STATEMENT OF

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before the

HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

"Investing for the Future: 529 State Tuition Savings Plans"

Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, I am Marc E. Lackritz, President of the Securities Industry Association.[1] We commend you for holding this hearing on the importance of 529 state tuition savings plans in helping American families save for post-secondary education.

As financial intermediaries and providers of investment advice, our member-firms are deeply committed to reviving a national culture of saving, particularly among the nation's youth. We have worked hard to educate and encourage both students and parents to invest regularly in a product with marginal risk to help foster a renewed sense of personal responsibility. One such product – Section 529 education plans – offers some of the best benefits for saving for college. Our members are actively involved in all phases of the management and marketing of 529 plans because these plans have easier

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift and pension plans. In 2003, the industry generated an estimated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com).

eligibility and contribution requirements than certain other investment options, making them accessible to far more families and people.[2]

American families need help to meet the daunting challenge of financing ever-increasing post-secondary education costs. According to the College Board, in the 10-year period ending 2003-04, average tuition costs rose 47 percent at public institutions and 42 percent at private institutions.[3] The cost of four years of college in 2003 was nearly $43,000 for tuition, fees, room and board at a public college and more than $107,000 at private schools. As costs increase, parents and their children increasingly have relied on loans to finance education. In the 2000-01 academic year, loans comprised about 58 percent of all student aid.

History, Growth, and Regulation of 529 Plans

In recognition of the important policy goal of helping American families cope with the growing burden of college costs, many states pioneered the creation of dedicated tuition plans in the 1980s. The plans permitted residents to contribute to a trust to lock-in costs of future tuition payments. The federal taxation of the contributions and earnings, however, was uncertain during the early years of the plans' existence. To address that uncertainty, Congress approved an amendment to the tax code (Section 529 of the Internal Revenue Code) in 1996 to exempt state programs from federal income taxes on the earnings until the funds were distributed. In addition, the statute addressed the gift tax treatment of the funds. Congress amended Section 529 again in 1997 to include room

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[2] Coverdell education savings accounts (ESAs), for example, are limited by the amount of earned income and are restricted to a $2,000 annual contribution. Uniform Gift to Minors Act (UGMA) and Uniform Transfer to Minors Act (UTMA) accounts enjoy federal tax advantages, but have potential drawbacks, depending on financial circumstances and goals.

[3] The College Board is a national, nonprofit membership association of more than 4,300 schools, colleges, universities and other educational organizations. Trends in College Pricing 2003, p. 5.

and board expenses and additional relief in the area of gift and estate taxes. The most significant, beneficial change to Section 529 plans, however, came in 2001 when Congress authorized the tax-free treatment of distributions used for educational purposes as part of the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA).

The enhanced federal tax benefit instantly increased the popularity of Section 529 plans. More than $40 billion is now invested in 529 programs,[4] nearly 13 times more than the approximately $3.1 billion invested in 2000 (the year prior to enactment of EGTRRA).[5] The average 529-account balance is now about $8,200,[6] and between 7-8 percent of families with children under 18 own a 529 savings plan.[7] Research shows that 63 percent of accounts were opened in 2001 or later,[8] indicating that participation and account balances will undoubtedly continue to rise as individuals become more aware of the tax benefits of the plan. Indeed, if a family contributed $2,000 annually to a 529 account for 18 years (assuming an 8 percent rate of return) the family would have saved nearly $75,000 for college – an amount that would meet the requirements of most four-year public institutions across the country.[9] Under the same scenario, a taxable mutual fund investor who pays capital gains taxes at a marginal rate of 15 percent would have accumulated only $66,706, or 12.3 percent less than the 529 plan investor.[10] The favored tax treatment of 529 plans not only enhances returns, but also helps assure the funds will

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[4] Financial Research Corporation, Quarterly Update, April 2004.
[5] Cerulli Associates, Presentation by Luis Fleites, SIA 529 Plans Conference, January 23, 2003.
[6] Financial Research Corporation, Quarterly Update, April 2004.
[7] Cerulli Associates Presentation and Profile of Households Saving for College; Investment Company Institute Research Series, Fall 2003, p. 43.
[8] Profile of Households Saving for College, Investment Company Institute Research Series, Fall 2003, p. 43.
[9] Calculator provided by www.smartmoney.com/college/investing/index.cfm7.story=529calc: The 529 College-Savings Plan Estimator, May 19, 2004.
[10] www.smartmoney.com.

be there when needed for college by making it less attractive to withdraw them for other purposes.

