circumstances in its moving papers. The motion shall be filed within 10 days after service of the General Counsel's final decision. A motion for reconsideration shall state with particularity the extraordinary circumstances claimed and shall be supported by appropriate citations.

§ 2423.12 Settlement of unfair labor practice charges after a Regional Director determination to issue a complaint but prior to issuance of a complaint.

(a) *Bilateral informal settlement agreement.* Prior to issuing a complaint, the Regional Director may afford the Charging Party and the Charged Party a reasonable period of time to enter into an informal settlement agreement to be approved by the Regional Director. When a Charged Party complies with the terms of an informal settlement agreement approved by the Regional Director, no further action is taken in the case. If the Charged Party fails to perform its obligations under the approved informal settlement agreement, the Regional Director may institute further proceedings.

(b) *Unilateral informal settlement agreement.* If the Charging Party elects not to become a party to an informal settlement agreement which the Regional Director concludes effectuates the policies of the Federal Service Labor-Management Relations Statute, the agreement may be between the Charged Party and the Regional Director. The Regional Director issues a letter stating the grounds for approving the settlement agreement and declining to issue a complaint. The Charging Party may obtain review of the Regional Director's action by filing an appeal with the General Counsel in accordance with § 2423.11(c) and (d). The General Counsel takes action on the appeal as set forth in § 2423.11(f) and (g).

§§ 2423.13–2423.19 [Reserved]

PART 2429—MISCELLANEOUS AND GENERAL REQUIREMENTS

5. The authority citation for part 2429 continues to read as follows:

Authority: 5 U.S.C. 7134.

6. Section 2429.24 is amended by revising paragraph (e) to read as follows:

§ 2429.24 Place and method of filing; acknowledgment.

* * * * *

(e) All documents filed pursuant to this section shall be filed in person, by commercial delivery, by first-class mail, or by certified mail; except for unfair labor practice charges filed in accordance with § 2423.6 of this subchapter. Provided, however, that where facsimile equipment is available, motions; information pertaining to prehearing disclosure, conferences, orders, or hearing dates, times, and locations; information pertaining to subpoenas; and other similar matters; except for supporting evidence and documents submitted pursuant to §§ 2423.4 and 2423.6 of this subchapter, may be filed by facsimile transmission, provided that the entire individual filing by the party does not exceed 10 pages in total length, with normal margins and font sizes.

* * * * *

Dated: August 19, 1998.

Joseph Swerdzewski,

General Counsel, Federal Labor Relations Authority.

[FR Doc. 98–22645 Filed 8–21–98; 8:45 am]

BILLING CODE 6727–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–106177–97]

RIN 1545–AV18

Qualified State Tuition Programs

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to qualified State tuition programs (QSTPs). These proposed regulations reflect changes to the law made by the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997. The proposed regulations affect QSTPs established and maintained by a State or agency or instrumentality of a State, and individuals receiving distributions from QSTPs. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by November 23, 1998. Outlines of topics to be discussed at the public hearing scheduled for Wednesday, January 6, 1999, at 10 a.m. must be received by December 16, 1998.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–106177–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–106177–97), 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.ustreas.gov/prod/tax__regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Monice Rosenbaum, (202) 622–6070; concerning the proposed estate and gift tax regulations, Susan Hurwitz (202) 622–3090; concerning submissions and the hearing, Michael Slaughter, (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by October 23, 1998. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the *Internal Revenue Service,* including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase or services to provide information.

The collection of information in this proposed regulation is in §§ 1.529–

2(e)(4), 1.529–2(f) and (i), 1.529–4, and 1.529–5(b)(2). This information is required by the IRS to verify compliance with sections 529(b)(3), (4), (7) and (d). This information will be used by the IRS and individuals receiving distributions from QSTPs to determine that the taxable amount of the distribution has been computed correctly. The collection of information is required to obtain the benefit of being a QSTP described in section 529. The likely respondents and/or recordkeepers are state governments and distributees who receive distributions under the programs. The burden for reporting distributions is reflected in the burden for Form 1099–G, Certain Government Payments. The burden for electing to take certain contributions to a QSTP into account ratably over a five year period in determining the amount of gifts made during the calendar year is reflected in the burden for Form 709, Federal Gift Tax Return.

Estimated total annual reporting/recordkeeping burden: 705,000 hours.

Estimated average annual burden per respondent/recordkeeper: 35 hours, 10 minutes.

Estimated number of respondents/recordkeepers: 20,051.

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to qualified State tuition programs described in section 529. Section 529 was added to the Internal Revenue Code by section 1806 of the Small Business Job Protection Act of 1996, Public Law 104–188, 110 Stat. 1895. Section 529 was modified by sections 211 and 1601(h) of the Taxpayer Relief Act of 1997, Public Law 105–34, 111 Stat. 810 and 1092.

Section 529 provides tax-exempt status to qualified State tuition programs (QSTPs) established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary entitling the beneficiary to a waiver or payment of qualified higher education expenses, or (2) contribute to an account established exclusively for the purpose of meeting qualified higher education expenses of the designated beneficiary. Qualified higher education expenses, for purposes of section 529, are tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution, as well as certain room and board expenses for students who attend an eligible educational institution at least half-time. An eligible educational institution is an accredited post-secondary educational institution offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. The institution must be eligible to participate in Department of Education student aid programs.

QSTPs established and maintained by a State (or agency or instrumentality thereof) must require all contributions to the program be made only in cash. Neither contributors nor designated beneficiaries may direct the investment of any contributions or any earnings on contributions. No interest in the program may be pledged as security for a loan. A separate accounting must be provided to each designated beneficiary in the program. A program must impose a more than de minimis penalty on refunds that are not used for qualified higher education expenses, not made on account of death or disability of the designated beneficiary, or not made on account of a scholarship or certain other educational allowances. A program must provide adequate safeguards to prevent contributions in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a QSTP, unless the interests in the program are purchased by a State or local government or a tax-exempt organization described in section 501(c)(3) as part of a scholarship program operated by such government or organization under which beneficiaries to be named in the future will receive the interests as scholarships.

Distributions under a QSTP are includible in the gross income of the distributee in the manner as provided under section 72 to the extent not excluded from gross income under any other provision. Distributions include in-kind benefits furnished to a designated beneficiary under a QSTP. Any distribution, or portion of a distribution, that is transferred within 60 days under a QSTP to the credit of a new designated beneficiary who is a member of the family of the old designated beneficiary shall not be treated as a distribution. A change in the designated beneficiary of an interest in a QSTP shall not be treated as a distribution if the new beneficiary is a member of the family of the old beneficiary. A member of the family means the spouse of the designated beneficiary or an individual who is related to the designated beneficiary as described in section 152(a)(1) through (8) or is the spouse of any of these individuals.

Section 529, as added to the Code by the Small Business Job Protection Act of 1996 (1996 Act), contained provisions addressing the estate, gift, and generation-skipping transfer tax. The provisions were significantly revised, effective prospectively, by the Taxpayer Relief Act of 1997 (1997 Act).

A contribution on behalf of a designated beneficiary to a QSTP which is made after August 20, 1996, and before August 6, 1997, is not treated as a taxable gift. Rather, the subsequent waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under the QSTP is treated as a qualified transfer under section 2503(e) and is not treated as a transfer of property by gift for purposes of section 2501. As such, the contribution is not subject to the generation-skipping transfer tax imposed by section 2601.

In contrast, under section 529 as amended by the 1997 Act, a contribution on behalf of a designated beneficiary to a QSTP after August 5, 1997, is a completed gift of a present interest in property under section 2503(b) from the contributor to the designated beneficiary and is not a qualified transfer within themeaning of section 2503(e). The portion of a contribution excludible from taxable gifts under section 2503(b) also satisfies the requirements of section 2642(c)(2) and, therefore, is also excludible for purposes of the generation-skipping transfer tax imposed under section 2601. For purposes of the annual exclusion, a contributor may elect to take certain contributions to a QSTP into account ratably over a five-year period in determining the amount of gifts made during the calendar year. Under section 529 as amended by the 1997 Act, a transfer which occurs by reason of a change in the designated beneficiary of a QSTP, or a rollover from the account of one beneficiary to the account of another beneficiary in a

QSTP, is not a taxable gift if the new beneficiary is a member of the family, as defined in section 529(e)(2), of the old beneficiary, and is assigned to the same generation, as defined in section 2651, as the old beneficiary. If the new beneficiary is assigned to a lower generation than the old beneficiary, the transfer is a taxable gift from the old beneficiary to the new beneficiary regardless of whether the new beneficiary is a member of the family of the old beneficiary. In addition, the transfer will be subject to the generation-skipping transfer tax if the new beneficiary is assigned to a generation which is two or more levels lower than the generation assignment of the old beneficiary. The five-year averaging election for purposes of the gift tax annual exclusion may be applied to the transfer.

