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**BUY NOW, USE LATER:**
**A NEW APPROACH TO PAYING FOR A COLLEGE EDUCATION**

By Connie Erickson, Research Analyst
Legislative Services Division
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## INTRODUCTION

In years past, a college education was viewed as the pathway to a career in a profession, such as law or medicine. In other careers, such as journalism or business, a college degree was helpful but not required. For a person with just a high school diploma, the American dream was still accessible either through blue-collar jobs that paid high wages or by moving up the organizational ladder through hard work and dedication. Today, however, all of that has changed. Most manufacturing jobs have been exported overseas.[1] Service-sector jobs, which are among the fastest growing jobs in the United States, fail to pay a living wage. The days of working for a single company your whole working life are long gone, with the average worker now changing jobs seven to ten times during a working career.[2] Today, a college education is an important gateway to economic stability. A college degree leads to higher salaries, greater financial security, and a greater ability to adapt to the ever-changing world of work.

But as a college degree becomes more essential, financing a college education is becoming more challenging than in the past. Federal and state funding of higher education has consistently decreased over the past two decades.[3] As a result, the cost of a college education has nearly doubled over the same period.[4] To compensate for the loss of public funding and to pay the ever-increasing costs, colleges and universities have increased tuition to the point where, without pre-planning on the part of parents or

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[1]Jan Reha, "Working into the 21st Century," available from http://www.careerdiscoveryinc.com; Internet; accessed 14 August 2002.

[2]MetLife Consumer Education Center, "About Changing Your Job," available from http://www.lifeadvice.com; Internet; accessed 14 August 2002.

[3]ECS Issue Site: Access, Education Commission of the States, available from http://www.ecs.org; Internet; accessed 9 November 2001.

[4]Ibid.

the assumption of tremendous debt by students, a college degree is almost unobtainable.

However, to address these financing challenges, every state has created innovative college savings plans to assist parents and students in paying for college. These state-sponsored savings plans promote:

- planning for education expenses;
- saving for education expenses instead of relying on debt;
- reliance on family resources instead of total reliance on government aid programs; and
- state-level planning designed to meet the differing needs in each state instead of a "one size fits all" national approach.

While there are many savings programs available to parents, this report will discuss those programs generally referred to as "Section 529 plans". Section 529 is the part of the United States Code Annotated that governs qualified state tuition programs, thus the commonly accepted name for these tax-deferred savings plans. There are two Section 529 plans available to families: a prepaid tuition plan and a college savings plan. Both are state-based, so the details and options will differ from state to state. However, as a result of the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, both plans are entitled to a federal tax exemption on earnings when used for qualified higher education expenses. Qualified higher education expenses include tuition, room and board, books and fees, and any other expenses that students are required to pay to attend any accredited college or university in the United States. In addition to the tax exemption, the tax law also:

- increased limits on room and board expenses that may be paid from an account;
- allows for the transfer of account benefits to first cousins; and
- allows for an annual "rollover" of an account from one qualified tuition program to another qualified tuition program for the same beneficiary.

In addition to the federal tax benefits, many states also offer significant state tax incentives that include a state tax exemption on the earnings and deductions from income taxes based on annual contributions.

Currently, all 50 states plus the District of Columbia offer one or both plans. Montana has established a college savings plan called the "Montana Family Education Savings Program".

## SECTION 529 PLANS

A college savings plan is just that, a plan that allows parents, grandparents, or anyone else to save money for a child's college education in a special account. College savings plans are basically investment programs in which the investments are chosen and managed by a professional money manager. The manager takes all of the contributions and invests them in a wide range of securities. Each individual account is then credited with a pro rata share of any earnings. A college savings plan provides opportunities for investments that equal or, better yet, exceed future inflationary increases in college costs.

