529 College Savings Plans:
Lessons Learned for State-Sponsored Retirement Initiatives

Presented by

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STATE OF CONNECTICUT
RETIREMENT SECURITY BOARD

Summary: 529 Parallels for Retirement Plans

- **State actions create the momentum for change**

- **Resolution of federal challenges is an absolute growth driver of plans, assets and accounts accumulated nationwide**

- **Governance and operating models reflect fundamental decisions about state resources and internal competencies**

- **Evolution of the 529 industry reflects:**
  - **Power of the promise of higher education**
  - **Increasing awareness of burden of student loans**
  - **Opportunities for related private sector businesses**
  - **Greater visibility for the solutions offered by 529 plans**
  - **Simplification of plan access and investments**

States as Policy Leaders: Recognizing the Challenges

- **States created tuition prepayment plans to enable families to limit exposure to rapidly increasing tuition costs:**
  - **Fundamental public policy is to encourage families to save for higher education**
  - **Early plans allowed families to lock-in future tuition costs at then-current rates**
  - **States assumed plans were tax-exempt entities**

- **States today understand the future implications of an aging population with insufficient retirement savings:**
  - **Underlying policy is to provide savings vehicles for employees who otherwise lack an employer-provided plan**
  - **Challenge is providing a state-mandated solution without running afoul of Department of Labor and ERISA**

- **Internal Revenue Service attempts to tax earnings on tuition prepayment trusts led States to promote a federal solution**

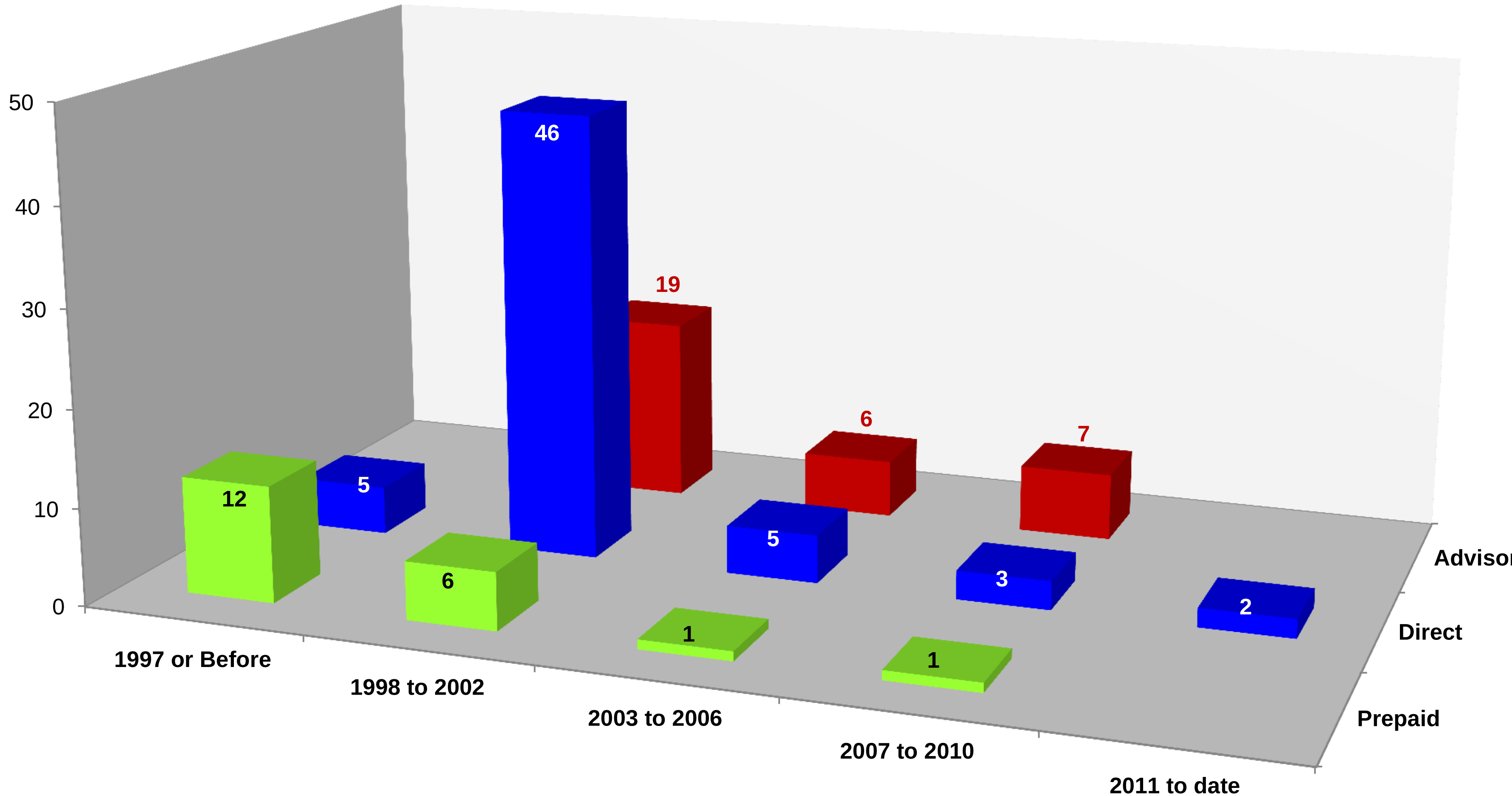
Federal Resolution: Industry Growth Driver

