A Review of the Golden State Scholarshare

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(College Savings Plan)

The Small Business Job Protection Act of 1996 created Sec. 529 of the Internal Revenue Code. IRC Sec. 529 (to which California conforms) allows each state to sponsor a qualified state tuition program (QSTP). A QSTP allows a person to:

- 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 or
- to make contributions to an account established for the purpose financing a beneficiary's future higher education expenses.

The tax on earnings attributable to prepayments or contributions is deferred until the earnings are distributed from the QSTP, and then they are taxed to the beneficiary. If the full amount of the funds is not used by the beneficiary, the remaining account balance can either be rolled over to another beneficiary or returned to the original donor.

California established its version of a Sec. 529 QSTP on January 1, 1998, by enacting the California Golden State Scholarshare Trust Act (Scholarshare) (Ch. 97-851, R&TC Secs. 17140, 17410.3, 23711 and 24328). Scholarshare is a tax-deferred contribution plan. Other state programs use names such as the U.Fund, Postsecondary Education Plan or the College Savings Program.

The Scholarshare plan and the other state plans have many implications that affect federal and state income, gift and estate taxes. Some of these federal consequences are acknowledged in the different plans. To completely understand California's program and others, a thorough examination is necessary.

Most QSTPs are fundamentally similar. Each state's plan can set its own minimum and maximum contribution levels and charges for management, and each state adopts a unique investment strategy. Any adult can contribute to most states' plans, and the funds may be used to pay for the higher education costs in any state, not just those incurred in the sponsor's state. Deciding which plan to choose is a difficult task, but not an impossible one.

California conforms to IRC Sec. 529 and allows the same beneficial tax treatment to taxpayers who invest in any state's plan. Each state plan is administered by a trust, and the funds are generally invested in special mutual funds established for the state plan. California's plan is administered by TIAA-CREF, while other state plans are administered by Merrill Lynch, Fidelity, etc. Investment choices are made by the plan administrator, not by the contributor. The only investment choice available to the contributor is to select the state plan that seems best.

The information provided in this discussion is for California's Golden State Scholarshare Plan.

Plan—In General

Any adult or emancipated minor living in the United States can open a Scholarshare account on behalf of a designated beneficiary. The money contributed to the account is placed in a trust, which invests in special portfolios designed to meet the needs of beneficiaries of different ages. The portfolios combine stocks, bonds and money market instruments. For younger beneficiaries allocations are weighted more heavily toward equities, and as beneficiaries become older, allocations are weighted more heavily toward bonds and money market instruments.

Earnings in a Scholarshare account grow on both a federal and California tax-deferred basis until the beneficiary is ready to go to college. Then, the funds in the account can be used to pay for qualified higher education expenses at eligible schools in California or anywhere in the country. Upon disbursement the beneficiary pays income tax on the earnings. If the account balance is not spent on qualified educational expenses, it can either be rolled over to a qualified beneficiary or paid back to the original contributor.

Management of the Scholarshare portfolio is governed by a seven-member Scholarshare Investment Board, which includes the California State Treasurer, the Director of Department of Finance and the California Secretary for Education. TIAA-CREF Tuition Financing, Inc. provides all investment management and administrative services to Scholarshare.

A word of caution: As with all tax plans the devil is in the details. The summary seems so simple, but the plans aren't. Each phrase has one or more conditions, definitions, exceptions or other complications. Research your choice of plan carefully before taking the plunge.

Benefits—In General

The income tax benefit of funding a Scholarshare account is that the earnings are tax-free until withdrawn. The gift tax benefit is that the amounts used to fund the plan are considered present gifts for gift tax purposes, and the owner can elect to treat amounts in excess of the current year's limit on tax-free gifts as subsequent years' gifts for up to four more years, thus accelerating the use of the present gift exclusion.

If a student is using a QSTP to pay for educational expenses, the student or the student's parents may also claim a federal HOPE scholarship credit or a lifetime learning credit for qualified expenses covered by the QSTP, as long as other eligibility requirements for the credits are met (IRS Notice 97-60, 1997-2 C.B. 310). However, any amount contributed to an education IRA on behalf of a designated beneficiary during a taxable year in which an amount is also contributed to a QSTP on behalf of the same beneficiary is treated as an excess contribution to the education IRA.