Regarding the application of the estate tax, the value of any interest in any QSTP which is attributable to contributions made by a decedent who died after August 20, 1996, and before June 9, 1997, is includible in the decedent's gross estate. In contrast, pursuant to the 1997 Act amendments to section 529, the value of such an interest is not includible in the gross estate of a decedent who dies after June 8, 1997, unless the decedent had elected the five-year averaging rule for purposes of the gift tax annual exclusion and died before the close of the five-year period. In that case, the portion of the contribution allocable to calendar years beginning after the decedent's date of death is includible in his gross estate.

Also, pursuant to the 1997 Act amendments to section 529, the value of any interest in a QSTP held for a designated beneficiary who dies after June 8, 1997, is includible in the designated beneficiary's gross estate.

The Federal estate and gift tax treatment of QSTP interests has no effect on the actual rights and obligations of the parties pursuant to the terms of the contracts under State law. In addition, the estate and gift tax treatment of contributions to a QSTP and interests in a QSTP is generally different from the treatment that would otherwise apply under generally applicable estate and gift tax principles. For example, under most contracts, the contributor may retain the right to change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated. Such rights would ordinarily cause the transfer to the account to fail to be a completed gift and mandate inclusion of the value of the undistributed interest in the QSTP in the gross estate of the contributor under sections 2036 and/or 2038. However, under section 529, the gross estate of a contributor who dies after June 8, 1997, does not include the value of any interest in a QSTP attributable to contributions from the contributor (except amounts attributable to calendar years after death where the five-year averaging rule has been elected). Also, because a contribution after August 5, 1997, is a completed gift from the contributor to the designated beneficiary, any subsequent transfer which occurs by reason of a change in the designated beneficiary or a rollover from the account of the original designated beneficiary to the account of another beneficiary is treated, to the extent it is subject to the gift and/or generation-skipping transfer tax, as a transfer from the original designated beneficiary to the new beneficiary. This is the result even though the change in beneficiary or the rollover is made at the direction of the contributor under the terms of the contract.

Comments From Notice 96–58

In Notice 96–58, 1996–2 C.B. 226, the Internal Revenue Service invited comments on section 529 including the requirements for reporting distributions by QSTPs, the requirements for qualification and operation of programs, and the treatment of distributions made by programs for federal tax purposes. Eighteen comments were received. The comments addressed a broad range of issues, including but not limited to, those outlined by Notice 96–58, the concept of account ownership and gift tax rules, enforcement of penalties, accounting and recordkeeping, and transition relief for programs in existence on August 20, 1996. The summary below is not intended to be a complete discussion of the comments. However, all matters presented in the comments were considered in the drafting of this notice of proposed rulemaking.

One commenter discussed in detail the requirements that a QSTP be "established and maintained" by a State or agency or instrumentality of a State. The commenter recommended a list of factors to be considered in determining whether a State maintains the program. This commenter and others urged that the use of outside contractors or the holding of program deposits at a private financial institution selected by the State not be determinative of whether the program was maintained by the State.

One commenter was endorsed by several others for suggesting two specific safe harbors to satisfy the requirement that a program impose more than a de minimis penalty on refunds. The first safe harbor was a 5 percent of earnings penalty on refunds of earnings prior to the designated beneficiary matriculating, reduced to at least a 1 percent penalty on refunds of earnings only after the age of matriculation. The second safe harbor was a fixed-rate safe harbor equal to the lesser of $50 or 1 percent of the assets distributed. Another commenter suggested an additional safe harbor based on the return of Series EE savings bonds. That commenter also suggested that safe harbors are not necessarily the minimum acceptable penalties and that all facts and circumstances should be taken into account in determining the adequacy of penalties that are less than the safe harbor penalties.

Commenters urged that regulations limit or avoid rules requiring programs to enforce penalties or require substantiation to ensure that disbursements are used to pay for qualified higher education expenses. Recognizing however that there may be some misuse in this area, commenters recommended that checks from QSTPs be marked with a special endorsement or be payable to both the educational institution and the designated beneficiary.

Commenters suggested that the prohibition on investment direction not include a choice between a prepaid tuition program and a savings program (established and maintained in one State), a choice among options in a prepaid tuition program, a choice among options for the initial contribution to the program, or an opportunity to change investment strategies. One commenter suggested that the prohibition on investment direction not apply to prevent participation in the program by program board and staff members.

Commenters suggested several approaches for satisfying the prohibition on excess contributions. Two safe harbors were proposed; one was based upon eight times the average annual undergraduate tuition and required fees at private four-year universities; the other was based upon five years of tuition, fees, books, supplies, and equipment at the highest cost institution allowed by the State's program. Other approaches proposed allowing the provision of adequate safeguards to prevent excess contributions to be left to the discretion of the program or allowing the contributor to certify that no attempt would be made to overfund the account.

Commenters made suggestions and raised concerns regarding: separate accounting rules including, but not limited to, the valuation and tracking of tuition units; the operating rules treating all programs in which an individual is a designated beneficiary as one program, and treating all distributions during a taxable year as one distribution; the application of section 72 to calculate distributions; and, income tax consequences relating to account ownership, penalties, and withholding.

The modifications made to section 529 by the Taxpayer Relief Act of 1997 have addressed, in large part, the issues raised by commenters concerning transition relief for programs in existence on August 20, 1996, estate and gift tax consequences for contributors and designated beneficiaries, and definitions pertaining to family members and eligible educational institutions.

Explanation of Provisions

Qualification as Qualified State Tuition Program (QSTP): Unrelated Business Income Tax and Filing Requirements

The proposed regulations provide guidance on the requirements a program must satisfy in order to be a QSTP described in section 529. A program that meets these requirements generally is exempt from income taxation. However, a QSTP is subject to the taxes imposed by section 511 relating to imposition of tax on unrelated business income. For purposes of section 529 and these regulations, an interest in a QSTP shall not be treated as debt for purposes of section 514; consequently, investment income earned on contributions to the program by purchasers will not constitute debt-financed income subject to the unrelated business income tax. However, investment income of the QSTP shall be subject to the unrelated business income tax to the extent the program incurs indebtedness when acquiring or improving income-producing property. Earnings forfeited on educational contracts or savings, amounts collected as penalties on refunds or excess contributions, and certain administrative and other fees are not unrelated business income to the QSTP. A QSTP is not required to file Form 990, Return of Organization Exempt From Income Tax, however, this does not affect the obligation of a QSTP to file Form 990–T, Exempt Organization Business Income Tax Return.

Established and Maintained

The proposed regulations provide that a program is established by a State or agency or instrumentality of the State if the program is initiated by State statute or regulation, or by an act of a State official or agency with the authority to act on behalf of the State. A program is maintained by a State or agency or instrumentality of a State if all the terms and conditions of the program are set by the State or agency or instrumentality and the State or agency or instrumentality is actively involved on an ongoing basis in the administration of the program, including supervising all decisions relating to the investment of assets contributed to the program. The proposed regulations set forth factors that are relevant in determining whether a State, agency or instrumentality is actively involved in the administration of the program. Included in the factors is the manner and extent to which it is permissible for the program to contract out for professional and financial services.

Penalties and Substantiation—Safe Harbors

As required by section 529(b)(3), a more than de minimis penalty must be imposed on the earnings portion of any distribution from the program that is not used for the qualified higher education expenses of the designated beneficiary, not made on account of the death or disability of the designated beneficiary, or not made on account of a scholarship or certain other payments described in sections 135(d)(1)(B) and (C) that are received by the designated beneficiary to the extent the amount of the refund does not exceed the amount of the scholarship, allowance, or payment. The penalty shall also not apply to rollover distributions described in section 529(c)(3)(C) which are discussed in the section titled *Income Tax Treatment of Distributees,* below. The proposed regulations provide that a penalty is more than de minimis if it is consistent with a program intended to assist individuals in saving exclusively for qualified higher education expenses. Whether any penalty is more than de minimis will depend upon the facts and circumstance of the particular program, including the extent to which the penalty offsets the federal income tax benefit from having deferred income tax liability on the earnings portion of any distribution. The proposed regulations provide a safe harbor penalty that a program may adopt for satisfying this requirement. For purposes of the safe harbor, a penalty imposed on the earnings portion of a distribution is more than de minimis if it is equal to or greater than 10 percent of the earnings.