Each individual state elects to establish or sponsor a 529 program. Without the state's involvement, 529 savings plans would not exist. States either manage the plan on their own, or select an outside manager, usually a brokerage firm, mutual fund company, or insurance company. States approve selection of investment options, administration issues, and fees. States usually approve the methods of distribution both in-state and nationally, and broker-dealers that distribute 529 plans must also coordinate with the states to negotiate selling agreements and produce marketing and other program literature. Tax treatment of 529 plans is subject to both federal and state law, and the Securities and Exchange Commission (SEC) and the Municipal Securities Rulemaking Board (MSRB) oversee the broker-dealers and investment advisers who distribute the plans.

The MSRB has released extensive guidance on the sale of 529 plans, including the requirement to disclose the potential of a home-state tax benefit, suitability requirements, and advertising of 529 plans. MSRB rules applicable to 529 plans include the following:

- Registration and qualification (Rules A-12, A-14, G-2, and G-3);
- Advertising (Rule G-21);
- Recommendations and suitability determinations on the purchase or sale of 529 plans and disclosure of state tax implications (MSRB Rules G-17 and G-19);
- Prices and commissions (MSRB Rule G-30);

- Providing new customers with a copy of the official statement (MSRB Rule G-32);
- Political contributions (MSRB Rules G-37 and G-38) from municipal security dealer firms must be tracked and disclosed.

<u>Improving 529 Plans</u>

Make the Tax-Free Treatment of Distributions Permanent

The short-term success in expanding 529 plans resulting from enhanced federal tax advantages could be undermined by remaining uncertainties or barriers to investing in 529 plans. Probably the greatest inhibitor to investing in 529 plans is the uncertainty that the tax incentive will be renewed after it sunsets on December 31, 2010. If Congress does not extend the policy of tax-free withdrawals on 529 plans, then beginning after December 31, 2010, earnings in the account will be taxed at the recipient's rate as they are withdrawn.[11] Clearly, families with children close to entering post-secondary institutions do not find 529 plans as attractive as saving in taxable accounts or Coverdell Education Savings Accounts. Congress should make the tax-free treatment of distributions permanent as soon as possible to ensure that participants can invest in 529 plans with complete certainty that the tax incentive will exist when they make their withdrawals.

Create Tax Parity Among States

Creating tax parity among all 50 states would significantly increase participation and lower costs for investors. Currently, more than 50 percent of the state plans have different tax rates and policies in place. Twenty-four states provide an up-front deduction for contributions into the home-state plan. Five states do not conform to the federal tax

[11] In most cases a higher rate than if invested in a taxable account subject to the capital gains tax rate.

exemption for distributions and tax distributions from other state plans, even when used for educational expenses. Seven states require residents to add back to their state taxable income previous deductions on contributions if they choose to roll over their 529 accounts to another state. (A map showing the different tax treatment of these investments by state is attached as Appendix I). At the very least, families and their financial advisers face a stiff challenge to determine the value of a particular state's tax benefit when placed in the proper context of other investment considerations.

In addition, disparate tax treatment has hurt the potential for employers to provide their employees with a workplace 529-plan option. An employer with a national presence may find it difficult to select a small number of state plans for its employees because of the concern that employees in some states will not be able to take advantage of a home-state plan. The employer-based model has worked well in expanding the reach of retirement plans, and so greater encouragement of this model for 529 accounts could substantially increase education savings.

SIA and our member-firms are actively working at the state level to achieve tax parity across the board. We have had some success, although current state fiscal constraints are hampering broader progress. We will continue to aggressively advocate tax parity, and would welcome any help or support from the subcommittee in this area, because we believe a level playing field for 529 plan investors would increase consumer choice, create additional competition, and lower costs.

Improve Disclosure

We also believe that clearer, more complete, and more understandable disclosure of fee- and investment-related information would help investors make relevant, consistent comparisons among different types of plans. Currently, marketing material for investment-related disclosure of mutual funds purchased through a broker-dealer must comply with the NASD advertising rules. The SEC has noted that about 75 percent of 529 plans are sold through brokers, and so generally, investment-related disclosure in broker advertising is consistent across 529 plans.[12] Currently, other fees that have an impact on overall performance, such as annual maintenance fees, are not required to be part of investment-related disclosures in offering materials. We believe that all fees should be transparent and should be included in investment performance information. A gap that could be filled is a more standardized location for information about fees. SIA has worked with the states as they developed the draft disclosure guidelines that will standardize the type of information as well as its location for investors.

