecondary institutions for qualified 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. Earnings on the contributions are excluded from the gross income of the purchaser or beneficiary for purposes of N's state income tax as long as the distributions are used for educational purposes in accordance with the contract. Further, should the program be discontinued, N provides a guarantee to contributors to refund all payments made to M plus interest. Therefore, N has a financial stake in the program. N has demonstrated that it sets the terms and conditions of the program and is actively involved on an ongoing basis in the administration of the program.

Contract purchasers will make payments on the contracts through payroll deductions, automatic deductions from the purchaser's bank account, or direct payments using coupon books. Thus, payments to the program can be made only in cash pursuant to section 529(b)(2) of the Code.

M will maintain a separate account for each qualified beneficiary and provide annual reports showing account activity for the period pursuant to section 529(b)(3) of the Code.

M's amended authorizing legislation indicates that the N state treasurer will be responsible for investing payments and contributions to the program. **M's** program rules prohibit contract purchasers and designated beneficiaries from directing the investment of earnings or contributions to the program pursuant to section 529(b)(4) of the Code.

M s program rules provide that the contract purchasers and qualified beneficiaries are prohibited to use the contract as security for a loan pursuant to section 529(b)(5) of the Code.

M's authorizing legislation and program rules will limit the total contributions or contract payments to an amount sufficient to prepay tuition benefits and mandatory fees limited to the equivalent of four years, or the equivalent number of credit hours, at a postsecondary institution for purposes of the award of a baccalaureate degree. **M** will maintain records to insure that the amounts paid or contributed on behalf of each qualified beneficiary are not in excess of the funds required to pay for the tuition benefits and mandatory fees for four years or eight semesters. **M's** program provides adequate safeguards to prevent contributions on behalf of the designated beneficiary in excess of that necessary to provide for the qualified higher education expenses of the beneficiary pursuant to section 529(b)(6) of the Code.

Based on the above, we rule that **M** meets the requirements for exemption from federal income tax as a qualified tuition program described in section 529 of the Code.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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

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

We are informing **M's** key District Director of this ruling.

Sincerely yours,

(signed) Robert C. Harper, Jr.

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