Exempt Organizations

Section 529 Programs

Notice 2001-81

This notice provides guidance regarding certain recordkeeping, reporting, and other requirements applicable to qualified tuition programs described in § 529 of the Internal Revenue Code, in light of certain amendments made to § 529 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16, 115 Stat. 38) (EGTRRA).

Among other changes to § 529, EGTRRA: (1) expands the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions; (2) provides an exclusion from gross income for distributions from a State § 529 program (and, beginning in 2004, a prepaid tuition program established and maintained by one or more eligible educational institutions) which are used to pay for qualified higher education expenses of the designated beneficiary; (3) repeals the requirement that a § 529 program impose a more than de minimis penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary; and (4) replaces that penalty with an additional 10-percent tax on the amount of a distribution from a § 529 program that is includible in gross income (with certain exceptions). In general, these amendments are effective for taxable years beginning after December 31, 2001.[1]

In light of these changes, and to give § 529 programs adequate time to implement appropriate recordkeeping and reporting procedures, the Internal Revenue Service and the Treasury Department are issuing this guidance, which they intend to incorporate in final regulations under § 529. Section 529 programs and their

[1] Unless otherwise indicated, references herein are to § 529 of the Internal Revenue Code, as amended by EGTRRA.

participants may rely on this notice pending the issuance of final regulations under § 529.

a. Imposition of a penalty and verification of purpose of a distribution.

As currently in effect (prior to the effective date of EGTRRA), § 529(b)(3) provides that a program is not treated as a qualified § 529 program unless it imposes a more than de minimis penalty on any refund of earnings that is 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 certain scholarships or other educational assistance received by the beneficiary. Prop. Treas. Reg. § 1.529-2(e) provides rules on de minimis penalties and procedures for verifying the use of distributions and imposing and collecting penalties.

EGTRRA repeals § 529(b)(3), effective for taxable years beginning after December 31, 2001. Therefore, the final regulations under § 529 will provide that, with respect to any distributions made after December 31, 2001, a § 529 program will no longer be required to verify how distributions are used or to collect any penalty. However, with respect to any distributions made on or before December 31, 2001, a § 529 program must continue to verify whether the distribution is used for qualified higher education expenses of the beneficiary and to collect a more than de minimis penalty on nonqualified distributions.

b. Reporting of distributions.

Section 529(d) provides that a § 529 program shall make reports regarding the program to the Internal Revenue Service and to designated beneficiaries regarding contributions, distributions, and such other matters as the Internal Revenue Service may require. Prop. Treas. Reg. § 1.529-4 requires a State tuition program to report on Form 1099-G, Certain Government Payments, the earnings portion of any distribution made during the year, together with other information such as the name, address and TIN of the distributee. A § 529 program must furnish a statement to the distributee on or before January 31st of the year following the calendar year in which the distribution is made. In addition, a § 529 program must file Form 1099-G on or before February 28th of the year following the calendar year in which the distribution is made.

These reporting requirements continue in effect for distributions made in 2001. Thus, with respect to any distributions made in 2001, a § 529 program must furnish statements to the distributees on or before January 31, 2002, and file returns on Form 1099-G on or before February 28, 2002.

In light of the expansion of § 529 to include prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions), the Internal Revenue Service will issue a new form, Form 1099-Q, for taxable years beginning after December 31, 2001. A copy of Form 1099-Q is available on the IRS website at www.irs.gov.

c. Calculation of earnings.

1. In general.

Section 529(c)(3)(A) provides that a distribution from a § 529 program is includible in the gross income of the distributee in the manner as provided under § 72, to the extent not excluded from gross income under any other provision of Chapter 1 of the Code. Section 529(c)(3)(D)(iii) provides that, except to the extent provided by the Secretary, the value of the contract, income on the contract, and the investment in the contract are to be computed as of the close of the calendar year.

2. Recordkeeping requirements with respect to rollover contributions.

Section 529(b)(3)[2] states that a program must provide a separate accounting for

[2] Section 529(b)(4) was renumbered as § 529(b)(3) by EGTRRA.

each designated beneficiary. Prop. Treas. Reg. § 1.529-2(f) requires a § 529 program to maintain records with respect to the designated beneficiary of each account showing the total investment in the account and any earnings attributable thereto.

In the case of a contribution to a § 529 account that represents a transfer from a Coverdell education savings account described in § 530(b)(2)(B), a transfer of proceeds of a qualified U.S. Savings Bond described in § 135(c)(2)(C), or a "rollover" of amounts from another § 529 program account (each, a "rollover contribution"), the recipient § 529 program must determine the basis and earnings portions of the amounts contributed. (See Prop. Treas. Reg. § 1.529-3(a)(2), which provides that the earnings portion of the rollover amount must be added to the earnings of the account that received the contribution.)