Detriments—In General

Under California and federal law account owners of QSTPs may not exercise any investment direction over their accounts. So, Scholarshare's assets cannot be invested by the owner. Instead, the investments are determined by the plan sponsor, and they are usually conservative.

Because the income is deferred into years in which the child may be working part-time, the income may be taxed at a higher rate than if the money were given as a gift directly to the (minor) beneficiary and taxed at the lower tax rate each year. In addition, by investing in the plan, income is taxed as ordinary income, when distributed, compared to a direct gift to a minor, which is subject to tax each year often at the lower long-term capital gains tax rates.

Who Can Contribute?

People who have reached their majority (including an emancipated minor) may contribute funds to open a Scholarshare account. An account owner, or contributor, can also be a trust, estate, partnership, association, company or corporation, a custodian under the California Uniform Transfers to Minors Act, or a state or local government agency (Ed. Code Sec. 69980(h)).

Unlike many IRA investments, such as the education IRA, there are no limitations on the contributor's adjusted gross income.

Who Can Be a Beneficiary?

An account can be set up for any beneficiary who can use the funds for post-secondary educational expenses. So, it is possible for someone to be both the contributor and the beneficiary, but only if the person still has a need for college or post-graduate funds. In addition, although these accounts are traditionally set up for a child or grandchild, there is no requirement that the contributor and the beneficiary be related. In fact, the plans can be set up for any qualified individual. Businesses can, in fact, use a Scholarshare account as part of their benefits package to lure qualified employees. However, it appears that payments would not be a tax exempt fringe benefit.

Separate/Multiple Accounts

Separate accounts must be set up for each beneficiary. That is, a taxpayer cannot group children or grandchildren into one account.

Although separate accounts must be set up for the same beneficiary if they are opened by different contributors, Scholarshare's investment manager combines the accounts when determining the maximum contribution or the taxation of the distribution.

Duration of Plan

In California a plan can remain open until 10 years after the beneficiary reaches the age of 35. If the beneficiary is age 35 or older at the time he or she is named as the beneficiary, a full 10-year period is permitted from the time that person becomes the beneficiary. A further extension may be granted upon approval by Scholarshare. Any balance remaining undistributed at the end of this period must either be rolled over to another qualified beneficiary or distributed to the account owner.

If a beneficiary graduates from an institution of higher education or has no intention of further attendance at an institution of higher education, the contributor may:

- Hold the investment until a later date when the student may decide to attend college;
- Transfer the benefits to another member of the beneficiary's; or
- Withdraw the money, in which case the contributor will be subject to a 10 percent penalty on the earnings portion and the balance taxed at the contributor's (not the beneficiary's) tax rate.

The Scholarshare plan will subtract a penalty of 10 percent of the earnings, except in the case of the beneficiary's death or disability.

Contribution Limits

Maximum Scholarshare contribution

Each designated beneficiary has a maximum contribution limit that applies to all accounts opened for him or her. Maximum contribution limits are based on the beneficiary's age and the estimated costs for the most expensive California higher education institution for the year that the beneficiary would normally enroll. In setting these contribution limits, the Scholarshare Trust:

- Determines the year in which people the same age as the beneficiary would normally attend college;
- Estimates the present value of college costs for four years (five years on January 1, 2000) at the most expensive institution in the State of California; and
- Uses the difference in projected earnings and projected inflation in college costs, calculates the maximum investment in today's dollars that can be allowed so that the Scholarshare account does not exceed the projected future cost of attending college.

The investment limits are reviewed and recalculated each year to reflect the most recent data for college costs and investment yields. Because the calculations are based on estimates, no assurances are given that the amount held in an account(s) for any beneficiary, even if the maximum contribution limit is met, will be sufficient to pay the qualified higher education expenses of the beneficiary.

Note

The maximum contribution for a beneficiary varies from state to state.