To be treated as imposing a more than de minimis penalty as required by section 529(b)(3) a program must implement practices and procedures for identifying whether a distribution is subject to a penalty and collecting any penalty that is due. The proposed regulations, in the form of a safe harbor, set forth practices and procedures that may be implemented by a program. The safe harbor provides that distributions are treated as payments of qualified higher education expenses if the distribution is made directly to an eligible educational institution; the distribution is made in the form of a check payable to both the designated beneficiary and the eligible educational institution; the distribution is made after the designated beneficiary submits substantiation showing that the qualified higher education expenses were paid and the program reviews the substantiation; or the designated beneficiary certifies prior to distribution the amount to be used for qualified higher education expenses and the program requires substantiation of payment within 30 days of making the distribution, the program reviews the substantiation, and the program retains an amount necessary to collect the penalty owed on the distribution if valid substantiation is not produced.

The safe harbor procedure provides that a penalty be collected on all other distributions except where prior to distribution the program receives written third party confirmation that the designated beneficiary has died or become disabled or has received a scholarship or allowance or payment described in section 135(d)(1) (B) or (C). Alternatively, distributions may be made upon the certification of the account owner that the designated beneficiary has died or become disabled or has received a scholarship or allowance or payment described above, if the program withholds a portion of the distribution as a penalty. The penalty may be refunded after receipt of third party confirmation of the certification made by the account owner.

The safe harbor procedure provides that a program may document amounts refunded from eligible educational institutions that were not used for qualified higher education expenses by requiring a signed written statement from the distributee identifying the amount of any refund received from an eligible educational institution at the end of each year in which distributions for qualified higher education expenses were made and of the next year. A program must also have procedures to collect the penalty either by retaining a sufficient balance in the account to pay the penalty, withholding an amount equal to the penalty from a distribution, or collecting the penalty on a State income tax return.

Other Requirements for QSTP Qualification

As described in section 529(b)(1)(A), the proposed regulations provide that contributions to the program can be placed into either a prepaid educational arrangement or contract, or an educational savings account, or both, but cannot be placed into any other type of account. Contributions may be made only in cash and not in property as provided in section 529(b)(2), however, the proposed regulations provide that a program may accept payment in cash, or by check, money order, credit card, or similar methods.

Section 529(b)(4) requires that a program provide separate accounting for each designated beneficiary. Separate accounting requires that contributions for the benefit of a designated beneficiary and earning attributable to those contributions are allocated to the appropriate account. The proposed regulations provide that if a program does not ordinarily provide each account owner an annual account statement showing the transactions related to the account, the program must give this information to the account owner or designated beneficiary upon request.

Section 529(b)(5) states that a program shall not be treated as a QSTP unless it provides that any contributor to, or designated beneficiary under, such program may not directly or indirectly direct the investment of any contributions to the program or any earnings thereon. A program will not violate the requirement of this paragraph if it permits a person who establishes an account to select between a prepaid educational services account and an educational savings account, or to select among different investment strategies designed exclusively by the program, at the time that an educational savings account is established. However, the proposed regulations clarify that a program will violate this requirement if, after an account with the program initially is established, the account owner, a contributor, or the designated beneficiary subsequently is permitted to select among different investment options or strategies. A program will not violate this requirement merely because it permits its board members, its employees, or the board members or employees of a contractor it hires to perform administrative services to purchase tuition credits or certificates or make contributions.

Section 529(b)(6) provides that a program may not allow any interest in the program, or any portion of an interest in the program, to be used as security for a loan. The proposed regulations clarify that this restriction includes, but is not limited to, a prohibition on the use of any interest in the program as security for a loan used to purchase the interest in the program.

Section 529(b)(7) requires a program to establish adequate safeguards to prevent contributions for the benefit of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the designated beneficiary. The proposed regulations provide a safe harbor that permits a program to satisfy this requirement if the program will bar any additional contributions to an account as soon as the account reaches a specified limit applicable to all accounts of designated beneficiaries with the same expected year of enrollment. The total contributions may not exceed the amount determined by actuarial estimates that is necessary to pay tuition, required fees, and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program. The safe harbor in the proposed regulations applies only to the program. Despite the fact that a program has met the safe harbor, a particular account established under the program may have a balance that exceeds the amount actually needed to cover the particular designated beneficiary's qualified higher education expenses. Distributions made that are not used for qualified higher education expenses of the designated beneficiary are subject to the penalty provisions of section 529(b)(3).

Income Tax Treatment of Distributees

In accordance with section 529(c)(3), the proposed regulations provide that distributions made by a QSTP, including any benefit furnished in-kind, must be included in the gross income of the distributee to the extent that the distribution consists of earnings. The proposed regulations clarify that term ''distributee'' refers to the designated beneficiary or the account owner who receives or is treated as receiving a distribution from a QSTP. As required by section 529(c)(3)(A), distributions under a QSTP must be included in income in the manner as provided under section 72. Therefore, deposits or contributions made into an account under a QSTP are recovered ratably over the period of time distributions are made. The amount of taxable earnings shall be determined by applying an earnings ratio, generally the earnings allocable to the account as of the close of the calendar year divided by the total account balance as of the close of the calendar year, to the distribution. In the case of a prepaid educational services account, this method of calculating taxable earnings utilizes an average value for each unit of education (e.g., credit, hour, semester, or other unit of education) that is distributed rather than the recovery of the cost of any particular unit of education.

In accordance with section 529(c)(3)(C), the proposed regulations permit nontaxable rollover distributions. A rollover consists of a distribution or transfer from an account of a designated beneficiary that is transferred to or deposited within 60 days of the distribution into an account of another individual who is a member of the family of the designated beneficiary. A distribution is not a rollover distribution unless there is a change in beneficiary. The new designated beneficiary's account may be in a QSTP established or maintained by the same State or by another State. A transfer from the designated beneficiary to himself or herself, regardless of whether the transfer is to an account within the same QSTP or another QSTP in the same or another State, is not a rollover distribution and is taxable under the general rule. The Internal Revenue Service is concerned about the use of multiple rollovers to circumvent the restriction on investment direction. In particular, the Internal Revenue Service requests comments on this issue, including whether limits should be placed on the number of rollovers permitted within a certain time period or rollovers back to the original designated beneficiary. No taxable distribution will result from a change in designated beneficiary of an interest in a QSTP purchased by a State or local government or an organization described in section 501(c)(3) as part of a scholarship program.

Reporting Requirements

The proposed regulations set forth recordkeeping and reporting requirements. A QSTP must maintain records that enable the program to produce an annual account balance for each account. See, requirements related to section 529(b)(4) above. A QSTP must report taxable earnings on Form 1099–G, Certain Government Payments, to distributees. Any reporting requirements promulgated under section 529(d) apply in lieu of any other reporting requirement for a program that may apply with respect to information returns or payee statements or distributions. The proposed regulations contain more detail on how the information must be reported.

Estate and Gift Tax

The proposed regulations provide guidance on the gift and generation-skipping transfer tax consequences of contributions to a QSTP, a change in the designated beneficiary of a QSTP, and a rollover from the account of one beneficiary to the account of another beneficiary under a QSTP. The proposed regulations also provide guidance on whether and to what extent the value of an interest in a QSTP is includible in the gross estate of a contributor to a QSTP or the gross estate of a designated beneficiary of a QSTP. Because of the amendments to section 529 made by the Taxpayer Relief Act of 1997, different gift tax rules apply to contributions made after August 20, 1996, and before August 6, 1997, than apply to contributions made after August 5, 1997. Also, estates of decedents dying after August 20, 1996, and before June 9, 1997, are treated differently from estates of decedents dying after June 8, 1997. Comments are requested specifically on whether there is a need for more detailed guidance with respect to the estate, gift, and generation-skipping transfer tax provisions.

Transition Rules

In accordance with section 1806(c) of the Small Business Job Protection Act of 1996 and section 1601(h) of the Taxpayer Relief Act of 1997, special transition rules apply to programs in existence on August 20, 1996. The proposed regulations provide that no income tax liability will be asserted against a QSTP for any period before the program meets the requirements of section 529 and these regulations if the program qualifies for the transition relief. A program shall be treated as meeting the transition rule if it conforms to the requirements of section 529 and these regulations by the date of final regulations.

The proposed regulations provide transition rules that grandfather certain provisions in contracts issued and accounts opened before August 20, 1996. These contracts may be honored without regard to the definitions of ''member of the family'' and ''eligible educational institution'' used in section 529(e) (2) and (3), and without regard to section 529(b)(6) which prohibits the pledging of a QSTP interest as security for a loan. However, regardless of the terms of any agreement executed before August 20, 1996, distributions made by the QSTP are subject to tax according to the rules of § 1.529–3 and subject to the reporting requirements of § 1.529–4.