- Congressional and regulatory actions provided favorable tax treatment for college savings plans:
  - Section 529 enacted in 1996, enhanced in 1997, 2001 and 2006
  - Treasury and IRS private letter rulings and notices clarified key tax and operating issues
  - SEC and MSRB provided additional direction on securities laws and best practices

- With federal advantages in place, States rapidly offered 529 plans with specific state incentives:
  - Twenty eight States offer state tax benefits for investments in their state plan only
  - Six States offer tax benefits for investments in ANY plan
  - Many states include other benefits (e.g., creditor protection, financial aid preferences, matching grants or scholarships)

- Favorable federal tax treatment also signaled wealth and investment management opportunities for the private sector:
  - Plans offered directly to the public ("Direct Plans") was the starting point
  - Plans offered only through advisors ("Advisor Plans") presented additional distribution opportunities

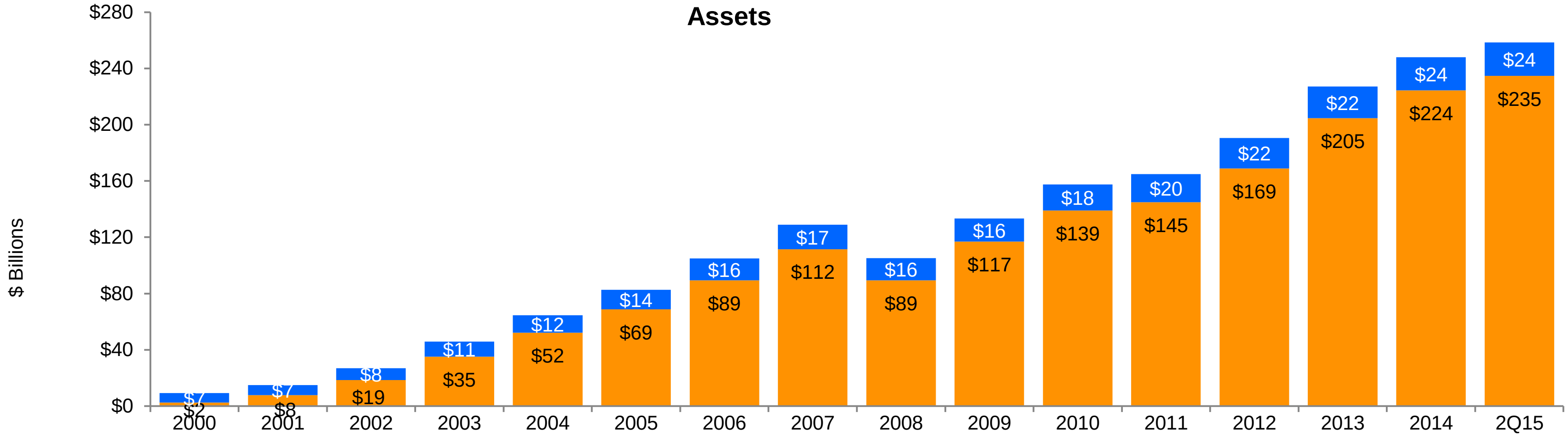
Industry Growth Driver: Launch of 529 Plans Over Time