Although separate plans for one beneficiary can be funded by different donors, for example by a grandparent and a parent for the (grand)child, the maximum contribution is calculated on a per beneficiary basis. The number of contributors does not change the maximum contribution.

Calculation of maximum contribution

The calculation of the amount needed to fund a five-year undergraduate education is the amount needed in current investment dollars that will not exceed (when invested) the future cost of attending college based on:

- The year in which the beneficiary will normally begin to attend college;
- The cost of five succeeding years of college education, using the most expensive California college beginning on that date; and
- The expected rate of return on the investments in the Scholarshare fund.

The maximum based on the above criteria for the Golden State Scholarshare in the year 2000 is:

Beneficiary's Year of Birth	Maximum Contribution
2000 or 2001	$110,033
1998 or 1999	116,108
1996 or 1997	122,797
1994 or 1995	129,544
1992 or 1993	135,713
1990 or 1991	141,396
1988 or 1989	146,609
1986 or 1987	151,418
1984 or 1985	155,491
Pre-1984	158,146

Minimum contribution

Although federal law does not appear to specify a minimum contribution, a contributor can open a Scholarshare account with a regular minimum contribution of $15 per pay period through payroll deduction at a participating employer. If the account is opened using a check, money order, electronic funds transfer, or automatic withdrawals from a bank account, the initial and subsequent contributions must be at least $25.

How Are the Scholarshare Funds Invested

Prior to July 2000 Scholarshare funds were invested under with Age Based Allocation Option made up of stock, bond and money market funds. They include these four TIAA-CREF mutual funds (and their benchmarks):

- Growth Equity Fund—This fund seeks favorable long-term return through capital appreciation (Russell 3000 Growth);
- Institutional International Equity Fund—This fund is broadly based, mostly foreign corporations seeking long-term capital appreciation (Morgan Stanley Capital International EAFE);
- Bond Fund—This fund invests primarily in U.S. Treasury and U.S. agency securities and corporate bonds and mortgage-backed securities (Lehman Brothers Aggregate Bond Index); and
- Money Market Fund—This fund invests in money market-type investments.

New investment options

Beginning July 2000 a participant may choose from either the Age Based Allocation Option or one of the following:

- A 100 percent equity option comprised of domestic and international stock mutual funds;
- A 10 percent social choice equity option; and
- A guaranteed option that will provide a specified rate of return.

It does not appear that once elected, the investment choice can be changed. The proposed regulations under Sec. 529 state that the selection of the investment alternatives can be made "only at the time the initial contribution is made establishing the account."

Asset Allocation

The Scholarshare funds for each beneficiary under the original investment plan are invested in a combination of the four mutual funds based on the age of the beneficiary, as follows:

		Asset Allocation Percentage			
Beneficiary's Year of birth	Investment Horizon	Growth Equity Fund	Intrn'l Fund	Bond Fund	Money Market
2000 or 2001	17-18 years	70%	10%	20%	0%
1998 or 1999	15-16 years	60%	10%	30%	0%
1996 or 1997	13-14 years	50%	10%	40%	0%
1994 or 1995	11-12 years	45%	10%	45%	0%
1992 or 1993	9-10 years	40%	5%	55%	0%
1990 or 1991	7-8 years	35%	5%	60%	0%
1988 or 1989	5-6 years	30%	5%	65%	0%
1986 or 1987	3-4 years	20%	5%	65%	10%
1984 or 1985	1-2 years	15%	5%	45%	35%
Pre-1984	Withdrawal	10%	5%	35%	50%

How to Contribute

Contributions must be made to TIAA-CREF. (They are the operators of the plan and the world's largest pension funding organization. They also administer the New York College Savings Program.)

Cash Contributions Only

Contributions must be made in cash. It is not possible to roll stocks or mutual fund accounts into a Scholarshare plan. If a participant wants to fund the Scholarshare (or any other prepaid state tuition plan), he must sell the stock, recognize the gain and contribute the cash to the plan.

Withdrawals

Distributions may be made from a Scholarshare account for the qualified higher educational expenses of the designated beneficiary. The amount of the withdrawal is determined by the account owner, not the beneficiary.