Proposed Effective Date

These regulations are proposed to be effective on the date they are published in the **Federal Register** as final regulations. Taxpayers may, however, rely on the proposed regulations for taxable years ending after August 20, 1996. Programs that were in existence on August 20, 1996, may also rely upon the transition rules provided.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, January 6, 1999, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by December 16, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these proposed regulations are Monice Rosenbaum, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations) and Susan Hurwitz, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. An undesignated centerheading and §§ 1.529–0 through 1.529–6 are added to read as follows:

Qualified State Tuition Programs

§ 1.529–0 Table of contents.

This section lists the following captions contained in §§ 1.529–1 through 1.529–6:

§ 1.529–1 Qualified State tuition program, unrelated business income tax and definitions.

(a) In general.
(b) Unrelated business income tax rules.
(1) Application of section 514.
(2) Penalties and forfeitures.
(3) Administrative and other fees.
(c) Definitions.

§ 1.529–2 Qualified State tuition program described.

(a) In general.
(b) Established and maintained by a State or agency or instrumentality of a State.
(1) Established.
(2) Maintained.
(3) Actively involved.
(c) Permissible uses of contributions.
(d) Cash contributions.
(e) Penalties on refunds.
(1) General rule.
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(i) In general.
(ii) Safe harbor.

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(4) Procedures for verifying use of distributions and imposing and collecting penalties.
(i) In general.
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(A) Distributions treated as payments of qualified higher education expenses.
(B) Treatment of all other distributions.
(C) Refunds of penalties.
(D) Documentation of amounts refunded and not used for qualified higher education expenses.
(E) Procedures to collect penalty.
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(1) Amount of taxable earnings in a distribution.
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§ 1.529–4 Time, form, and manner of reporting distributions from QSTPs and backup withholding.

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(b) Requirement to file return.
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(2) Payor.
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(5) Returns required on magnetic media.
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(3) Time for furnishing statement.
(4) Extension of time to furnish statement.
(d) Backup withholding.
(e) Effective date.

§ 1.529–5 Estate, gift, and generation-skipping transfer tax rules relating to qualified State tuition programs.

(a) Gift and generation-skipping transfer tax treatment of contributions after August 20, 1996, and before August 6, 1997.
(b) Gift and generation-skipping transfer tax treatment of contributions after August 5, 1997.
(1) In general.
(2) Contributions that exceed the annual exclusion amount.
(3) Change of designated beneficiary or rollover.
(c) Estate tax treatment for estates of decedents dying after August 20, 1996, and before June 9, 1997.
(d) Estate tax treatment for estates of decedents dying after June 8, 1997.
(1) In general.
(2) Excess contributions.
(3) Designated beneficiary decedents.

§ 1.529–6 Transition rules.

(a) Effective date.
(b) Programs maintained on August 20, 1996.
(c) Retroactive effect.
(d) Contracts entered into and accounts opened before August 20, 1996.
(1) In general.
(2) Interest in program pledged as security for a loan.
(3) Member of the family.
(4) Eligible educational institution.

§ 1.529–1 Qualified State tuition program, unrelated business income tax and definitions.

(a) *In general.* A qualified State tuition program (QSTP) described in section 529 is exempt from income tax, except for the tax imposed under section 511 on the QSTP's unrelated business taxable income. A QSTP is not required to file Form 990, Return of Organization Exempt From Income Tax, Form 1041, U.S. Income Tax Return for Estates and Trusts, or Form 1120, U.S. Corporation Income Tax Return. A QSTP may be required to file Form 990–T, Exempt Organization Business Income Tax Return. See §§ 1.6012–2(e) and 1.6012–3(a)(5) for requirements for filing Form 990–T.

(b) *Unrelated business income tax rules.* For purposes of section 529, this section and §§ 1.529–2 through 1.529–6:

(1) *Application of section 514.* An interest in a QSTP shall not be treated as debt for purposes of section 514. Consequently, a QSTP's investment income will not constitute debt-financed income subject to the unrelated business income tax merely because the program accepts contributions and is obligated to pay out or refund such contributions and certain earnings attributable thereto to designated beneficiaries or to account owners. However, investment income of a QSTP shall be subject to the unrelated business income tax as debt-financed income to the extent the program incurs indebtedness when acquiring or improving income-producing property.

(2) *Penalties and forfeitures.* Earnings forfeited on prepaid educational arrangements or contracts and educational savings accounts and retained by a QSTP, or amounts collected by a QSTP as penalties on refunds or excess contributions are not unrelated business income to the QSTP.

(3) *Administrative and other fees.* Amounts paid, in order to open or maintain prepaid educational arrangements or contracts and educational savings accounts, as administrative or maintenance fees, and other similar fees including late fees, service charges, and finance charges, are not unrelated business income to the QSTP.

(c) *Definitions.* For purposes of section 529, this section and §§ 1.529–2 through 1.529–6:

Account means the formal record of transactions relating to a particular designated beneficiary when it is used alone without further modification in these regulations. The term includes prepaid educational arrangements or contracts described in section 529(b)(1)(A)(i) and educational savings accounts described in section 529(b)(1)(A)(ii).

Account owner means the person who, under the terms of the QSTP or any contract setting forth the terms under which contributions may be made to an account for the benefit of a designated beneficiary, is entitled to select or change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated.

Contribution means any payment directly allocated to an account for the benefit of a designated beneficiary or used to pay late fees or administrative fees associated with the account. In the case of a tax-free *rollover,* within the meaning of this paragraph (c), into a QSTP account, only the portion of the rollover amount that constituted *investment in the account,* within the meaning of this paragraph (c), is treated as a contribution to the account as required by § 1.529–3(a)(2).

Designated beneficiary means—

(1) The individual designated as the beneficiary of the account at the time an account is established with the QSTP;

(2) The individual who is designated as the new beneficiary when beneficiaries are changed; and

(3) The individual receiving the benefits accumulated in the account as a scholarship in the case of a QSTP account established by a State or local government or an organization described in section 501(c)(3) and exempt from taxation under section 501(a) as part of a scholarship program operated by such government or organization.

Distributee means the designated beneficiary or the account owner who receives or is treated as receiving a distribution from a QSTP. For example, if a QSTP makes a distribution directly to an eligible educational institution to pay tuition and fees for a designated beneficiary or a QSTP makes a distribution in the form of a check payable to both a designated beneficiary and an eligible educational institution, the distribution shall be treated as having been made in full to the designated beneficiary.

Distribution means any disbursement, whether in cash or in-kind, from a QSTP. Distributions include, but are not limited to, tuition credits or certificates, payment vouchers, tuition waivers or other similar items. Distributions also include, but are not limited to, a refund to the account owner, the designated beneficiary or the designated beneficiary's estate.

Earnings attributable to an account are the total account balance on a particular date minus the investment in the account as of that date.

Earnings ratio means the amount of earnings allocable to the account on the last day of the calendar year divided by the total account balance on the last day of that calendar year. The earnings ratio is applied to any distribution made during the calendar year. For purposes of computing the earnings ratio, the earnings allocable to the account on the last day of the calendar year and the total account balance on the last day of the calendar year include all distributions made during the calendar year and any amounts that have been forfeited from the account during the calendar year.

Eligible educational institution means an institution which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C 1088) as in effect on August 5, 1997, and which is eligible to participate in a program under title IV of such Act. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Final distribution means the distribution from a QSTP account that reduces the total account balance to zero.

Forfeit means that earnings and contributions allocable to a QSTP account are withdrawn by the QSTP from the account or deducted by the QSTP from a distribution to pay a penalty as required by § 1.529–2(e).

Investment in the account means the sum of all contributions made to the account on or before a particular date less the aggregate amount of contributions included in distributions, if any, made from the account on or before that date.

Member of the family means an individual who is related to the designated beneficiary as described in paragraphs (1) through (9) of this definition. For purposes of determining who is a member of the family, a legally adopted child of an individual shall be treated as the child of such individual by blood. The terms brother and sister include a brother or sister by the halfblood. Member of the family means—

(1) A son or daughter, or a descendant of either;

(2) A stepson or stepdaughter;

(3) A brother, sister, stepbrother, or stepsister;

(4) The father or mother, or an ancestor of either;

(5) A stepfather or stepmother;

(6) A son or daughter of a brother or sister;

(7) A brother or sister of the father or mother;

(8) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or

(9) The spouse of the designated beneficiary or the spouse of any individual described in paragraphs (1) through (8) of this definition.

Person has the same meaning as under section 7701(a)(1).

