



## Tax and Legal Considerations for 529 Plans

### **Federal Tax Law Features**

529 college savings plans are characterized by three principal types of federal tax benefits. First, investment earnings from a plan are excluded from gross income of both the account owner and the beneficiary for federal income tax purposes if used to pay "qualified higher education expenses." Qualified higher education expenses generally include tuition, fees, books, supplies and room and board for students who attend at least half-time. Investment earnings not used to pay qualified higher education expenses will be subject to taxation and a penalty for the tax year in which the earnings are distributed, subject to certain exceptions. Second, federal tax law permits a single lump-sum gift of up to the five-year cumulative limit to be made for tax-free gifting, as opposed to making separate annual gifts, for purposes of the annual federal gift tax limitation. Third, contributions made to an account generally are excluded from the estate of the contributor for federal estate tax purposes. Account owners, other contributors and beneficiaries, as well as dealers and others involved in marketing 529 college savings plans, are advised to consult with their tax professionals on these and other federal tax consequences, limitations and conditions of investing in 529 college savings plans. The federal tax consequences can differ significantly depending upon the specific facts and circumstances.

### **State Tax and Other Benefits**

Many states offer favorable state tax treatment or other valuable benefits to their residents in connection with investments in their home state's 529 college savings plan. Any state-based benefit offered with respect to a particular 529 college savings plan should be one of many appropriately weighted factors to be considered in making an investment decision. Account owners of 529 college savings plans are advised to consult with their financial, tax or other adviser to learn more about how state-based benefits (including any limitations) would apply to their specific circumstances and also may wish to contact their home state's or any other state's 529 college savings plan to learn more about the features, benefits and limitations.

### **Federal Securities Laws**

Although most 529 college savings plans have been modeled after mutual funds or funds of funds, these plans are considered municipal fund securities because they are municipal securities issued by a state or state-authorized agency. The role of the state in issuing the plans means 529 college savings plans are not subject to regulation under federal securities laws. In particular, in structuring a 529 college savings plan, the state or agency is not required to meet the basic requirements set forth in the [Investment Company Act](#), including, among other things, registration with the [Securities and Exchange Commission](#), preparation of a prospectus and statement of additional information, daily calculation of net asset value, and establishment of a board of directors that includes independent directors. While the plans may be subject to these exemptions from federal securities laws, municipal securities dealers that market 529 college savings plans must comply with [MSRB rules](#).

MSRB rules establish basic protections for customers purchasing dealer-sold 529 college savings plans. A key rule is [MSRB Rule G-17](#), on fair dealing, which establishes the principle that dealers must deal fairly with all persons and must not engage in any deceptive, dishonest or unfair practice.

*Disclosures.* In the case of sales of out-of-state 529 college savings plan interests to an investor, the MSRB views Rule G-17 as requiring the dealer to make at or before the time of trade, the following disclosures:

- Depending on the laws of the investor's or designated beneficiary's home state, favorable state tax treatment or other benefits that may be available only if the investor invests in the home state's 529 college savings plan
- Any state-based benefit offered with respect to a particular 529 college savings plan should be one of many appropriately weighted factors to consider in making an investment decision; and
- The investor should consult with his or her financial, tax, or other adviser to learn more about how state-based benefits (including any limitations) would apply to the investor's specific circumstances and also may wish to contact his or her home state or any other 529 college saving plan to learn more about the features, benefits and limitations of that state's 529 college savings plan.

The out-of-state disclosure obligation may be met if the disclosure appears in the program disclosure statement. Most, if not all, program disclosure statements include this disclosure.

*Advertisements.* Dealers that assist states with the marketing of 529 college savings plans are subject to MSRB rules related to marketing and advertisement. Investors should be aware that under [MSRB Rule G-21](#), specific statements and information must be included in an advertisement, and that the dealer cannot publish an advertisement that it knows or has reason to know is materially false or misleading.

- Some of the information that must be included in 529 college savings plan advertisements includes statements to the effect that:
- An investor should consider the investment objectives, risks, and charges and expenses associated with investing in the 529 college saving plan before investing;
- More information about the 529 college savings plan is available in the issuer's program disclosure statement;
- Dealer's status as the underwriter, if the advertisement identifies a source from which an investor may obtain the program disclosure statement and if the dealer that publishes the advertisement is the underwriter for such 529 college savings plan;
- The program disclosure statement should be read carefully before investing.