Montana established the Montana Family Education Savings Program in 1997. The program is managed by the College Savings Bank of Princeton, New Jersey, through its affiliate, College Savings Trust of Helena. Contributions to an account are invested in the CollegeSure CD, a certificate of deposit indexed to college costs and guaranteed to meet future tuition, fees, and room and board. The CollegeSure CD is a college cost prepayment product. It pays an annual percentage yield equal to the rise in college costs each year, and it has a floor rate for added protection. Over the past 10 years, the annual college inflation rate has averaged 5.12%. As of June 30, 2001, the College Savings Bank had established a total of 2,879 Montana Family Education Savings Program accounts. Funds from an account can be used to pay qualified higher education expenses at any eligible institution of higher education. Qualified expenses include tuition, fees, room and board, textbooks, supplies, and equipment that are required for a student to attend school. An eligible educational institution is any college, university, vocational school, or postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. This means that almost all accredited, public, nonprofit, and proprietary postsecondary institutions are eligible. In Montana, the units of the Montana University System, tribal colleges, community colleges, and private colleges are eligible institutions.

The second type of Section 529 plan is the prepaid tuition plan.  This plan allows an individual to lock in current tuition rates by purchasing tuition credits at today's prices to be used at a later date.  Regardless of what tuition increases might occur in the future, the number of tuition credits purchased today are guaranteed for the future.   A prepaid tuition plan is not an investment plan, but rather a hedge against tuition inflation. Credits are purchased in the form of years or units, and payments can be made monthly or in a lump sum.  The money is then invested with a rate of return guaranteed to keep pace with or exceed tuition increases.  Nineteen states have established prepaid tuition plans, although Wyoming is currently not accepting new contracts and the Massachusetts plan's status as a Section 529 plan is questionable.  It is important to note that enrollment in a prepaid tuition plan does not guarantee acceptance at a college or university.  A student still has to apply and be accepted in the same manner as any other student.

How are these two plans alike?  Both plans offer tax incentives.  At the federal level, money earned by Section 529 plans are exempt from federal taxes.  In addition, most states exempt the plans from state income taxes, and some states allow residents to deduct contributions for state income tax purposes.  Unlike an education IRA, there are no income restrictions for contributions to these plans.  Also, contributions generally have high maximums, unlike an education IRA that limits contributions to $500 per year.

Section 529 plans also offer a unique twist on the gift tax.  Contributions to a Section 529 plan are considered gifts.  Normally, any gift that exceeds $10,000 in a year is subject to federal gift taxes.  However, an individual can put $50,000 into a Section 529 plan in one year and have it count as five gifts of $10,000 spread over the next five years.  This provision makes Section 529 plans particularly attractive to people who need to reduce large estates subject to potentially large estate taxes.

If the beneficiary of either plan should receive a scholarship that covers college expenses or should decide to not attend college, the money in either type of account can be transferred to another family member, can be refunded, or can remain in the account for use in the future.  The amount of the refund and any penalties incurred will vary from state to state.

How are these two plans different? Prepaid tuition plans are based on the tuition at a state public postsecondary institution with an inflation factor. If a student chooses to attend a private college or an out-of-state college, the amount of money in the account can still be used but probably will not cover all of the college expenses. A college savings plan can be tailored to the costs of an education at a public, private, or out-of-state institution. However, a college savings plan is subject to the market risks that a prepaid tuition plan is not.

Probably the most important difference between the two plans is how each is treated under the federal financial aid rules. Under the current rules, a savings plan is treated as a parental asset and can be counted in the expected family contribution to higher education. A prepaid tuition plan, however, is treated as a student asset and will be used in the calculations to determine need, thereby reducing eligibility for financial aid. Proposals are currently being developed to eliminate these financial aid rule disparities. One proposal would treat prepaid tuition as a parental asset, while the other proposal would replace the expected family contribution with the prepaid tuition funds.[5]

## PREPAID TUITION PLANS

The purpose of this report is to look more closely at prepaid tuition plans and determine if such a plan is feasible for Montana. As presented earlier in this report, Montana already has a college savings plan in place. A prepaid tuition plan would be in addition to the Montana Family Education Savings Program.

There are a number of issues that Montana policymakers will have to assess before deciding to create a prepaid tuition plan. To help in this assessment, this report identifies a number of these issues and provides information on how other states have addressed them in their prepaid tuition plans.

**Plan Managers:** Because the success of a prepaid tuition plan is dependent upon the investments made on behalf of the plan, the choice of a plan manager is very important.

[5]Georgie A. Thomas, "A better way to pay for college," *State Government News*, September 2001, 15.

The vast majority of states with prepaid tuition plans have given management authority to a state agency or board. Treasury departments and higher education student assistance entities are the most popular. Two states contract with private firms to manage their plans.