Qualified higher education expenses means—

(1) Tuition, fees, and the costs of books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution; and

(2) The costs of room and board (as limited by paragraph (2)(i) of this definition) of a designated beneficiary (who meets requirements of paragraph (2)(ii) of this definition) incurred while attending an eligible educational institution:

(i) The amount of room and board treated as qualified higher education expenses shall not exceed the minimum room and board allowance determined in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965 (20 U.S.C. 108711) as in effect on August 5, 1997. For purposes of these regulations, room and board costs shall not exceed $1,500 per academic year for a designated beneficiary residing at home with parents or guardians. For a designated beneficiary residing in institutionally owned or operated housing, room and board costs shall not exceed the amount normally assessed most residents for room and board at the institution. For all other designated beneficiaries the amount shall not exceed $2,500 per academic year. For this purpose the term academic year has the same meaning as that term is given in 20 U.S.C. 1088(d) as in effect on August 5, 1997.

(ii) Room and board shall be treated as qualified higher education expenses for a designated beneficiary if they are incurred during any academic period during which the designated beneficiary is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the eligible educational institution) that leads to a recognized educational credential awarded by an eligible educational institution. In addition, the designated beneficiary must be enrolled at least half-time. A student will be considered to be enrolled at least half-time if the student is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. The institution's standard for a full-time workload must equal or exceed the standard established by the Department of Education under the Higher Education Act and set forth in 34 CFR 674.2(b).

Rollover distribution means a distribution or transfer from an account of a designated beneficiary that is transferred to or deposited within 60 days of the distribution into an account of another individual who is a member of the family of the designated beneficiary. A distribution is not a rollover distribution unless there is a change in beneficiary. The new designated beneficiary's account may be in a QSTP in either the same State or a QSTP in another State.

Total account balance means the total amount or the total fair market value of tuition credits or certificates or similar benefits allocable to the account on a particular date. For purposes of computing the *earnings ratio,* the total account balance is adjusted as described in this paragraph (c).

§ 1.529–2 Qualified State tuition program described.

(a) *In general.* To be a QSTP, a program must satisfy the requirements described in paragraphs (a) through (i) of this section. A QSTP is a program established and maintained by a State or an agency or instrumentality of a State under which a person—

(1) 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; or

(2) May make contributions to an account that is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account.

(b) *Established and maintained by a State or agency or instrumentality of a State*—(1) *Established.* A program is established by a State or an agency or instrumentality of a State if the program is initiated by State statute or regulation, or by an act of a State official or agency with the authority to act on behalf of the State.

(2) *Maintained.* A program is maintained by a State or an agency or instrumentality of a State if—

(i) The State or agency or instrumentality sets all of the terms and conditions of the program, including but not limited to who may contribute to the program, who may be a designated beneficiary of the program, what benefits the program may provide, when penalties will apply to refunds and what those penalties will be; and

(ii) The State or agency or instrumentality is actively involved on an ongoing basis in the administration of the program, including supervising all decisions relating to the investment of assets contributed to the program.

(3) *Actively involved.* Factors that are relevant in determining whether a State, agency or instrumentality is actively involved include, but are not limited to: whether the State provides services or benefits (such as tax, student aid or other financial benefits) to account owners or designated beneficiaries that are not provided to persons who are not account owners or designated beneficiaries; whether the State or agency or instrumentality establishes detailed operating rules for administering the program; whether officials of the State or agency or instrumentality play a substantial role in the operation of the program, including selecting, supervising, monitoring, auditing, and terminating any private contractors that provide services under the program; whether the State or agency or instrumentality holds the private contractors that provide services under the program to the same standards and requirements that apply when private contractors handle funds that belong to the State or provide services to the State; whether the State provides funding for the program; and, whether the State or agency or instrumentality acts as trustee or holds program assets directly or for the benefit of the account owners or designated beneficiaries. If the State or an agency or instrumentality thereof exercises the same authority over the funds invested in the program as it does over the investments in or pool of funds of a State employees' defined benefit pension plan, then the State or agency or instrumentality will be considered actively involved on an ongoing basis in the administration of the program.

(c) *Permissible uses of contributions.* Contributions to a QSTP can be placed into either a prepaid educational arrangement or contract described in section 529(b)(1)(A)(i) or an educational savings account described in section 529(b)(1)(A)(ii), or both, but cannot be placed into any other type of account.

(1) A prepaid educational services arrangement or contract is an account through which tuition credits or certificates or other rights are acquired that entitle the designated beneficiary of the account to the waiver or payment of qualified higher education expenses.

(2) An educational savings account is an account that is established exclusively for the purpose of meeting the qualified higher education expenses of a designated beneficiary.

(d) *Cash contributions.* A program shall not be treated as a QSTP unless it provides that contributions may be made only in cash and not in property. A QSTP may accept payment, however, in cash, or by check, money order, credit card, or similar methods.

(e) *Penalties on refunds*—(1) *General rule.* A program shall not be treated as a QSTP unless it imposes a more than de minimis penalty on the earnings portion of any distribution from the program that is not—

(i) Used exclusively for qualified higher education expenses of the designated beneficiary;

(ii) Made on account of the death or disability of the designated beneficiary;

(iii) Made on account of the receipt of a scholarship (or allowance or payment described in section 135(d)(1) (B) or (C)) by the designated beneficiary to the extent the amount of the distribution does not exceed the amount of the scholarship, allowance, or payment; or

(iv) A rollover distribution.

(2) *More than de minimis penalty*—(i) *In general.* A penalty is more than de minimis if it is consistent with a program intended to assist individuals in saving exclusively for qualified higher education expenses. Except as provided in paragraph (e)(2)(ii) of this section, whether any particular penalty is more than de minimis depends on the facts and circumstances of the particular program, including the extent to which the penalty offsets the federal income tax benefit from having deferred income tax liability on the earnings portion of any distribution.

(ii) *Safe harbor.* A penalty imposed on the earnings portion of a distribution is more than de minimis if it is equal to or greater than 10 percent of the earnings.

(3) *Separate distributions.* For purposes of applying the penalty, any single distribution described in paragraph (e)(1) of this section will be treated as a separate distribution and not part of a single aggregated annual distribution by the program, notwithstanding the rules under § 1.529–3 and § 1.529–4.

(4) *Procedures for verifying use of distributions and imposing and collecting penalties*—(i) *In general.* To be treated as imposing a more than de minimis penalty as required in paragraph (e)(1) of this section, a program must implement practices and procedures to identify whether a distribution is subject to a penalty and collect any penalty that is due.

(ii) *Safe harbor.* A program that falls within the safe harbor described in paragraphs (e)(4)(ii) (A) through (E) of this section will be treated as implementing practices and procedures to identify whether a more than de minimis penalty must be imposed as required in paragraph (e)(1) of this section.

(A) *Distributions treated as payments of qualified higher education expenses.* The program treats distributions as being used to pay for qualified higher education expenses only if—

(*1*) The distribution is made directly to an eligible educational institution;

(*2*) The distribution is made in the form of a check payable to both the designated beneficiary and the eligible educational institution;

(*3*) The distribution is made after the designated beneficiary submits substantiation to show that the distribution is a reimbursement for qualified higher education expenses that the designated beneficiary has already paid and the program has a process for reviewing the validity of the substantiation prior to the distribution; or

(*4*) The designated beneficiary certifies prior to the distribution that the distribution will be expended for his or her qualified higher education expenses within a reasonable time after the distribution; the program requires the designated beneficiary to provide substantiation of payment of qualified higher education expenses within 30 days after making the distribution and has a process for reviewing the substantiation; and the program retains an account balance that is large enough to collect any penalty owed on the distribution if valid substantiation is not produced.

(B) *Treatment of all other distributions.* The program collects a penalty on all distributions not treated as made to pay qualified higher education expenses except where—

(*1*) Prior to the distribution the program receives written third party confirmation that the designated beneficiary has died or become disabled or has received a scholarship (or allowance or payment described in section 135(d)(1) (B) or (C)) in an amount equal to the distribution; or

(*2*) Prior to the distribution the program receives a certification from the account owner that the distribution is being made because the designated beneficiary has died or become disabled or has received a scholarship (or allowance or payment described in section 135(d)(1) (B) or (C)) received by the designated beneficiary (and the distribution is equal to the amount of the scholarship, allowance, or payment) and the program withholds and reserves a portion of the distribution as a penalty. Any penalty withheld by the program may be refunded after the program receives third party confirmation that the designated beneficiary has died or become disabled or has received a scholarship or allowance (or payment described in section 135(d)(1) (B) or (C)).