Amounts may also be distributed as a rollover to another beneficiary (discussed below). In addition, the account balance can be distributed to the account owner at any time. However, such a distribution will be subject to a 10 percent penalty unless it is due to the death or disability of the designated beneficiary.

Note

The donor never loses control of the Scholarshare account. The beneficiary cannot force the donor to use the funds in the account, which can be returned to the donor at any time, even if the beneficiary still needs funds for his or her higher education.

Qualified educational expense

In general, qualified distributions are those payments made for the beneficiary's higher educational costs. These costs include tuition, fees, room and board, books, supplies and required equipment. Qualified institutions include both undergraduate and graduate education at any accredited university in the United States.

A qualified institution for the purposes of this provision is any eligible educational institution described in Sec. 481 of the Higher Education Act of 1965, as in effect on August 5, 1997, which is eligible to participate in a program under Title IV of the act and is eligible to participate in U.S. Department of Education student aid programs. A student can therefore study abroad, if that education is paid through an exchange program as part of a qualified United States university. Direct enrollment in most foreign universities does not appear to be covered.

Under the above definition, various accredited institutions will be covered including post-secondary educational institutions offering credit toward a:

- Bachelor's degree;
- Associate's degree;
- Graduate level or professional degree; and
- Certain vocational institutions.

Clarification: Although the amount that can be contributed is based on the cost of a five-year undergraduate education, the qualified expenses can be used for many vocational schools and for graduate schools for as many years as needed or up to age 35 or 10 years after the plan is established, whichever is later. (Note: The time limit may be extended if approved by the plan.)

For room and board to qualify, the beneficiary must be enrolled at least half-time. In that case the cost of on-campus housing is a qualified expense. If the student is living at home, the amount of room and board cannot exceed $1,500 per academic year for beneficiaries who reside at home with parents or guardians, or $2,500 per academic year for beneficiaries who live off campus. For beneficiaries who live in housing that is owned or operated by the educational institution, the cost cannot exceed that which is normally assessed for most of its residents.

Planning Point

Suppose the child is attending a very expensive private college or graduate school, and the participant must supplement the Scholarshare account because the funds don't cover the cost. If the payment is made to the school directly for education, it is not considered a taxable gift. Therefore, an individual may make direct payments to the school for education and use the Scholarshare to pay for books, supplies and room and board and still retain the entire $10,000 gift tax exclusion.

Disbursement of funds

At the present time, it is unclear how a Scholarshare account will be disbursed. It appears that all qualified funds will go to the educational institution to cover tuition, fees, etc. Any remaining amounts will be transferred by the educational institution to the beneficiary, presumably to pay for those costs not owed to the institution, such as for room and board, books, and other qualified expenses.

There are pending regulatory changes that will permit direct payments to the beneficiary. Payments will not be permitted without adequate proof that they are for qualified expenses.

Transfer to Another State's Plan

As the current law stands, once a state's program is selected, it appears that the funds must stay in that state's program and cannot be rolled into another state plan. The reason for this is to prevent the use of transfers to get around the investment rules that prohibit the account owners to invest or direct the investment of the funds in the account. It appears, however, that if the beneficiary is changed, the funds may be moved into another state's program.

You can roll over accumulations from another state's qualified tuition savings program provided that the other state's plan allows for such transfers. Any rollovers from other state plans will count toward the maximum contribution limit for the beneficiary. Also, the Scholarshare beneficiary must be a "member of the family" of the beneficiary in the other state's qualified tuition savings plan.

Transfer to a New Beneficiary

If the fund has a balance and either the beneficiary is age 45 (maximum allowable age) or it is unlikely the funds will be needed for the beneficiary's education, then the money can be transferred to a new beneficiary. To be eligible, the new beneficiary must be a qualified relative of the original beneficiary, not the contributor. The original contributor (the account owner) is the person who selects the new beneficiary. In order to qualify for a tax free rollover, the new beneficiary must be qualified. Any rollover must be made within 60 days of the date of distribution from the plan. It is not clear whether this must be a complete rollover or whether a partial rollover is permitted.