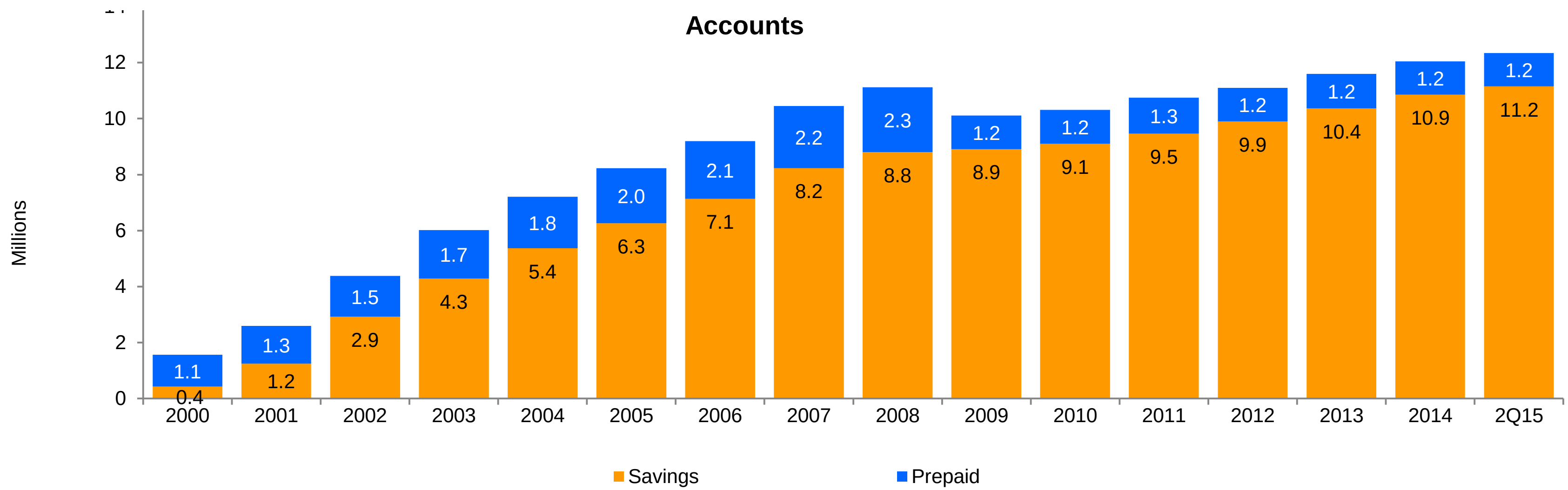


Source: Savingforcollege.com for year of launch data as of October 1, 2015

Certain plans are counted twice, including District of Columbia (direct and advisor) and University of Alaska (prepaid and direct)

Industry Growth Driver: Growth of National 529 Market





Source: College Savings Plans Network ("CSPN") and certain states including AL, DC, IL, ME, NJ, NM, SC, SD and VA as of June 30, 2015

Governance and Management Structures: Legislative Direction

- **State legislatures made fundamental decisions about governing and managing bodies:**

Governance Structures of 529 Savings Programs			
Treasurers / Comptrollers (Chair or Sole Trustee)		Student Loan or Debt Issuing Authorities	Independent 529 or Higher Education Related Entities
Alabama	Nebraska	Colorado	Alabama
California	New Hampshire	Kentucky	Arkansas
Connecticut	Nevada	Massachusetts	Arizona
District of Columbia	New York	Maine	Delaware
Illinois	Oklahoma	North Carolina	Florida
Indiana	Oregon	New Jersey	Georgia
Iowa	Pennsylvania	Utah	Idaho
Kansas	Rhode Island	Vermont	Hawaii
Louisiana	South Carolina		Louisiana
Maryland	South Dakota		Maryland
Maine	Tennessee		Minnesota
Michigan	Texas		Montana
Mississippi	West Virginia		North Dakota
Missouri			New Mexico
			New York
			Ohio
			Virginia
			Wisconsin
27 States (54%)		8 States (16%)	18 States (36%)

Program Operating Models: Board Direction

- Services necessary to “establish and maintain” a 529 plan include:
  - Program administration (including compliance with applicable laws and regulations)
  - Participant recordkeeping (contributions and distributions)
  - Customer service (call centers)
  - Investment management (structuring plan investment options based upon professionally managed underlying investments)
  - Marketing and outreach (educating potential participants)

- Three 529 Program Operating Models:

Program Operating Models of 529 Savings Plans		
State-Run	Hybrid	Turnkey
Colorado (Stable Value and Smart Choice) Louisiana North Carolina Tennessee Virginia (inVEST and College Wealth) Utah	Florida Iowa Direct Ohio Direct Pennsylvania	All other Plans
8 Plans (9%)	4 Plans (4%)	81 Plans (87%)

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Program Operating Models: Variations of Solutions