Similarly, we support improved disclosures of potential home-state tax benefits. Regulators and state-plan sponsors have recently questioned why investors would forego a tax deduction for investing in their home-state plan in favor of an out-of-state plan.[13] Under the MSRB guidelines, broker-dealers must provide disclosures to clients of any potential home-state tax benefit. Brokers may rely on the 529-program description as long as it discloses that a home-state tax benefit may exist. However, the location of the notice in the description is not standard among plans. We believe a statement on the first page of the program description would help investors and financial advisers give proper consideration to the state tax implications. That statement, however, should indicate that investors should take into account that tax treatment is only one of many features that

[12] See letter from Chairman William H. Donaldson, Securities & Exchange Commission, to Chairman Michael. G. Oxley, House Financial Services Committee, March 12, 2004.
[13] An Investment Company Institute survey recently found that only 20 percent of investors had purchased an out-of-state plan, while 80 percent of households owned an in-state plan.

should be weighed in selecting a 529 plan. Moreover, we support a requirement that 529 program applications include an acknowledgement that the investor understands there may be state-tax implications. Since program managers, not the advisers, develop the application forms, this acknowledgement should be in standardized language to accommodate plans that are sold nationally.

Ensure Suitability

The securities laws mandate that broker-dealers ensure that products they sell to their clients are "suitable" for them. The variety of different 529 plans as well as other education savings vehicles can make choosing the right one a difficult and confusing exercise for investors. Registered representatives and financial advisers help investors make the right investment decisions by encouraging their clients to consider the following factors, among others, when reviewing college savings plan options:

- 529 as an alternative. Do any of the other tax-advantaged vehicles make sense for the investor?
- Evaluate investment options. Are the options age-based, static, or individual portfolios? How has the investment or investment manager performed in comparison to peers? What is the length of contract with the program manager? What is the minimum contribution? Is there a state guarantee? Other principal protection options? How do the potential options compliment the investor's overall investment goals and time horizon?
- Compare fees and expenses. Do fees vary whether or not the investor is a state resident? How do fees impact the overall performance? What other expenses may not be included in the management fees?

- Restrictions. Residency requirements? Can non-owners contribute to the account? Is there a state-income tax deduction? Is the value of the state tax benefit outweighed by other factors?[14] How are rollovers to another state treated if the investor takes advantage of an in-state deduction? Are there other benefits such as state financial aid considerations? Distribution options? Does the plan specify a date at which withdrawals must begin?

Focus on Investor Education

Investors continue to state that they lack knowledge about investing and that they want the securities industry's help in educating them.[15] As a result, SIA recently has strengthened our investor education programs. We have published new investor education brochures available in print or online to supplement our flagship primer – *Your Guide to Understanding Investing*, an easy-to-read handbook that covers the basics of investing. We recently updated our *Guide to Understanding 529 Plans* to include a list of questions a 529 investor should consider before investing in a particular plan. The brochure is available free of charge to the public. In addition, our highly rated investor education website, www.pathtoinvesting.org, includes information on 529 plans, as well as opportunities to invest a hypothetical account.

Many other companies have developed search tools to assist do-it-yourself investors as well as advisers in comparing the advantages and disadvantages of the various 529 plan offerings.[16]

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[14] Depending on the amount of the up-front deduction and the state-income tax rate, the value could be as low as $99 in Rhode Island (joint tax return with top marginal rate of 9.9 percent and limited to $1,000 per tax return) or $1,000 for Mississippi (joint tax return with a top marginal rate of 5 percent limited to $20,000 per tax return).
[15] Annual SIA Investor Survey, November 2003, p. 51.
[16] Some of the offerings include Search529 and Savingforcollege.com – products that are similar to those offered to plan sponsors and advisers who market 401(k) plans.