(C) *Refunds of penalties.* The program will refund a penalty collected on a distribution only after the designated beneficiary substantiates that he or she had qualified higher education expenses greater than or equal to the distribution, and the program has reviewed the substantiation.

(D) *Documentation of amounts refunded and not used for qualified higher education expenses.* The program requires the distributee, defined in § 1.529–1(c), to provide a signed statement identifying the amount of any refunds received from eligible educational institutions at the end of each year in which distributions for qualified higher education expenses were made and of the next year.

(E) *Procedures to collect penalty.* The program collects required penalties by retaining a sufficient balance in the account to pay the amount of penalty, withholding an amount equal to the penalty from a distribution, or collecting the penalty on a State income tax return.

(f) *Separate accounting.* A program shall not be treated as a QSTP unless it provides separate accounting for each designated beneficiary. Separate accounting requires that contributions for the benefit of a designated beneficiary and any earnings attributable thereto must be allocated to the appropriate account. If a program does not ordinarily provide each account owner an annual account statement showing the total account balance, the investment in the account, earnings, and distributions from the account, the program must give this information to the account owner or designated beneficiary upon request. In the case of a prepaid educational arrangement or contract described in section 529(b)(1)(A)(i) the total account balance may be shown as credits or units of benefits instead of fair market value.

(g) *No investment direction.* A program shall not be treated as a QSTP unless it provides that any account owner in, or contributor to, or designated beneficiary under, such program may not directly or indirectly direct the investment of any contribution to the program or directly or indirectly direct the investment of any earnings attributable to contributions. A program does not violate this requirement if a person who establishes an account with the program is permitted to select among different investment strategies designed exclusively by the program, only at the time the initial contribution is made establishing the account. A program will not violate the requirement of this paragraph (g) if it permits a person who establishes an account to select between a prepaid educational services account and an educational savings account. A program also will not violate the requirement of this paragraph (g) merely because it permits its board members, its employees, or the board members or employees of a contractor it hires to perform administrative services to purchase tuition credits or certificates or make contributions as described in paragraph (c) of this section.

(h) *No pledging of interest as security.* A program shall not be treated as a QSTP unless the terms of the program or a state statute or regulation that governs the program prohibit any interest in the program or any portion thereof from being used as security for a loan. This restriction includes, but is not limited to, a prohibition on the use of any interest in the program as security for a loan used to purchase such interest in the program.

(i) *Prohibition on excess contributions*—(1) *In general.* A program shall not be treated as a QSTP unless it provides adequate safeguards to prevent contributions for the benefit of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the designated beneficiary.

(2) *Safe harbor.* A program satisfies this requirement if it will bar any additional contributions to an account as soon as the account reaches a specified account balance limit applicable to all accounts of designated beneficiaries with the same expected year of enrollment. The total contributions may not exceed the amount determined by actuarial estimates that is necessary to pay tuition, required fees, and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program.

§ 1.529–3 Income tax treatment of distributees.

(a) *Taxation of distributions*—(1) *In general.* Any distribution, other than a rollover distribution, from a QSTP account must be included in the gross income of the distributee to the extent of the earnings portion of the distribution and to the extent not excluded from gross income under any other provision of chapter 1 of the Internal Revenue Code. If any amount of a distribution is forfeited under a QSTP as required by § 1.529–2(e), this amount is neither included in the gross income of the distributee nor deductible by the distributee.

(2) *Rollover distributions.* No part of a rollover distribution is included in the income of the distributee. Following the rollover distribution, that portion of the rollover amount that constituted investment in the account, defined in § 1.529–1(c), of the account from which the distribution was made is added to the investment in the account of the account that received the distribution. That portion of the rollover amount that constituted earnings of the account that made the distribution is added to the earnings of the account that received the distribution.

(b) *Computing taxable earnings*—(1) *Amount of taxable earnings in a distribution*—(i) *Educational savings account.* In the case of an educational savings account, the earnings portion of a distribution is equal to the product of the amount of the distribution and the earnings ratio, defined in § 1.529–1(c). The return of investment portion of the distribution is equal to the amount of the distribution minus the earnings portion of the distribution.

(ii) *Prepaid educational services account.* In the case of a prepaid educational services account, the earnings portion of a distribution is equal to the value of the credits, hours, or other units of education distributed at the time of distribution minus the return of investment portion of the distribution. The value of the credits, hours, or other units of education may be based on the tuition waived or the cash distributed. The return of investment portion of the distribution is determined by dividing the investment in the account at the end of the year in which the distribution is made by the number of credits, hours, or other units of education in the account at the end of the calendar year (including all credits, hours, or other units of education distributed during the calendar year), and multiplying that amount by the number of credits, hours, or other units of education distributed during the current calendar year.

(2) *Adjustment for programs that treated distributions and earnings in a different manner for years beginning before January 1, 1999.* For calendar years beginning after December 31, 1998, a QSTP must treat taxpayers as recovering investment in the account and earnings ratably with each distribution. Prior to January 1, 1999, a program may have treated distributions in a different manner and reported them to taxpayers accordingly. In order to adjust to the method described in this section, if distributions were treated as coming first from the investment in the account, the QSTP must adjust the investment in the account by subtracting the amount of the investment in the account previously treated as distributed. If distributions were treated as coming first from earnings, the QSTP must adjust the earnings portion of the account by subtracting the amount of earnings previously treated as distributed. After the adjustment is made, the investment in the account is recovered ratably in accordance with this section. If no previous distribution was made but earnings were treated as taxable to the taxpayer in the year they were allocated to the account, the earnings treated as already taxable are treated as additional contributions and added to the investment in the account.

(3) *Examples.* The application of this paragraph (b) is illustrated by the following examples. The rounding convention used (rounding to three decimal places) in these examples is for purposes of illustration only. A QSTP may use another rounding convention as long as it consistently applies the convention. The examples are as follows:

Example 1. (i) In 1998, an individual, A, opens a prepaid educational services account with a QSTP on behalf of a designated beneficiary. Through the account A purchases units of education equivalent to eight semesters of tuition for full-time attendance at a public four-year university covered by the QSTP. A contributes $16,000 that includes payment of processing fees to the QSTP. In 2011 the designated beneficiary enrolls at a public four-year university. The QSTP makes distributions on behalf of the designated beneficiary to the university in August for the fall semester and in December for the spring semester. Tuition for full-time attendance at the university is $7,500 per academic year in 2011 and 2012, $7,875 for the academic year in 2013, and $8,200 for the academic year in 2014. The only expense covered by the QSTP distribution is tuition for four academic years. The calculations are as follows:

2011		
Investment in the account as of 12/31/2011	=	$16,000
Units in account	=	8
Per unit investment	=	$2,000
Units distributed in 2011	=	2
Investment portion of distribution in 2011 ($2,000 per unit × 2 units)	=	$4,000
Current value of two units distributed in 2011	=	$7,500
Earnings portion of distribution in 2011 ($7,500–$4,000)	=	$3,500
2012		
Investment in the account as of 12/31/2012 ($16,000–$4,000)	=	$12,000
Units in account	=	6
Per unit investment	=	$2,000
Units distributed in 2012	=	2
Investment portion of distribution in 2012 ($2,000 per unit × 2 units)	=	$4,000
Current value of two units distributed in 2012	=	$7,500
Earnings portion of distribution in 2012 ($7,500–$4,000)	=	$3,500
2013		
Investment in the account as of 12/31/2013 ($12,000–$4000)	=	$8,000
Units in account	=	4
Per unit investment	=	$2,000
Units distributed in 2013	=	2
Investment portion of distribution in 2013 ($2,000 per unit × 2 units)	=	$4,000
Current value of two units distributed in 2013	=	$7,875
Earnings portion of distribution in 2013 ($7,875–$4,000)	=	$3,875
2014		
Investment in the account as of 12/31/2014 ($8,000–$4000)	=	$4,000
Units in account	=	2
Per unit investment	=	$2,000
Units distributed in 2014	=	2
Investment portion of distribution in 2014 ($4,000 per unit × 2 units)	=	$4,000
Current value of two units distributed in 2014	=	$8,200
Earnings portion of distribution in 2014 ($8,200–$4,000)	=	$4,200
12/31/2014 (after distributions)		
Investment in the account as of 12/31/2014 ($4,000–$4000)	=	0

(ii) In each year the designated beneficiary includes in his or her gross income the earnings portion of the distribution for tuition.

