

**DESCRIPTION OF THE CHAIRMAN'S MARK OF S. 335,  
A BILL TO AMEND THE INTERNAL REVENUE CODE  
OF 1986 TO IMPROVE 529 PLANS, AS MODIFIED**

Scheduled for Markup  
by the  
SENATE COMMITTEE ON FINANCE  
on April 29, 2015

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

The Senate Committee on Finance has scheduled a committee markup on April 29, 2015 of S. 335, a bill to amend the Internal Revenue Code of 1986 to improve 529 plans, as modified. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the proposal.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Mark of S. 335, a Bill to Amend the Internal Revenue Code of 1986 to Improve 529 Plans, as Modified* (JCX-83-15), April 27, 2015. This document can also be found on the Joint Committee on Taxation website at [www.jct.gov](http://www.jct.gov).

## A. Qualified Tuition Programs

### Present Law

#### Section 529 qualified tuition programs

##### In general

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a “prepaid tuition program”). Section 529<sup>2</sup> provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.<sup>3</sup> In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a “savings account program”). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary’s higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”)<sup>4</sup> whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

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<sup>2</sup> Except where otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>3</sup> For purposes of this description, the term “account” is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

<sup>4</sup> Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term “account owner,” which is a commonly used term among qualified tuition programs.

### Qualified higher education expenses

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the Code, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time. For taxable years 2009 and 2010 only, qualified higher education expenses included the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used by the beneficiary or the beneficiary's family during any of the years a beneficiary was enrolled at an eligible institution.

### Contributions to qualified tuition programs

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (*i.e.*, income on accounts in the plan is not subject to current income tax).

A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to direct (directly or indirectly) the investment of any contributions (or earnings thereon) more than two times in any calendar year, and must provide separate accounting for each designated beneficiary. A qualified tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan.

### Distributions from qualified tuition programs

Distributions from a qualified tuition program are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified higher education expenses incurred for the beneficiary.<sup>5</sup>

If a distribution from a qualified tuition program exceeds the qualified higher education expenses incurred for the beneficiary, the amount includible in gross income is determined, first, by applying the annuity rules of section 72<sup>6</sup> to determine the amount which would be includible

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<sup>5</sup> Sec. 529(c)(3)(B)(i) and (ii)(I).

<sup>6</sup> Under section 72, a distribution is includible in income to the extent that the distribution represents earnings on the contribution to the program, determined on a *pro rata* basis.

in gross income if none of the amount distributed was for qualified higher education expenses and, then, reducing that amount by an amount which bears the same ratio to that amount as the qualified higher education expenses bear to the amount of the distribution.<sup>7</sup>

For example, assume a taxpayer had \$5,000 in a qualified tuition program account, \$4,000 of which was the amount contributed. Also assume the taxpayer withdraws \$1,000 from the account and \$500 is used for qualified higher education expenses. First, the taxpayer applies the annuity rules of section 72 which results in \$200 being included in income under section 72 assuming none of the distribution is used for qualified higher education expenses. Then the taxpayer reduces the \$200 by one-half because 50 percent of the distribution was used for qualified higher education expenses. Thus, \$100 is includible in gross income. This amount is subject to an additional 10-percent tax (unless an exception applies).

The Code provides that, except as provided by the Secretary of the Treasury (“Secretary”), for purposes of this calculation, the taxpayer’s account value, income, and investment amount, are generally measured as of December 31<sup>st</sup> of the taxable year in which the distribution was made. The Secretary has issued guidance providing that the earnings portion of a distribution is to be computed on the date of each distribution.<sup>8</sup>

In the case of an individual who is the designated beneficiary for more than one qualified tuition program, all such accounts are aggregated for purposes of calculating the earnings in the account under section 72. The Secretary has provided in guidance that this aggregation is required only in the case of accounts contained within the same 529 program, having the same account owner and the same designated beneficiary.<sup>9</sup>

### **Description of Proposal**

The proposal includes the provisions of S. 335, and adds minor technical modifications described below.<sup>10</sup>

S. 335 makes three modifications to section 529.

First, S. 335 restores the 2009 and 2010 rule permitting qualified higher education expenses to include the purchase of any computer technology or equipment, or Internet access or related services. However, S. 335 modifies that rule by providing that such expenses qualify only if such technology or services are to be used primarily by the beneficiary (and not the beneficiary’s family) during any of the years the beneficiary is enrolled at an eligible institution.

