CollegeSavings FOUNDATION

September 7, 2005

Joint Interim Committee on Investments in Higher Education Savings Programs
State Capitol Building
Jefferson City, MO 65101

Dear Members of the Committee:

We appreciate the opportunity to work with the Joint Committee on Investments in Higher Education Savings Programs as you study methods to expand investment opportunities for Missouri parents and families. At Senator Delbert Scott's request, we are providing you with some background information on Section 529 College Savings Plans ("529 plans").

Before beginning, we wanted to clarify that there are actually two types of 529 plans. The first, more common type is 529 savings plans, which allow residents to contribute to an account, the value of which is based on the performance of particular investments, to pay for a beneficiary's qualified higher education expenses. The second, less prevalent type is 529 prepaid tuition plans, which allow residents to establish an account in the name of a student to lock in the costs of future tuition payments. This paper focuses on the more widely used 529 savings plans.

We hope you will find this information helpful, and we are happy to answer additional questions you may have throughout your review process.

Cost of College Education is Rising

A post-secondary education is critical to helping many people reach their full personal and professional potential. Indeed, financing a child's college education can often be the chief economic goal of an entire extended family. One of the benefits of a post-secondary education is increased lifetime earning potential. The College Board reports that the gap in earnings between those with a high school diploma and those with a bachelor's degree (or higher) exceeds $1 million over the course of a lifetime (*College Board, Education Pays, 2004*). Despite the clear economic and personal advantages, the rising cost of post-secondary education poses a significant financial hurdle for many American families.

Missouri, like most states, has seen a significant increase in tuition and fees at its four-year institutions and community colleges. At Missouri's four-year institutions, tuition and fees have increased by an average of 23.8% in the last two years, while tuition and fees at Missouri's community colleges have increased by an average of 16.2% over that same period. The increases over the past five years have been even more dramatic. Tuition costs at four-year institutions and community colleges have risen by 60.1% and 45.0%, respectively. (*Missouri Budget and Legislative Agenda, Making Public Education a Priority, 2005.*) Even more telling, the costs of college have dramatically outpaced growth in family income. In Missouri, real median family income increased by only 10.9% in the 1990s (*Office of Social and Economic Data Analysis, 2002*). Consequently, it is more important than ever to encourage Americans to save for their children's higher education. The states, in cooperation with Congress, have provided a way for Americans to meet these costs by contributing to tax-favored, state-sponsored qualified savings plans created under Internal Revenue Code Section 529.

<u>History of 529 Plans</u>

Michigan and Florida in the late 1980s were the first states to establish prepaid tuition plans to encourage families to save for college. Starting in 1990, a number of states began offering a more flexible means to save for college called college savings plans. The federal tax rules governing contributions to and earnings in college savings plans were uncertain during the early years. To address that uncertainty, Congress approved an amendment to Section 529 of the Internal Revenue Code in 1996 to exempt state programs from federal income taxes on the earnings until the funds were distributed. The law initially taxed the earnings upon distribution at the beneficiary's presumably lower tax rate. The most significant, beneficial change to college savings plans, however, came in 2001 when Congress authorized the tax-free treatment of distributions used for higher educational purposes as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

<u>Success of 529 Plans</u>

With the enhanced federal tax benefit provided by EGTRRA, the increase in the popularity of 529 plans has been spectacular. Today, all 50 states and the District of Columbia offer at least one 529 plan, with many states offering more than one option. Assets in 529 college savings plans rose to an estimated $55.4 billion at the end of the first quarter 2005, up 38.6% from the first quarter of 2004. There were 5.6 million 529 college savings plan accounts with an average account size of about $9,900. (*Investment Company Institute and College Savings Plan Network, March 31, 2005.*) As of the end of the first quarter 2005, assets in the Missouri MOST program were approximately $687.4 million and the total number of accounts was approximately 77,000 (*College Savings Plan Network, March 31, 2005).*

Under the current federal income tax rules, individuals can make after-tax contributions to a qualified 529 plan that then grow tax-free and are free from tax upon withdrawal if used to pay for qualified higher education expenses. While individual states create their own 529 plans, federal law does not require a state resident to invest in his or her own state's 529 plan; instead, it provides a platform upon which a nationwide network of state-sponsored 529 plans can compete, providing Americans with multiple opportunities to save for post-secondary education expenses on a tax-favored basis.

States frequently provide additional incentives for residents to participate in state-sponsored 529 plans. For example, twenty-six states and the District of Columbia permit residents to deduct some or all of their contributions to the state-sponsored plan from their state taxable income. The annual deduction ranges in amount from $1,000 per married couple filing jointly to an unlimited deduction in a handful of states. Under the existing Missouri MOST program, state residents can receive a deduction of up to $8,000 per taxpayer or $16,000 per married couple filing jointly. In addition, some states provide further incentives to state residents, such as small matching grants for qualifying families or access to scholarship opportunities.