In addition, the advertisement may be required to include the following disclosures:

- A source from which the investor may obtain the program disclosure statement; and
- A statement to the effect that an investor should consider, before investing, whether the investor's or the designated beneficiary's home state offers any state tax or other benefits that are only applicable for investment in such state's qualified tuition program.

Also, there are disclosure requirements relating to performance data. Among the required disclosures relating to performance data is a statement that the use of past performance is not indicative of future investment performance.

*Point-of-Sale Required Disclosures.* In all transactions with investors, dealers must provide certain basic disclosures under MSRB rules. MSRB Rule G-47 requires dealers to disclose, at the point-of-sale, all material facts about the transaction known by the dealer, as well as material facts about 529 college savings plan that are reasonably accessible to the market. The 529 plan's program disclosure statement is often the source of the information, which dealers are required to provide to each investor at or before the transaction settlement date of the 529 plan purchase.

*Suitability of Recommended Transactions.* Dealers must also make a suitability determination for recommended transactions in 529 plans as required by MSRB Rule G-19. A suitability determination should be based on a number of factors, including the investor's financial status, tax status and

investment objectives. In addition, state-based tax benefits should be one of the weighted factors in analyzing the suitability of a recommended transaction. The existence of state-based benefits does not mean that an in-state 529 college savings plan is superior to an out-of-state 529 college savings plans; so at the plan-level, dealers should be evaluating portfolio management, investment choices offered by the plan and fees before making a recommendation.

In addition, at the plan-level, when making a recommendation about an investment option, including any class of shares, the dealer must also consider an investor's investment objectives, including the number of years until withdrawals are expected to be made in determining which share class would be suitable for an investor.

Investors with questions regarding the suitability of a particular 529 college savings plan should ask their financial professional about how a suitability determination is made. Dealers must maintain records for each investor of the information used in making recommendations of a particular product.

*Churning and Rollovers.* Dealers are prohibited from recommending transactions that are excessive in size and frequency, in view of information known to the dealer about the customer's financial background, tax status and investment objectives. Investors should be aware of a dealer recommending roll-overs from one 529 college savings plans to another with a frequency that causes the investor to lose any possible federal tax benefits. Such recommendation may, depending on the facts and circumstances, be violating [MSRB Rule G-19](#) and [Rule G-30](#), on commissions. Similarly, dealers should not recommend investments in one or more 529 college savings plans in amounts that would exceed the amount reasonably needed by the designated beneficiary to pay for qualified higher education expenses. Information known about the designated beneficiary (e.g., age and number of years until college) generally would be important in making a suitability determination.

*Commission and Fees.* All 529 college savings plans charge fees and expenses that vary among plans, but can also vary within a single 529 plan. Given the multiple classes of shares and fees associated with 529 college savings plans, dealers must ensure that they do not engage in transactions primarily designed to increase commission revenues.

Under [MSRB Rule G-30](#), on prices and commissions, dealers are prohibited from selling 529 plans to a customer for a commission or service charge in excess of a price that is fair and reasonable. In instances where a dealer offers multiple 529 college savings plans and consistently recommends that the customer invest in plans and share classes that offer the highest commissions, the dealer may, depending on the facts and circumstances, be in violation of [MSRB Rule G-17](#) if the recommendation does not reflect a legitimate investment-based purpose.

Dealers must provide to investors, by no later than the settlement of the transaction, written disclosure of the amount of any fee received by the dealer in connection with the distribution of a 529 college savings plans.

*Non-Cash Compensation.* Generally, dealers are prohibited from accepting non-cash compensation, which is any form of compensation that is not cash received in connection with a primary offering of municipal securities, including the sale of interests in 529 college savings plans. [MSRB Rule G-20](#) permits sales contests that involve gifts or payments to employees of dealers other than the dealer sponsoring the contest, as long as certain conditions are met, because such contests have been deemed to constitute "compensation for services." However, the general fair practice principles apply, meaning dealers must avoid engaging in any marketing or other practices that would result in an investor being treated unfairly because of the enticement of sales incentives. An investor should exercise due diligence and ask questions if there is reason to believe that a particular 529 college savings plan is being recommended over another on grounds other than the merits of the investment.