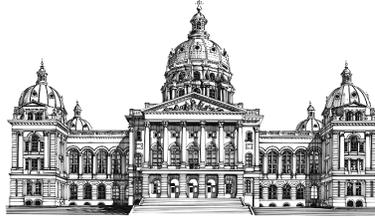

Iowa Legislative Services Agency Fiscal Services

Dennis Prouty
(515) 281-5279
FAX 281-8451



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Des Moines, IA 50319
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Iowa College Savings Plans

ISSUE

This **Issue Review** provides an overview of college savings plans and information about the College Savings Iowa Plan that is part of the Iowa Educational Savings Plan Trust administered by the Treasurer of State.

AFFECTED AGENCIES

Treasurer of State

CODE AUTHORITY

Section 529, U.S. Internal Revenue Code
Chapter 12D, Code of Iowa

BACKGROUND

Nationally, over the past 30 years, college tuition rates have been increasing two to three times the rate of inflation each year. During this same period of time, federal financial aid funding has shifted away from student grants to providing access to guaranteed student loans. Today, nearly 60.0% of all federal financial aid is in the form of loans, significantly increasing the debt load of college graduates. On September 5, 2005, *U.S News & World Report* magazine published an article on paying for college that included debt loads for students of the class of 2004. Iowa colleges and universities were shown on the list of most debt.

Concerned by the mounting financial strain placed on college graduates and their families, states began to develop programs designed to help families and students save for their college education. The original plans were created by states such as Florida, Michigan, Ohio, and Wyoming in the late 1980's. Nationally, since that time, over five million families have saved more than \$35.0 billion in what are commonly referred to as "Section 529 College Savings Plans." More than 225,000 students nationwide have used these programs to help pay for their college education.

Although states initially created savings plans more than 15 years ago to encourage citizens to save for college, utilization started to gain momentum in 1994 as a result of a Michigan court decision that determined the Michigan Education Trust prepaid tuition plan was nontaxable as an instrumentality of the state.

Following the court decision, the Internal Revenue Service declared its intention to contest the tax status of each state's plan on a case-by-case basis. This prompted states to lobby Congress for the development of tax advantages to promote college savings. In 1996, Congress enacted Section 529, U.S. Internal Revenue Code (IRC), that allowed tax deferred treatment on the earnings of savings plans when used for higher education.

The enactment of the Economic Growth and Tax Relief Reconciliation Act on June 7, 2001, provided further congressional support for Section 529 plans, and exempted the distributions from a Section 529 plan made after December 31, 2001, from federal taxation to promote college savings. An estimated \$70.0 to \$100.0 billion more is expected to flow into Section 529 plans over the next five years.

In Iowa, HF 2119 (Iowa Educational Savings Plan Trust Act) was approved by the General Assembly in 1998 and established Chapter 12D, Code of Iowa, authorizing the Treasurer of State to create state-sponsored college savings plans. The College Savings Iowa Plan was established in September 1998 as part of the Trust.

For Iowa income tax purposes, contributions to the Trust are deductible (each participant may deduct up to \$2,375 per beneficiary for calendar year 2005) and earnings grow tax-free while in the Plan. At the federal level, assets in the Plan also grow tax-free. Withdrawals taken for qualified higher education expenses are tax-free for both federal and Iowa income tax purposes.

The tax benefits of Section 529 plans are not permanent. Unless Congress extends the current exemption beyond December 31, 2010, the earnings portion of qualified withdrawals will be subject to federal income tax beginning January 1, 2011. Both houses of Congress have introduced legislation to make the Section 529 plan tax benefits permanently exempt from federal tax.

Contribution levels are adjusted annually for inflation and have increased significantly since 1998. The table below reflects the amount of change in Iowa contributions and participants in the Plan through June 2005.

<u>History of Contributions to the College Savings Iowa Plan</u>		
<u>Period Ending</u>	<u>Asset Balance</u>	<u>Number of Accounts</u>
12/31/1998	\$ 3,338,000	2,419
12/31/1999	26,151,000	12,789
12/31/2000	49,141,000	18,052
12/31/2001	113,560,000	25,987
12/31/2002	374,768,454	66,154
12/31/2003	688,267,585	83,440
12/31/2004	1,003,939,928	100,205
06/30/2005	1,122,822,572	107,882

CURRENT SITUATION

States have structured investment options in Section 529 plans to benefit participants that are not experienced investors. Most savings plans offer investment options that automatically re-balance assets based on the age of the beneficiary. Additionally, the states' roles in selecting financial firms or investment managers through competitive procurement is intended to assure participants that they receive better pricing and account servicing than they could obtain independently. All 50 states and the District of Columbia now have Section 529 plans and new investment options and program enhancements are also being developed.

House File 2553 (Technical Changes to the Iowa Educational Savings Plan Trust) approved by the General Assembly in 2004, required the Treasurer of State to establish an educational savings plan option through licensed security agents by December 31, 2005. A Request for Proposals (RFP) was issued on July 15, 2005, seeking firms interested in managing and offering a reasonably-priced Advisor-Sold Plan. The Advisor-Sold Plan would create a new distribution channel for the Trust and will increase the options for lowans to invest in Iowa's 529 Plan. The Treasurer expects this added distribution channel to increase the number of lowans that take advantage of and participate in the Trust.

The RFP requires the successful "Advisor Manager" to demonstrate extensive knowledge regarding 529 plans and have an excellent reputation for investment performance, product distribution and customer service. The Advisor Manager will work with the Treasurer's Office to ensure that the Advisor Plan meets all requirements of federal tax and securities laws and all state laws and regulatory provisions. The Advisor Manager will be expected to provide services including investment management, marketing and distribution, advisor support, and systems administration necessary to integrate with the College Savings Iowa Plan.

BUDGET IMPACT

Contributions to College Savings Iowa Plans saved lowans \$2.7 million in Calendar Year (CY) 2003 and \$3.5 million in CY 2004 through reduced Iowa income tax liability as reported by the Treasurer of State. The Treasurer also projects a reduction for CY 2005 of \$4.5 million and \$6.0 million for CY 2006. These savings for Iowa taxpayers results in decreased General Fund revenue for the State of the same amount.

STAFF CONTACT: Sam Leto (Ext. 16764)