Change of account owner/contingent owner

The account owner may change ownership of the account to another individual who is eligible to be an account owner (an adult or an emancipated minor). This does not require a change in beneficiaries.

By informing Scholarshare an account owner can name a Contingent Account Owner who automatically becomes the owner upon the owner's death. Once made, the designation may be changed or revoked at any time. If the change is contingent upon death, a certified copy of the death certificate, or other proof of death, and a participation agreement must be sent to Scholarshare to effect the change.

Qualified relatives for rollover purposes

Qualified relatives are those who are related to the beneficiary under the relationship test in Sec. 152(a)(1)-(8) relating to dependency exemptions, plus the spouse of those dependents. That list includes:

- A son or daughter, or a descendant of either;
- A stepson or stepdaughter;
- A father or mother, or an ancestor of either;
- A stepfather or stepmother;
- A brother, sister, stepbrother or stepsister;
- A son or daughter of a brother or sister (nephew or niece);

- A brother or sister of the father or mother (uncle or aunt);
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law; or
- The spouse of the designated beneficiary also qualifies.

Penalty on Distribution

If the beneficiary does not attend college, or if the amounts available in the plan exceed the qualified expenses, the owner/donor may choose not to roll over the plan. In that case, the account balance is returned to the contributor. Unless the cancellation is due to the death or disability of the beneficiary, the plan imposes a cancellation penalty. The IRS temporary regulations state that the safe harbor penalty is 10 percent. Scholarshare has adopted the 10 percent penalty, which applies only to the earnings. The penalty is paid to the plan, not to the IRS or to the FTB. In addition to the penalty, the donor must pay federal and state income tax on the accumulated earnings when they are received.

It is unclear who will receive this penalty. Is it the fund manager, the state of California or is it given to the other Scholarshare beneficiaries on a pro-rata basis?

Planning Point

If the owner needs the funds, the plan's assets can be distributed to the owner rather than to the beneficiary. There are apparently no requirements that the owner wait until the beneficiary no longer needs the funds for higher education costs. This conclusion is based on the Scholarshare legislation that provides that an account owner may cancel a Scholarshare account at will.

Income Taxation

Contributions

No deduction is allowed for federal or California income tax purposes for contributions to Scholarshare. Some states do allow deductions to their residents for contributions to their plans.

Annual earnings

Earnings in the Scholarshare program, which are credited to the beneficiary's account, are not subject to either federal or California income tax to either the account owner or the account beneficiary. Once the funds are distributed, the earnings are then taxed to the beneficiary.

Taxable amounts

A portion of each withdrawal for qualified educational costs will be included in the beneficiary's taxable income. The calculation of this taxable amount is made at the close of each year, and it combines all the beneficiary's accounts. The amount taxable is determined as if the distribution is from an annuity in which the total basis (contributions) is recovered pro rata. The rest of the distribution is taxable as ordinary income.

> **Example of Taxable Income**
>
> In 1999 \$10,000 was contributed to an account for Baby X. In 2010 the balance in the account was \$28,000. If \$6,000 was distributed for qualified expenses, \$3,857 would be taxable as follows:
>
> Calculation of return of basis:
>
> \$10,000/\$28,000 × \$6,000 = \$2,143
>
> Calculation of taxable amount:
>
> \$6,000 – \$2,143 = \$3,857
>
> The next year, 2011, the balance in the account, prior to another \$6,000 qualified distribution, is \$24,200 (a 10-percent return for the year). The taxable income would be \$4,052 calculated as follows:
>
> Calculation of return of basis:
>
> (Basis = \$10,000 – \$2,143 = \$7,857)
>
> \$7,857/\$24,200 × \$6,000 = \$1,948
>
> Calculation of taxable amount:
>
> \$6,000 – \$1,948 = \$4,052
>
> See Treas. Reg. Sec. 1.529 for more examples.

Form 1099-G reporting

Although it seems strange, the regulations state that the plan must distribute a copy of Form 1099-G (normally used to report state tax refunds) on or before January 31 each year to each distributee. It must include the amount distributed. Whether the plan must calculate the taxable amount is not addressed in the regulations. Treas. Reg. Sec. 1.529-4(b)

Backup withholding

Amounts distributed are not subject to backup withholding.