529 Plan Market Structure

A common framework for 529 plans involves investors purchasing interests, units or shares in a trust established by a state or its instrumentality and trust assets being invested according to stated investment objectives. The state typically engages an investment management firm to manage the investment of trust assets. In most states, trust assets are invested in mutual funds offered by one or more fund families. States also engage broker-dealers to serve as primary distributors for the shares in their 529 plans. In many cases, primary distributors enter into selling agreements with other broker-dealers to provide further distribution channels to customers. Many states also market their 529 plans directly to investors and some states offer their 529 plans directly and through broker-dealers.

Some, but not all, states receive some program funding to cover their costs in establishing and maintaining their 529 plans. For most states, the fees received are quite small. We are not aware of a state that commingles this fee with their general fund. In most states, the bulk of the fees associated with the 529 plans are received by the private sector firms providing investment, administrative, marketing, or operational management services.

Regulation of 529 Plans

Interests in 529 plans are deemed to be municipal securities for purposes of the federal securities laws. This means they are not subject to the Securities Act of 1933 or the Securities Exchange Act of 1934, other than the anti-fraud provisions and broker-dealer regulation by the Municipal Securities Rulemaking Board ("MSRB") and Securities Exchange Commission. Because the issuers of 529 plans are state governmental entities, 529 plans are also exempt from the Investment Company Act of 1940. 529 plans are, of course, subject to the laws of the states that offer the plans.

Brokerage firms selling 529 plans are subject to MSRB rules, which are designed, first and foremost, to protect investors and the public interest. MSRB rules obligate brokerage firms to deal fairly with investors, not to engage in any deceptive, dishonest or unfair practices, and to provide investors with information vital to making investment decisions. The MSRB monitors the 529 plan market closely and has been adopting rule changes, issuing interpretive guidance, conducting outreach and speaking to the 529 plan industry on a regular basis.

The MSRB has adopted a number of rules in furtherance of the broad purposes of ensuring the protection of investors and the public interest. Among the most important of these are the primary customer protection rules (fair dealing, suitability, and fair commissions and transaction prices) that require broker-dealers to observe the highest professional standards in their activities and relationship with customers. For example, the suitability rule requires a brokerage firm recommending to a customer a 529 plan have reasonable grounds for believing the recommendation is suitable, based on information available about the investment and information on the customer's financial status, tax status, investment objectives, and other relevant information. In addition, the MSRB also has adopted professional qualification standards for financial advisors that sell and supervise 529 plans. Financial advisors and supervisors that sell or oversee the sale of 529 plans must either be qualified generally to sell or supervise 529 plans or must pass special qualification exams geared toward 529 plans.

Disclosure of 529 Plans

The College Savings Plan Network ("CSPN"), the states and the financial services industry have been involved in clarifying and enhancing the disclosure of 529 plans. CSPN was formed in 1991 as an affiliate to the National Association of State Treasurers to provide an invaluable networking opportunity for all state officials to gather and share their unique innovations and experiences in an effort to improve 529 plans. In 2004, CSPN adopted the first set of detailed disclosure principles for its membership to use in their offering materials. These principles provide guidance on standards for summary information, risk factors, fees, federal and state tax information, performance data and a number of other areas of disclosure. To date, 45 states, including Missouri and the District of Columbia have implemented the first set of disclosure principles. CSPN, at its recent annual meeting, adopted its second set of disclosure principles, which enhances and clarifies certain disclosure matters related to the comparability of one 529 plan to another.

We hope this information provides a useful overview of 529 savings plans. If you have any questions, please do not hesitate to call Kevin McMullen at 309-766-4288 or Kim Chamberlain at 212-720-0611.

Regards,

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The College Savings Foundation (CSF) is a Washington, D.C.-based not-for-profit organization with the mission of helping American families achieve their education savings goals, by working with public policy makers, media representatives and financial services industry executives in support of education savings programs. CSF serves the education savings industry as a central repository of information and an expert resource for representatives of state and federal government, institutions of higher education and other related organizations and associations. A primary focus of CSF is building public awareness of and providing public policy support for 529 plans — an increasingly vital college savings vehicle. CSF's members include firms that offer 529 college savings programs and/or participate in those programs as investment managers; associate members include law firms, accounting and consulting firms, governmental bodies and non-profit agencies and individuals who support CSF and its mission.

The Securities Industry Association brings together the shared interests of more than 550 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated $227.5 billion in domestic revenue and $305 billion in global revenues.