Conclusion

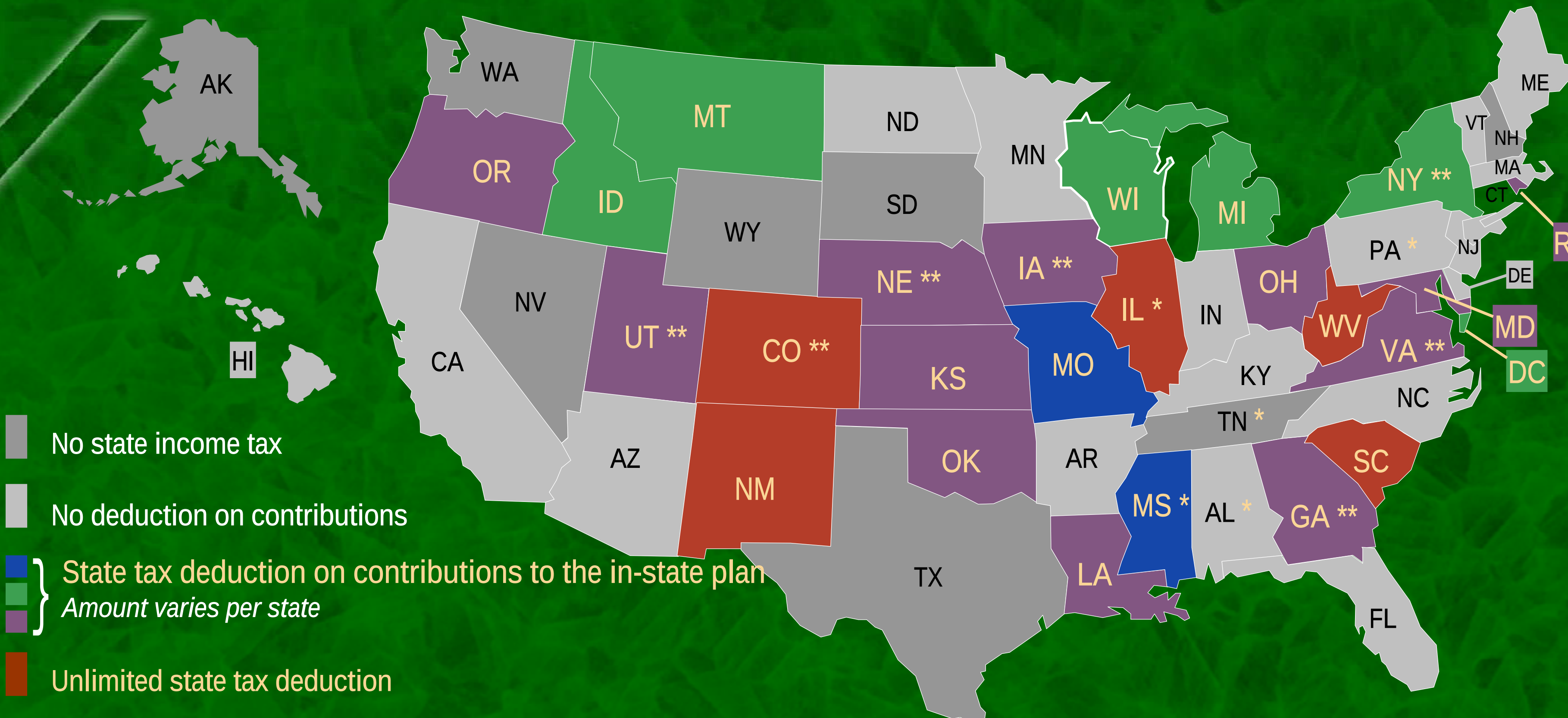
SIA is committed to ensuring that 529 plans remain among the best possible products available for people who need to save for higher education. We have met with members of the 529-task force established by SEC Chairman Donaldson, and we will continue our outreach efforts to promote a greater awareness and understanding of 529 plans. We look forward to working with you, the regulatory agencies, and state officials to make permanent the federal policy of tax-free withdrawals on 529 plans, achieve tax parity among states, improve disclosures, and provide ongoing education on 529 plans and other appropriate investment vehicles. Together we will expand the opportunities for all families to save for their children's educations – the most important investment in our future.

Thank you.

Appendix

Note: On May 18, 2004, the Governor of Tennessee signed into law legislation providing for back-end tax parity. Thus, Tennessee will no longer tax the withdrawals of out-of-state plans.

State tax deduction on contributions



* States which tax earnings on withdrawals from out-of-state plans are Alabama, Illinois, Mississippi, Pennsylvania and Tennessee

** States which require add back to state income tax ("recapture") of previous deductions are Colorado, Georgia, Iowa, Nebraska, New York, Utah and Virginia.

Favorable tax treatment for investing in a Section 529 College Savings Plan may be limited to investments made in a 529 plan offered by your home state. Please consult your tax advisor about any state tax consequences of an investment in a specific Section 529 College Savings Plan. You may be able to invest in your state plan directly. Information provided from various third parties and is subject to change. Information as of 5/2004