Distribution to account owner

The owner will receive an amount equal to the then-current market value of the account, less a 10 percent penalty with respect to the earnings, if applicable.

Death or disability

No penalty applies if the Scholarshare trust is canceled due to the death or disability of the beneficiary.

State taxes

California taxes Scholarshare in the same manner as the federal law. Beneficiaries who are California residents will be subject to taxation on their receipt of Scholarshare. They will also be taxable on their receipt of similar amounts from other state plans.

If the beneficiary is a California nonresident, he or she will not be subject to California tax on the taxable portion of the Scholarshare proceeds. However, it is likely that the state where the beneficiary resides will subject the receipts to their income tax.

Other states have given their residents some tax benefits. New York, for example, allows their residents to deduct up to $5,000 ($10,000 for married filing a joint return) for contributions by each account owner each year. Louisiana and Minnesota match up to 15 percent of a resident's contributions, based on the owner's income. Connecticut's plan exempts withdrawals from state tax. New Jersey's plan also exempts earnings from state tax and, in addition, gives beneficiaries who attend in-state colleges a $500 freshman scholarship.

There is one area where no guidance has been issued. What happens when an account is closed, and the funds are returned to the owner? If the normal rules apply, state taxation would be based on the residence of the person receiving the funds. Because the taxation of distribution follows the rules of IRC Sec. 72, it appears that California could not tax the earnings if the recipient of the funds (owner or beneficiary) is a nonresident.

Gift Tax

Transfers to a Scholarshare account are considered to be completed gifts for gift tax purposes. A donor can make a single contribution of up to $50,000 to a plan without paying any gift tax because he or she can elect to spread the gift over a five-year period. That moves $50,000, and five years' earnings, out of the donor's estate, with no gift or estate taxes. When one spouse makes a gift, a couple can elect to gift split, which allows up to $100,000 of present gifts, per beneficiary.

Planning Point

If the election is made to treat the $50,000 as a present interest for five years at $10,000 per year, any additional gifts, such as a birthday present or a car would be a taxable gift.

Since California does not have a gift tax, this should not present a state tax problem. However, other states do have gift taxes. So, if the account owner is a resident of another state, he or she may need to make the five-year spread election under their applicable state gift tax statute.

Gift tax return

Any individual who makes an annual contribution of more than $10,000 to the Scholarshare plan for any beneficiary must file a gift tax return, Form 709, which is due by April 15 of the following year. If they want to make the election to treat the amounts in excess of the annual exclusion (up to $50,000) as made ratably over a five-year period, they must check Box B on Schedule A (page 2 of Form 709). An attachment to the return must include:

- The total amount contributed per individual beneficiary;
- The amount for which the election is being made; and
- The name of the individual for whom the contribution was made.

The instructions to Form 709 also state that if an election is made, the taxpayer must then report the additional 20 percent of the total gift in each of the succeeding four years. It is unclear whether a gift tax return must be filed if the total for those years (including the 20 percent from the election) is less than $10,000.

If a gift-splitting election is made with a spouse, each spouse must make the five-year election on a separate Form 709.

Gift tax on a rollover

If the account is rolled over (transferred) to a new qualified beneficiary, the transfer is ordinarily not considered a new gift. However, the transfer will be subject to the gift tax if the new beneficiary is assigned to a lower generation than the old beneficiary. The transfer will be subject to the generation-skipping transfer tax if the new beneficiary is assigned to a generation that is one level lower than the generation of the old beneficiary (Treas. Reg. Sec. 529-5(b)(ii).

The gift is not from the owner, even though the owner selects the new beneficiary. Instead, it is considered a gift by the beneficiary. This is an odd result, since the beneficiary has nothing to do with the transfer. This will only be a problem if the amount exceeds the amount of the exclusion of $10,000 per year.

> **Example of Rollover**
>
> In year 1 P makes a contribution on behalf of Child C to Scholarshare. In year 5 P rolls the account over for the benefit of G, P's grandchild. The rollover is treated as a taxable gift by C to G, because G is considered to be in a lower generation than C.