Although this requirement was not changed by EGTRRA, § 529 programs have indicated that there is some confusion about the requirement that a § 529 program determine and maintain records that reflect the basis and earnings portions of any rollover contribution. Accordingly, it is expected that final regulations will clarify that, when accepting a contribution, a § 529 program must ask whether the contribution is a rollover contribution from a Coverdell education savings account, a qualified U.S. Savings Bond, or another § 529 program. If the contribution is a rollover contribution, the § 529 program must determine the earnings portion of the contribution, and add that amount to the earnings recorded in the account to which the rollover contribution is made. Until the § 529 program receives appropriate documentation showing the earnings portion of the contribution, the program must treat the entire amount of the contribution as earnings in the § 529 account receiving the distribution. For this purpose, "appropriate documentation" means: (1) in the case of a rollover contribution from a Coverdell education savings account, an account statement issued by the financial institution that acted as trustee or custodian of the education savings account that shows basis and earnings in the account; (2) in the case of a rollover contribution from the redemption of qualified U.S. Savings Bonds, an account statement or Form 1099-INT issued by the financial institution that redeemed the bonds showing interest from the redemption of the bonds; and (3) in the case of a rollover contribution from another § 529 program, a statement issued by the distributing § 529 program that shows the earnings portion of the distribution.

3. Rollover statement between § 529 programs.

In the case of any direct transfer (i.e., trustee-to-trustee rollover) between § 529 programs, the distributing program must provide to the receiving program a statement setting forth the earnings portion of the rollover distribution within 30 days after the distribution or by January 10th of the year following the calendar year in which the rollover occurred, whichever is earlier. This rule is effective for direct transfers between § 529 programs that occur on or after January 1, 2002.

4. Timing of earnings calculation.

Consistent with § 529(c)(3)(D), the proposed regulations provide that the earnings portion of any distribution is determined by applying an earnings ratio, generally the earnings allocable to an account as of the close of the year divided by the total account balance as of the close of the calendar year, determined by adding back the amount of all distributions made during the year. See Prop. Treas. Reg. § 1.529-1(c).

In response to comments received on the proposed regulations, and consistent with the Secretary's authority under § 529(c)(3)(D)(iii) to adopt a different rule, the Treasury Department and the Internal Revenue Service expect that final regulations will revise the time for determining the earnings portion of any distribution from a § 529 account. It is expected that final regulations will provide that, effective for distributions made after December 31, 2002, programs will be required to determine the earnings portion of each distribution as of the date of distribution. In the case of direct transfers between § 529 programs, this requirement is effective for distributions made after December 31, 2001. In the case of any State program for which this change would require legislation and whose State legislature has a biennial legislative session, the program will have until January 1, 2004, to conform to this method of calculating earnings.

5. Aggregation of Accounts.

Section 529 (c)(3)(D)(i) provides that to the extent provided by the Secretary, all § 529 programs of which an individual is a designated beneficiary shall be treated as one program. Prop. Treas. Reg. § 1.529-3(d) provides that all accounts maintained by a § 529 program for the benefit of a designated beneficiary shall be treated as a single account for purposes of calculating the earnings portion of any distribution. Based on comments received on the proposed regulations, it is expected that the final regulations will provide that only accounts maintained by a § 529 program and having the same account owner and the same designated beneficiary must be aggregated for purposes of computing the earnings portion of any distribution. For this purpose, a State that has both a prepaid § 529 program and a § 529 savings program should consider each program separately for purposes of calculating the earnings portion of any distribution from either the prepaid or the savings program. These changes will apply for purposes of the earnings calculation only, and will not affect the application of § 529(b)(6) (prohibition on excess contributions)[3]. The § 529(b)(6) limit will continue to be applied based upon all accounts, both savings and prepaid, in programs established and

[3] Section 529(b)(7) was renumbered as § 529(b)(6) by EGTRRA.

maintained by the State for the benefit of the same designated beneficiary.

Comments on Future Guidance Invited

The Internal Revenue Service invites comments on the matters described in this notice and any other matters relating to § 529 and the regulations thereunder. Please send written comments by March 25, 2002, to: CC:ITA:RU (Notice 2001-81), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submission may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (Notice 2001-81), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC. Alternatively, 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.gov/prod/tax_regs/regslist.html. Comments will be available for public inspection.

DRAFTING INFORMATION

The principal author of this notice is Monice Rosenbaum of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Rosenbaum at (202) 622-6070 (not a toll-free number).