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<sup>7</sup> Sec. 529(c)(3)(A) and (B)(ii).

<sup>8</sup> Notice 2001-81, 2001-2 C.B. 617, December 10, 2001.

<sup>9</sup> *Ibid.*

<sup>10</sup> S. 335 was introduced in the Senate by Senator Grassley on February 2, 2015. S. 335 is cosponsored by Senators Casey, Burr, Warner, Roberts, Cardin, Scott, Ayotte, Isakson, McConnell, Collins, Schumer, Fischer, Gardner, Moran, Wicker, and King.

Second, S. 335 provides that, in the case of a designated beneficiary who has received multiple distributions from a qualified tuition program in the taxable year, the portion of a distribution that represents earnings is now to be computed on a distribution-by-distribution basis, rather than an aggregate basis, such that the computation applies to each distribution from an account. The following example illustrates the operation of S. 335: Assume that two designated savings accounts have been established by the same account owner within the same qualified tuition program for the same designated beneficiary. Account A contains \$20,000, all of which consists of contributed amounts (*i.e.*, it has no earnings). Account B contains \$30,000, \$20,000 of which constitutes an investment in the account, and \$10,000 attributable to earnings on that investment. Assume a taxpayer were to receive a \$10,000 distribution from Account A, with none of the proceeds being spent on qualified higher education expenses. Under present law, both of the designated beneficiary's accounts would be aggregated for purposes of computing earnings. Thus, \$2,000 of the \$10,000 distribution from Account A ( $\$10,000 * \$10,000/\$50,000$ ) would be included in the designated beneficiary's income. Under S. 335, the accounts would not be aggregated for purposes of determining earnings on the account. Thus, because Account A has no earnings, no amount of the distribution would be included in the designated beneficiary's income for the taxable year.

Third, S. 335 creates a new rule that provides, in the case of a designated beneficiary who received a refund of any higher education expenses in connection with a withdrawal from enrollment, any distribution that was used to pay such refunded expenses shall not be subject to tax if the designated beneficiary recontributes the refunded amount to the qualified tuition program within 60 days of receiving the refund, to the extent that such recontribution is not in excess of the refund.

The proposal makes the following minor changes to S. 335:

The proposal makes a technical amendment to section 529(e)(3)(A)(iii), to incorporate the definition of computer equipment and software into section 529.

The proposal repeals 529(c)(3)(D). This is a technical amendment that, consistent with S. 335, will eliminate any requirement that the earnings portion of any distribution be determined by aggregating accounts. The Secretary of the Treasury retains authority to prescribe regulations as necessary to administer section 529(c)(3), under its general grant of authority under section 529(f).

The proposal provides that a tax-free recontribution of refunded tuition amounts to a qualified tuition program is not limited to the withdrawal of a student from an eligible educational institution. The proposal also provides for a special transition rule allowing recontributions of amounts refunded after December 31, 2014 to be made not later than 60 days after the enactment of this provision.

### **Effective Date**

The proposal allowing computer technology to be considered a higher education expense is effective for taxable years beginning after December 31, 2014. The proposal removing the aggregation requirement in the case of multiple distributions is effective for distributions made

after December 31, 2014. The proposal allowing a recontribution of refunded qualified higher education expenses in the case of withdrawal from enrollment is effective for qualified higher education expenses refunded after December 31, 2014.



## B. Estimated Revenue Effects

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Fiscal Years [Millions of Dollars]												
<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2015-20</u>	<u>2015-25</u>
-1	-2	-2	-3	-3	-4	-5	-6	-7	-8	-10	-15	-51

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