The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 10252

September 3, 1998

IRS RELEASES PROPOSED REGULATIONS ON QUALIFIED STATE TUITION PLANS

[10252] September 3, 1998 TO: PENSION COMMITTEE No. 58-98 RE: IRS RELEASES PROPOSED REGULATIONS ON QUALIFIED STATE TUITION PLANS

____ The Internal Revenue Service recently released proposed regulations relating to qualified state tuition programs ("QSTPs") under section 529 of the Internal Revenue Code. QSTPs were established under the Small Business Job Protection Act of 1996 and were modified by the Taxpayer Relief Act of 1997. The Service requested comments on section 529 plans in Notice 96-58, 1996-2 C.B. 226. The Service took into consideration the comments received with respect to Notice 96-58 when it drafted the proposed regulations. Section 529 of the Code provides tax-exempt status to QSTPs established and maintained by a state whereby persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary entitling the designated beneficiary to a waiver or payment of qualified higher education expenses, or (2) contribute to an account established exclusively for the purpose of meeting qualified higher education expenses of the designated beneficiary. In addition to other requirements, QSTPs must require the following: (1) contributions be made in cash; (2) neither contributors nor designated beneficiaries direct the investment of any contributions or earnings; (3) no interest in the program be pledged as security for a loan; (4) separate accounting be provided to each designated beneficiary in the program; (5) more than a de minimis penalty on refunds not used for qualified higher education expenses, not made on account of death or disability of the designated beneficiary or not made on account of scholarship or certain other educational allowances. Distributions under a QSTP are includible in gross income of the distributee and a change in the designated beneficiary of an interest in a QSTP is not treated as a distribution if the new beneficiary is a member of the family of the old beneficiary. The proposed regulations provide guidance on the requirements a program must satisfy in order to qualify as a QSTP under section 529. A program meeting these requirements is generally exempt from income taxation. However, a QSTP is subject to the taxes imposed by section 511 relating to the imposition of tax on unrelated business income. An interest in a QSTP will not be treated as debt for purposes of section 514 and therefore, investment income earned on contributions to the program by purchasers will not constitute debt-financed income subject to the unrelated business income tax. The proposed regulations describe when a program is established and maintained by a state or agency or instrumentality of the state. The proposed regulations provide that a penalty is more than de minimis, as required under section 529 for certain distributions, if it is consistent with a program intended to assist individuals in saving exclusively for qualified higher education expenses. Whether a penalty is more than de minimis will depend on the facts and circumstances of the particular program, including the extent to which the penalty offsets the federal income tax benefit from having deferred income tax liability on the earnings portion of any distribution. The proposed regulations provide a safe harbor penalty for programs to adopt in order to satisfy this requirement. For purposes of the safe harbor, a penalty imposed on the earnings portion of a distribution is more than de minimis if it is equal to or greater than 10 percent of the earnings. In order to be treated as imposing more than a de minimis penalty as required by section 529, a program must implement practices and procedures for identifying whether a distribution is subject to a penalty and collecting any penalty that is due. The proposed regulations also provide a practices and procedures safe harbor that may be implemented by a program. The safe harbor provides that distributions are treated as payments of qualified higher education expenses if the distribution is made directly to an eligible educational institution; the distribution is made in the form of a check payable to both the designated beneficiary and the eligible educational institution; the distribution is made after the designated beneficiary submits substantiation showing that the higher education expenses were paid and the program reviews the substantiation; or the designated beneficiary certifies prior to distribution the amount to be used for qualified higher education expenses and the program requires substantiation of the payment within 30 days of making the distribution, the program reviews the substantiation, and the program retains an amount necessary to collect the penalty owed on the distribution if valid substantiation is not produced. Contributions to a QSTP may be placed in either a prepaid educational arrangement or contract, or an educational savings account or both, but not in any other type of account. Section 529 requires separate accounting for each designated beneficiary, and the proposed regulations provide that if the program does not give accountholders annual statements, it must provide transaction information to the accountholder or designated beneficiary upon request. Section 529 states that a program may not permit a designated beneficiary or contributor to directly or indirectly direct the investment of any contributions to the program or any earnings. The proposed regulations provide that a program will violate this requirement if, after an account with the program is initially is established, the accountholder, a contributor or the designated beneficiary subsequently is permitted to select among different investment options or strategies. A QSTP must establish adequate safeguards to prevent contributions for the benefit of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the designated beneficiary. The proposed regulations provide a safe harbor for this requirement based on the actuarial estimate of what is required to pay tuition, fees and room and board expenses for five undergraduate years at the highest cost institution allowed by the program. Comments on the proposed regulations must be received by the Service by November 23, 1998. A public hearing is scheduled for January 6, 1999. Written comments must be sent to CC:DOM:CORP:R (REG-106177-97), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG- 106177-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. Taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. A copy of the proposed regulations is attached. Kathryn A. Ricard Assistant Counsel Attachment