**Eligibility Requirements:** The major eligibility issue is residency. Most state plans require that either the beneficiary or the account owner be a state resident. A few states require the beneficiary to be a state resident, regardless of the residency of the account owner. In Nevada, an account owner and a beneficiary can be nonresidents, provided the owner is an alumnus of a Nevada college. Three states have plans that are fully open to nonresidents. While account owners are generally parents, other family members, friends, or interested persons can open an account for someone. Some state laws allow corporations or not-for-profit organizations to open accounts.

**State Tax Benefits:** In a state with an income tax, there is a tremendous benefit to opening a prepaid tuition plan. States with an income tax generally offer a deduction for contributions, an exemption for earnings or withdrawals, or a deferment until funds are withdrawn. In those states with no state income tax, there are no state tax benefits to a prepaid tuition plan. However, there are federal tax benefits.

**State Guaranty:** A state guaranty of a prepaid tuition plan provides protection for the owner of the plan. Roughly half of the states either guarantee their plans with the full faith and credit of the state or are required to cover any shortfalls in the plan with an appropriation or some other source of funding.

**Time or Age Limitations:** The majority of states offering prepaid tuition plans place some limitations on enrollment in the plan and on the length of time for executing the contract. The most common enrollment limitation is grade level. Almost half of the states allow enrollment in the plan only up to a certain grade level, with ninth grade being the most common limitation. Some states enact no age restrictions at all, although these states usually require that a contract must be held for a certain period of time before funds can be withdrawn. Some states put a limit on the length of time in which a contract can be executed. The most common time limitation by far is that the benefits must be used within 10 years of the projected date for college enrollment

(immediately following high school graduation). Three states allow an extension for students who enlist in military service at any time during the 10-year period.

**Enrollment Period:** Most states have an annual enrollment period, generally lasting a few months, while in three states you can enroll in the program at any time. In those states with a set enrollment period, newborn beneficiaries may be enrolled at any time within or outside of the enrollment period. Most programs require an enrollment fee that varies from $25 to $90. Kentucky has an annual maintenance fee that is included in the pricing of the contract.

**Contract Options:** A prepaid tuition plan is not necessarily confined to colleges or universities that offer 4-year degrees and above. Most states allow contracts to be purchased for 2-year colleges as well. Some states allow a combination of the two. Florida's "2+2" plan covers tuition and fees for 60 semester credits at a community college and 60 semester credits at a state university. Kentucky offers three tuition plans:

(1) The Value Plan guarantees the price of tuition at every 2-year community college and technical college.

(2) The Standard Plan guarantees the price of tuition at all of Kentucky's eight public universities.

(3) The Premium Plan is intended to cover the average tuition at a Kentucky private college. It will also cover the tuition at all public in-state colleges and many private in-state colleges. An investment in the Premium Plan is guaranteed to grow at the same rate as tuition at the University of Kentucky.

While most states limit contracts to 2 years or 4 years, Virginia allows contracts for up to 3 years at a community college and up to 5 years at a university (benefits may be applied towards graduate school).

Colorado, Pennsylvania, Tennessee, and Washington offer a little different spin on the prepaid tuition concept. Instead of purchasing a contract based on semesters or years, these four state programs are based on the purchase of tuition units or credits. In Colorado and Tennessee, a purchaser may buy tuition units, with each unit worth at

least 1% of the average tuition at an in-state 4-year public institution. One hundred units equals about 1 year of the average tuition. In Washington, a tuition unit is worth 1% of the highest public tuition in Washington, with 100 units equaling 1 year's tuition at the University of Washington. In Pennsylvania, a purchaser selects a tuition level at which to save. The levels are based on tuition at the various public and private in-state institutions. Once the level is selected, the purchaser buys tuition credits for that level. Twelve tuition credits equals the tuition for one semester at the institution at that level.

Selection of a specific tuition level or contract option does not restrict a beneficiary from choosing to attend another institution. For example, a parent sets up an account in Kentucky and chooses the Standard Plan. However, following high school graduation, the beneficiary of the account chooses to attend Georgetown College, a private college. The account can be used to pay the beneficiary's qualified expenses at Georgetown.