Example 2. (i) In 1998, an individual, B, opens a college savings account with a QSTP on behalf of a designated beneficiary. B contributes $18,000 to the account that includes payment of processing fees to the QSTP. On December 31, 2011, the total balance in the account for the benefit of the designated beneficiary is $30,000 (including distributions made during the year 2011). In 2011 the designated beneficiary enrolls at a four-year university. The QSTP makes distributions on behalf of the designated beneficiary to the university in August for the fall semester and in December for the spring semester. Tuition for full-time attendance at the university is $7,500 per academic year in 2011 and 2012, $7,875 for the academic year in 2013, and $8,200 for the academic year in 2014. The only expense covered by the QSTP distributions is tuition for four academic years. On the last day of the calendar year the account is allocated earnings of 5% on the total account balance on that day. Under the terms of the QSTP, a penalty of 15% is applied to the earnings not used to pay tuition. The calculations are as follows:

2011		
Investment in the account	=	$18,000
Total account balance as of 12/31/2011	=	$30,000
Earnings as of 12/31/2011	=	$12,000
Distributions in 2011	=	$7,500
Earnings ratio for 2011 ($12,000÷$30,000)	=	40%
Earnings portion of distributions in 2011 ($7,500×.4)	=	$3,000
Return of investment portion of distributions in 2011 ($7,500−$3,000)	=	$4,500
2012		
Investment in the account as of 12/31/2012 ($18,000−$4,500)	=	$13,500
Total account balance as of 12/31/12 [($30,000−$7,500)×105%]	=	$23,625
Earnings as of 12/31/2012	=	$10,125
Distributions in 2012	=	$7,500
Earnings ratio for 2012 ($10,125÷$23,625)	=	42.9%
Earnings portion of distributions in 2012 ($7,500×.429)	=	$3,217.50
Return of investment portion of distributions in 2012 ($7,500−$3,217.50)	=	$4,282.50
2013		
Investment in the account as of 12/31/2013 ($13,500−$4,282.50)	=	$9,217.50
Total account balance as of 12/31/13 [($23,625−$7,500)×105%]	=	$16,931.25
Earnings as of 12/31/2013	=	$7,713.75
Distributions in 2013	=	$7,875
Earnings ratio for 2013 ($7,713.75÷$16,931.25)	=	45.6%
Earnings portion of distributions in 2013 ($7,875×.456)	=	$3,591
Return of investment portion of distributions in 2013 ($7,875−$3,591)	=	$4,284
2014		
Investment in the account as of 12/31/2014 ($9,217.50−$4,284)	=	$4,933.50
Total account balance as of 12/31/14 [($16,931.25−$7,875)×105%]	=	$9,509.06
Earnings as of 12/31/2014	=	$4,575.56
Distributions in 2014 for qualified higher education expenses (QHEE)	=	$8,200
Distributions in 2014 not for qualified higher education expenses (Non-QHEE)	=	$1,309.06
Total distributions	=	$9,509.06
Earnings portion of QHEE distribution in 2014 [($8,200÷$9,509.06)×$4,575.56]	=	$3,945.68
Return of investment portion of QHEE distribution in 2014	=	$4,254.32
Earnings portion of Non-QHEE distribution subject to penalty [($1,309.06÷$9,509.06)×$4,575.56)]	=	$629.89
Return of investment portion of non-QHEE distribution in 2014	=	$679.17

(ii) In years 2011 through 2013 the designated beneficiary includes in gross income the earnings portion of the distributions for tuition. In year 2014 the designated beneficiary includes in gross income the earnings portion of the distribution for tuition, $3,945.68, plus the earnings portion of the distribution that was not used for tuition after reduction for the penalty, i.e. $535.41 ($629.89 minus a 15% penalty of $94.48).

(c) *Change in designated beneficiaries*—(1) *General rule.* A change in the designated beneficiary of a QSTP account is not treated as a distribution if the new designated beneficiary is a member of the family of the transferor designated beneficiary. However, any change of designated beneficiary not described in the preceding sentence is treated as a distribution to the account owner, provided the account owner has the authority to change the designated beneficiary. For rules related to a change in the designated beneficiary pursuant to a rollover distribution see §§ 1.529–1(c) and 1.529–3(a)(2).

(2) *Scholarship program.* Notwithstanding paragraph (c)(1) of this section, the requirement that the new beneficiary be a member of the family of the transferor beneficiary shall not apply to a change in designated beneficiary of an interest in a QSTP account purchased by a State or local government or an organization described in section 501(c)(3) as part of a scholarship program.

(d) *Aggregation of accounts.* If an individual is a designated beneficiary of more than one account under a QSTP, the QSTP shall treat all contributions and earnings as allocable to a single account for purposes of calculating the earnings portion of any distribution from that QSTP. For purposes of determining the effect of the distribution on each account, the earnings portion and return of investment in the account portion of the distribution shall be allocated pro rata among the accounts based on total account value as of the close of the current calendar year.

§ 1.529–4 Time, form, and manner of reporting distributions from QSTPs and backup withholding.

(a) *Taxable distributions.* The portion of any distribution made during the calendar year by a QSTP that represents earnings shall be reported by the payor as described in this section.

(b) *Requirement to file return*—(1) *Form of return.* A payor must file a return required by this section on Form 1099–G. A payor may use forms containing provisions similar to Form 1099–G if it complies with applicable revenue procedures relating to substitute Forms 1099. A payor must file a separate return for each distributee who receives a taxable distribution.

(2) *Payor.* For purposes of this section, the term ‘‘payor’’ means the officer or employee having control of the program, or their designee.

(3) *Information included on return.* A payor must include on Form 1099–G—

(i) The name, address, and taxpayer identifying number (TIN) (as defined in section 7701(a)(41)) of the payor;

(ii) The name, address, and TIN of the distributee;

(iii) The amount of earnings distributed to the distributee in the calendar year; and

(iv) Any other information required by Form 1099–G or its instructions.

(4) *Time and place for filing return.* A payor must file any return required by this paragraph (b) on or before February 28 of the year following the calendar year in which the distribution is made. A payor must file the return with the IRS office designated in the instructions for Form 1099–G.

(5) *Returns required on magnetic media.* If a payor is required to file at least 250 returns during the calendar year, the returns must be filed on magnetic media. If a payor is required to file fewer than 250 returns, the prescribed paper form may be used.

(6) *Extension of time to file return.* For good cause, the Commissioner may grant an extension of time in which to file Form 1099–G for reporting taxable earnings under section 529. The application for extension of time must be submitted in the manner prescribed by the Commissioner.

(c) *Requirement to furnish statement to the distributee*—(1) *In general.* A payor that must file a return under paragraph (b) of this section must furnish a statement to the distributee. The requirement to furnish a statement to the distributee will be satisfied if the payor provides the distributee with a copy of the Form 1099–G (or a substitute statement that complies with applicable revenue procedures) containing all the information filed with the Internal Revenue Service and all the legends required by paragraph (c)(2) of this section by the time required by paragraph (c)(3) of this section.

(2) *Information included on statement.* A payor must include on the statement that it must furnish to the distributee—

(i) The information required under paragraph (b)(3) of this section;

(ii) The telephone number of a person to contact about questions pertaining to the statement; and

(iii) A legend as required on the official Internal Revenue Service Form 1099–G.

(3) *Time for furnishing statement.* A payor must furnish the statement required by paragraph (c)(1) of this section to the distributee on or before January 31 of the year following the calendar year in which the distribution was made. The statement will be considered furnished to the distributee if it is mailed to the distributee's last known address.

(4) *Extension of time to furnish statement.* For good cause, the Commissioner may grant an extension of time to furnish statements to distributees of taxable earnings under section 529. The application for extension of time must be submitted in the manner prescribed by the Commissioner.

(d) *Backup withholding.* Distributions from a QSTP are not subject to backup withholding.

(e) *Effective date.* The reporting requirements set forth in this section apply to distributions made after December 31, 1998.

§ 1.529–5 Estate, gift, and generation-skipping transfer tax rules relating to qualified State tuition programs.

(a) *Gift and generation-skipping transfer tax treatment of contributions after August 20, 1996, and before August 6, 1997.* A contribution on behalf of a designated beneficiary to a QSTP (or to a program that meets the transitional rule requirements under § 1.529–6(b)) after August 20, 1996, and before August 6, 1997, is not treated as a taxable gift. The subsequent waiver of qualified higher education expenses of a designated beneficiary by an educational institution (or the subsequent payment of higher education expenses of a designated beneficiary to an educational institution) under a QSTP is treated as a qualified transfer under section 2503(e) and is not treated as a transfer of property by gift for purposes of section 2501. As such, the contribution is not subject to the generation-skipping transfer tax imposed by section 2601.