Operating Model	Administration	Recordkeeping	Customer Service	Investment Management	Marketing
State-Run	State attorneys or outside counsel	State-managed proprietary or licensed system	State staffing	Options designed internally or with investment consultant advice	State employees
Hybrid	Varies	Varies	Varies	Varies	Varies
Turnkey	Outsourced to Plan Manager	Outsourced to Plan Manager	Outsourced to Plan Manager	Options designed by Plan Manager and recommended to governing / managing body	Outsourced to Plan Manager

Lessons Learned: 529 Parallels for Retirement Plans

- **State tuition prepayment plans foreshadowed Section 529 plans:**
  - **States proactively created solutions for public savings needs**
  - ***Lesson: consumers will be comfortable with state-led initiatives***

- **States provided the impetus for federal solutions, which drove industry growth:**
  - **Senators from key tuition prepayment states led the charge for Section 529**
  - ***Lesson: a favorable ruling on ERISA will accelerate success of state-supported retirement plans***

- **States understand the distinctions between operating models:**
  - **Fundamental decisions about plan management demonstrate sophistication in assessing risk, control and cost factors and providing oversight**
  - ***Lesson: 529 plans offer existing operational frameworks for pooled investment trusts operated for the benefit of individual investors***

- **The need to save coupled with increased visibility of 529 plans has attracted more investors:**
  - **529 plans have become less expensive, more accessible and easier to understand**
  - ***Lesson: states can achieve economies of scale through simplification, increased size and even tax or other incentives***

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Appendix

Earliest 529 Days: State-led Initiatives

- **Several States create tuition prepayment plans relying on State statutory authority:**
    - **Florida (1987)**
    - **Ohio (1989)**
    - **Kentucky (1990)**
    - **Pennsylvania (1993)**
    - **Texas (1996)**
    - **Michigan (1988)**
    - **Alabama (1990)**
    - **Alaska (1991)**
    - **Massachusetts (1995)**
    - **Virginia (1996)**

- **IRS taxes the Michigan Education Trust ("MET") beginning in 1988, and MET sues for tax refund in 1990**

- **November 1994, Sixth Circuit Court of Appeals holds that MET is a tax-exempt agency of the State of Michigan**
    - **MET should be exempt from federal taxation**
    - **IRS refunds taxes paid by MET**

- **Other States enact legislation providing similar tax-exempt status**

Federal Solution

- Senators Bob Graham (D-FL) and Mitch McConnell (R-KY) jointly introduce legislation seeking tax-exemption for qualified state tuition plans

- Small Business Job Protection Act of 1996 creates Section 529:
  - Confers tax-exempt status on "qualifying state tuition plans"
  - Identifies prepaid tuition and savings plans
  - Defers tax on undistributed earnings but taxes earnings at withdrawal as ordinary income (like a non-deductible IRA)

- Taxpayer Relief Act of 1997:
  - Room and board are qualified higher education expenses ("QHEE")
  - Creates favorable estate and gift tax provisions

- Proposed Treasury Regulations released in 1998

- Treasury issues various Private Letter Rulings regarding qualification under Section 529

- Securities and Exchange Commission issues various No-Action Letters related to States' exemptions from certain securities laws

Federal Solution, cont'd

- Economic Growth and Tax Relief Reconciliation Act of 2001:
  - Authorizes tax-free withdrawals through 2010
  - Creates the possibility of private prepaid plans

- Treasury Notice 2001-55:
  - Permits changes in investment selection without changing beneficiary (clarifying "investment direction")
  - Leads to individual mutual funds in savings plans

- Treasury Notice 2001-88:
  - Eases recordkeeping obligations (e.g., eliminates substantiation of expenses)
  - Removes plans from collecting federal penalties for non-qualified withdrawals
  - Creates Form 1099-Q

- Pension Protection Act of 2006:
  - Makes permanent tax-free withdrawals for QHEE
  - Introduces possibility of Treasury regulations to "prevent abuse" of 529

Five Phases of 529 Plan Development

- **Before the Federal Solution (1987 to 1997)**
  - ***Largely a State-led, defined benefit market***
  - ***Participants "buy" future tuition; they don't make investment choices***

- **The Earliest 529 Days (1998 to 2002)**
  - ***States and the private sector recognize growth opportunities***
  - ***Defined contribution-style investments are initially limited to asset allocation, fund-of-funds structures***
  - ***Broader investment choices emerge in late 2001***

- **Re-Bids Begin (2003 to 2006)**
  - ***Market opportunities increase competition among plans and private sector providers***

- **Market Pressures Take Over (2007 to 2010)**
  - ***Volatility leads to new products and new messages***
  - ***Federally-insured investments grow in numbers and appeal***

- **Growth Rebounds (2011 to Present)**
  - ***529 market recovers but undergoes consolidation among providers***