Estate Tax

Contributor

Transfers to the Scholarshare Plan are completed gifts for gift and estate tax purposes. This is true even though the account holder has the power to name a new beneficiary, including him or herself. Therefore, nothing is included in the owner's estate at the time of death, even if there is still a balance in the beneficiary's account.

There is one exception. In the case of a donor who makes the gift tax election to treat a contribution as made over a five-year period who dies before the beginning of the fifth year, the gross estate of the donor includes the portion of the contribution properly allocable to the periods after the date of death.

For example, if in 2000 a $50,000 contribution was made and the donor died in 2003, then only four of the five years have passed. Accordingly, the final year's $10,000 is included in the decedent's gross estate.

Beneficiary

It is not clear, but the House committee report to the Taxpayer Relief Act of 1997 indicates that although the Scholarshare account is not included in the owner's estate, it is included in the beneficiary's estate. The joint committee says that the House version was adopted, but this part of the House explanation was not included in their report.

Use of Multiple Educational Incentives

U.S. Savings Bond exclusion & Scholarshare

If the beneficiary is either the account owner, the account owner's spouse or a dependent of the account owner, and the account owner also tries to use the exclusion from income on the redemption of U.S. savings bonds issued after 1989, the amount treated as basis above is reduced by the amount of savings bond income, which is excluded from the owner's taxable income. Since that exclusion phases out for most middle income taxpayers, it is unlikely to apply to most account holders. Also, it will rarely apply in the case of grandparents, since the beneficiary will not ordinarily be a dependent of the owner.

HOPE scholarship & lifetime learning credits

Although the savings bond exclusion and the Scholarshare must be adjusted if they are used in the same year, this is not the case with the HOPE scholarship credit and the lifetime learning credit. Amounts used from the Scholarshare account may also be used for the HOPE or lifetime learning credits.

Educational IRAs & Scholarshare

Unlike the multiple benefits that are possible with the use of the Scholarshare and the HOPE and lifetime learning credits, a contributor may not fund both an Education IRA and a Scholarshare for the same beneficiary in the same year.

Administrative Costs

In California there is no sales charge, application fee or annual fee for a Scholarshare account. However, there is an annual fee that is based on the overall investment portfolio. That fee is 0.7 percent for TIAA-CREF and 0.1 percent for administrative services. The fees paid to the plan cannot exceed 0.8 percent per annum. In New York TIAA-CREF charges only 0.65 percent for similar services. In the New Jersey plan, which is operated by the state, the fee is 1 percent. Some states also charge a $15 annual account fee.

These fees may be more or less than those incurred by most people who invest in a similar investment through their own stockbrokers. The return from Scholarshare may be different from a similar investment in a similar mutual fund. In addition, remember that the investment fund cannot be changed by the owner. It is chosen at the time the contribution is made.

Minimum Period Prior to Withdrawal

Although there is no statutory requirement, the Scholarshare legislation allows the seven-member Scholarshare Investment Board to set a minimum waiting period prior to making withdrawals. It appears that the present requirement is a one-year period prior to making qualified payments of tuition, books, supplies, room and board and any other qualified costs. However, it also appears that this requirement may be reduced or eliminated. It is interesting that the New York plan requires a minimum of 36 months in the plan in order to be a qualified withdrawal.

Does Scholarshare Affect Financial Aid

It appears that being a beneficiary of Scholarshare may affect the calculation of financial sources such as the federal government or from a specific college or other private or public source. It is interesting that New Jersey's plan states that the first $25,000 saved in its plan will not be a factor in determining eligibility for state-funded, need-based financial aid. Whether California or other states adopt similar rules is unclear at this time.

Assignment, Borrowing, Pleading, etc. of Account

In order to qualify, a plan must prohibit any interest in the program from being used as security for a loan.

Sample List of Higher Education Costs

The following is a short list of California colleges and universities. It can be used to get a rough idea of the current cost of an undergraduate or vocational education. Remember that these costs will increase by the time the beneficiary goes to college. This abridged list, taken from the California Scholarshare Web site, shows the annual tuition and fees for in-state and select out-of-state colleges, plus annual room and board costs for a student living on campus.