(b) *Gift and generation-skipping transfer tax treatment of contributions after August 5, 1997*—(1) *In general.* A contribution on behalf of a designated beneficiary to a QSTP (or to a program that meets the transitional rule requirements under § 1.529–6(b)) after August 5, 1997, is a completed gift of a present interest in property under section 2503(b) from the person making the contribution to the designated beneficiary. As such, the contribution is eligible for the annual gift tax exclusion provided under section 2503(b). The portion of a contribution excludible from taxable gifts under section 2503(b) also satisfies the requirements of section 2642(c)(2) and, therefore, is also excludible for purposes of the generation-skipping transfer tax imposed under section 2601. A contribution to a QSTP after August 5, 1997, is not treated as a qualified transfer within the meaning of section 2503(e).

(2) *Contributions that exceed the annual exclusion amount.* (i) Under section 529(c)(2)(B) a donor may elect to take certain contributions to a QSTP into account ratably over a five year period in determining the amount of gifts made during the calendar year. The provision is applicable only with respect to contributions not in excess of five times the section 2503(b) exclusion amount available in the calendar year of the contribution. Any excess may not be taken into account ratably and is treated as a taxable gift in the calendar year of the contribution.

(ii) The election under section 529(c)(2)(B) may be made by a donor and his or her spouse with respect to a gift considered to be made one-half by each spouse under section 2513.

(iii) The election is made on Form 709, Federal Gift Tax Return, for the calendar year in which the contribution is made.

(iv) If in any year after the first year of the five year period described in section 529(c)(2)(B), the amount excludible under section 2503(b) is increased as provided in section 2503(b)(2), the donor may make an additional contribution in any one or more of the four remaining years up to the difference between the exclusion amount as increased and the original exclusion amount for the year or years in which the original contribution was made.

(v) *Example.* The application of this paragraph (b)(2) is illustrated by the following example:

Example. In Year 1, when the annual exclusion under section 2503(b) is $10,000, P makes a contribution of $60,000 to a QSTP for the benefit of P's child, C. P elects under section 529(c)(2)(B) to account for the gift ratably over a five year period beginning with the calendar year of contribution. P is treated as making an excludible gift of $10,000 in each of Years 1 through 5 and a taxable gift of $10,000 in Year 1. In Year 3, when the annual exclusion is increased to $12,000, P makes an additional contribution for the benefit of C in the amount of $8,000. P is treated as making an excludible gift of $2,000 under section 2503(b); the remaining $6,000 is a taxable gift in Year 3.

(3) *Change of designated beneficiary or rollover.* (i) A transfer which occurs by reason of a change in the designated beneficiary, or a rollover of credits or account balances from the account of one beneficiary to the account of another beneficiary, is not a taxable gift and is not subject to the generation-skipping transfer tax if the new beneficiary is a member of the family of the old beneficiary, as defined in § 1.529–1(c), and is assigned to the same generation as the old beneficiary, as defined in section 2651.

(ii) A transfer which occurs by reason of a change in the designated beneficiary, or a rollover of credits or account balances from the account of one beneficiary to the account of another beneficiary, will be treated as a taxable gift by the old beneficiary to the new beneficiary if the new beneficiary is assigned to a lower generation than the old beneficiary, as defined in section 2651, regardless of whether the new beneficiary is a member of the family of the old beneficiary. The transfer will be subject to the generation-skipping transfer tax if the new beneficiary is assigned to a generation which is two or more levels lower than the generation assignment of the old beneficiary. The five year averaging rule described in paragraph (b)(2) of this section may be applied to the transfer.

(iii) *Example.* The application of this paragraph (b)(3) is illustrated by the following example:

Example. In Year 1, P makes a contribution to a QSTP on behalf of P's child, C. In Year 4, P directs that a distribution from the account for the benefit of C be made to an account for the benefit of P's grandchild, G. The rollover distribution is treated as a taxable gift by C to G, because, under section 2651, G is assigned to a generation below the generation assignment of C.

(c) *Estate tax treatment for estates of decedents dying after August 20, 1996, and before June 9, 1997.* The gross estate of a decedent dying after August 20, 1996, and before June 9, 1997, includes the value of any interest in any QSTP which is attributable to contributions made by the decedent to such program on behalf of a designated beneficiary.

(d) *Estate tax treatment for estates of decedents dying after June 8, 1997*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, the gross estate of a decedent dying after June 8, 1997, does not include the value of any interest in a QSTP which is attributable to contributions made by the decedent to such program on behalf of any designated beneficiary.

(2) *Excess contributions.* In the case of a decedent who made the election under section 529(c)(2)(B) and paragraph (b)(3)(i) of this section who dies before the close of the five year period, that portion of the contribution allocable to calendar years beginning after the date of death of the decedent is includible in the decedent's gross estate.

(3) *Designated beneficiary decedents.* The gross estate of a designated beneficiary of a QSTP includes the value of any interest in the QSTP.

§ 1.529–6 Transition rules.

(a) *Effective date.* Section 529 is effective for taxable years ending after August 20, 1996, and applies to all contracts entered into or accounts opened on August 20, 1996, or later.

(b) *Programs maintained on August 20, 1996.* Transition relief is available to a program maintained by a State under which persons could purchase tuition credits, certification or similar rights on behalf of, or make contributions for educational expenses of, a designated beneficiary if the program was in existence on August 20, 1996. Such program must meet the requirements of a QSTP before the later of August 20, 1997, or the first day of the first calendar quarter after the close of the first regular session of the State legislature that begins after August 20, 1996. If a State has a two-year legislative session, each year of such session shall be deemed to be a separate regular session of the State legislature. The program, as in effect on August 20, 1996, shall be treated as a QSTP with respect to contributions (and earnings allocable thereto) pursuant to contracts entered into under the program. This relief is available for contributions (and earnings allocable thereto) made before, and the contracts entered into before, the first date on which the program becomes a QSTP. The provisions of the program, as in effect on August 20, 1996, shall apply in lieu of section 529(b) with respect to such contributions and earnings. A program shall be treated as meeting the transition rule if it conforms to the requirements of section 529, §§ 1.529–1 through 1.529–5 and this section by the date this document is published as final regulations in the **Federal Register**.

(c) *Retroactive effect.* No income tax liability will be asserted against a QSTP for any period before the program meets the requirements of section 529, §§ 1.529–1 through 1.529–5 and this section if the program qualifies for the transition relief described in paragraph (b) of this section.

(d) *Contracts entered into and accounts opened before August 20, 1996*—(1) *In general.* A QSTP may continue to maintain agreements in connection with contracts entered into and accounts opened before August 20, 1996, without jeopardizing its tax exempt status even if maintaining the agreements is contrary to section 529(b) provided that the QSTP operates in accordance with the restrictions contained in this paragraph (d). However, distributions made by the QSTP, regardless of the terms of any agreement executed before August 20, 1996, are subject to tax according to the rules of § 1.529–3 and subject to the reporting requirements of § 1.529–4.

(2) *Interest in program pledged as security for a loan.* An interest in the program, or a portion of an interest in the program, may be used as security for a loan if the contract giving rise to the interest was entered into or account was opened prior to August 20, 1996 and the agreement permitted such a pledge.

(3) *Member of the family.* In the case of an account opened or a contract entered into before August 20, 1996, the rules regarding a change in beneficiary, including the rollover rule in § 1.529–3(a) and the gift tax rule in § 1.529–5(b)(3), shall be applied by treating any transferee beneficiary permitted under the terms of the account or contract as a member of the family of the transferor beneficiary.

(4) *Eligible educational institution.* In the case of an account opened or contract entered into before August 20, 1996, an eligible educational institution is an educational institution in which the beneficiary may enroll under the terms of the account or contract.

Michael P. Dolan,

Deputy Commissioner of Internal Revenue.

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ENVIRONMENTAL PROTECTION AGENCY

40 CFR Parts 51, 52, 76, and 96

Availability of Documents for the Rulemaking for Certain States in the Ozone Transport Assessment Group Region

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice of availability.

SUMMARY: This document announces the availability of various documents that relate to the notice of proposed rulemaking and supplemental notice of proposed rulemaking for the ozone transport rule. These documents have been, or shortly will be, placed in the docket for this rule, or have been made available on the EPA website.

DATES: Documents were placed in the docket on or about August 10, 1998.

ADDRESSES: Some of the documents have been placed in the docket for the ozone transport rule, Docket No. A–96–56, at the Air and Radiation Docket and Information Center (6102), US Environmental Protection Agency, 401 M Street SW, Room M–1500, Washington, DC 20460, telephone (202) 260–7548, and are available for viewing between 8:00 a.m. and 4:00 p.m., Monday through Friday, excluding legal holidays. A reasonable fee may be