In addition, it costs an additional $2,700 annually for other expenses, including books and supplies, transportation and personal expenses. Of course, off-campus housing may cost more or less, and transportation to and from school must be factored into the cost. Graduate school may cost even more.

Institution	Annual Tuition in State/out of State	Room & Board
Biola University	$15,214/$15,214	$ 7,364
California College of Arts and Crafts	$17,188/$17,188	$ 5,408
California Institute of Technology	$19,116/$19,116	N/A
California State University (Varies by campus)	$1,685/$9,590	$ 5,939
California Community Colleges (Varies by campus)	$400/4,310	N/A
Chapman University	$19,724/$19,724	$ 9,234
Court Reporting Institute	$7,920/$7,920	$12,672
DeVry Institute of Technology-Pomona	$7,338/$7,338	$12,672
International School of Cosmetology	$6,300/$6,300	$ 9,504
National University	$6,795/$6,795	$12,672
New School of Architecture	$13,434/$13,434	$ 9,504
Pepperdine University	$22,120/$22,120	$ 8,876
Pitzer College	$23,226/$23,226	$ 8,148
Scripps College	$20,126/$20,126	$ 9,356
Stanford University	$22,110/$22,110	$ 9,833
University of California (Varies by campus)	$3,875/13,731	$13,449
University of Judaism	$14,400/$14,400	$ 9,572
University of San Diego	$16,575/$16,575	$ 9,504
University of San Francisco	$16,730/$16,730	$10,168
University of Southern California	$21,374/$21,374	$11,267
University of the Pacific	$19,365/$19,365	$ 7,833

Proposed Legislation

The IRC Sec. 529 plans are a relatively new tax-advantaged investment. There are many questions and unresolved issues. Pending federal and state legislation could change the details of how the plans work. There are also many unsettled areas and unanswered questions, and interpretations are constantly evolving. We suggest you keep up to date with changes and advances in this area so you can best advise your client.

Scholarshare Reporting

Under the California Education Code the Scholarshare Trust must make a report to each participant (the account owner) or beneficiary of the type and amount of each distribution, including payment of benefits and refunds.

It also states that the trust shall report annually by March 1 to each participant or beneficiary all of the following:

- The value of the beneficiary's account;
- The interest earned thereon;
- The rate of return of the investments in the beneficiary's account for that reporting period;
- The investment goal the participant will achieve if all future contributions with respect to that beneficiary are timely made;
- The amount of any missed contributions that the participant is eligible to make up; and
- Information regarding the trends in qualified higher education expenses and the state's public segments of higher education, and the names, address and phone number of the state senator and assembly member who represent the beneficiary's district (Ed. Code Sec. 69990).

Appendix

California Golden State Scholarshare Plan—Web/Phone

The World Wide Web:

http://www.csac.ca.gov/scholar/scholar.htm

The old way, by calling the plan at:

(800) SAV 4 EDU

Other Web Sites of Interest

IRS questions and answers:

http://www.irs.ustreas.gov/prod/hot/not97-606.html

Detailed WEB listing of each state's plan:

http://www.collegesavings.org/state-table.htm

Excellent articles, analysis, reviews and current information:

http://www.savingforcollege.com

Definitions

Account Owner—The contributor is the original owner. That designation can be passed at death to a new owner. In California the term "participant" also refers to the owner.

Beneficiary—This is the person who is named to receive the funds from the Scholarshare account.

College Savings Plan—The generic title for a plan established under Sec. 529 of the Internal Revenue Code.

Scholarshare—The California plan meeting the requirements of Sec. 529.

Sec. 529—This is the Internal Revenue Code section that provides the rules relating to Scholarshare.

Richard B. Malamud, CPA, J.D., LL.M. is a professor in the Department of Accounting and Law at CSU Dominguez Hills where he teaches federal income tax law. You may reach him by phone at (310) 243-2239, fax at (310) 217-6964 or e-mail at rmalamud@soma.csudh.edu.