**Portability and Transfer:** A prepaid tuition contract is generally based on the tuition at a public in-state college or university. That does not mean, however, that the contract must be used at a public institution or an in-state institution. Every state allows a contract to be used at other than a public in-state college or university. Texas has a separate private college plan. Pennsylvania has various tuition levels that include private institutions. However, the remainder of the states simply allow a contract owner to use the contract for a private or out-of-state institution. Because a contract is based on in-state tuition and fees, a contract used at a private or out-of-state institution may not cover all of the eligible expenses. South Carolina charges a $30 fee if the contract is used at an out-of-state institution.

A new feature of prepaid tuition plans as a result of changes in federal law is that plans are transferable from one state to another. Given the mobility of American society, this is an important feature.

What happens if a beneficiary decides not to attend college or receives a scholarship that covers all of the eligible expenses plus other expenses? Almost every prepaid tuition plan allows the plan owner to transfer the money in the account to another family member, usually a sibling, although federal law has broadened the definition of family to

include first cousins.  An account owner can also cancel a contract and apply for a refund.

**Qualified Withdrawals:** A prepaid tuition plan is designed to assist students and their parents in addressing the major costs associated with higher education, namely, tuition costs.  As a result, only a few states allow a contract to be used for other expenses such as books, supplies, equipment, and room and board.  Five states allow a contract to pay for these other expenses if the beneficiary has received a scholarship or grant that pays for or reduces tuition.  Florida offers a dormitory residence plan that covers housing fees for up to 10 semesters of full-time undergraduate enrollment in a state institution.  In most states, if the contract exceeds the actual tuition at the time the student enrolls in college, the excess may be applied to other legitimate college expenses.  This most often occurs when a student chooses a less expensive college than what was anticipated at the time of enrollment in the plan.

**Limitations on Contributions:** Federal law limits the amount of money that can be contributed to prepaid tuition accounts for a single student.  The limit applies to the sum of all accounts held for a single student no matter who owns the account.  The federal limit is the amount necessary to cover tuition, required fees, and room and board for 5 years of undergraduate school and 2 years of graduate school at the highest-cost institution allowed by the state plan.  Some states have established minimum and maximum contributions that match the contract options offered by an individual state.

**Payment Options:** Payment options are fairly uniform across the states.  Purchasers may make a lump-sum contribution to an account, which is probably the best option because the earnings will immediately begin to accumulate.  However, the purpose of a prepaid tuition plan is to allow families to prepare for college with the least financial hardship possible.  For them, monthly installment plans are available.  Depending upon the age of the beneficiary at the time of enrollment, some states offer an installment plan that will allow a purchaser to reach the maximum contribution within a set number of months.  Two states allow purchasers to make monthly installments only with no down payment or initial lump-sum payment required.  Most state plans allow for automatic transfers from bank accounts or automatic payroll deductions.

**Cancellations and Refunds:** With the exception of Michigan, every state allows participants to cancel participation in the prepaid tuition plan and seek a refund at any time. Michigan allows a cancellation and refund only after the beneficiary reaches age 18. The amount of the refund and cancellation penalties vary from state to state. Some states limit refunds to contributions only, while other states include all or part of an account's earnings. In Virginia and New Mexico, the refund includes a reasonable rate of interest if the contract is at least 3 years or 5 years old, respectively. In Maryland, the recipient of the refund must bear 90% of any losses over the enrollment period. In Michigan, the refund equals the tuition at the lowest-cost Michigan public institution, regardless of the contract option selected. A refund in Kentucky may be paid out in installments. Refunds from an account older than 6 months into which over $500 has been paid must be approved by the director of the prepaid tuition program in Washington. Over half of the states assess a cancellation penalty, ranging from $50 to $150. Two states deduct from the refund a percentage of the account's earnings as a penalty.

Refunds are subject to taxation. State and federal income tax will be imposed on the difference between the contribution and the total amount of the refund. In other words, the earnings are taxable. The owner of the account is liable for the taxes at the owner's tax rate.

**Financial Aid:** Because a prepaid tuition account is considered an asset of the student, the plan can negatively impact a student's ability to be considered for financial aid because the calculations to determine need focus first on the assets of the student. States with state-funded financial aid programs should consider treating prepaid tuition plans as parental assets.

## SELECTED STATE PLANS

To this point, the report has looked at state prepaid tuition plans in general. This next section will examine selected state plans based on the following criteria: Hurley cap ratings and states with populations similar to Montana's.[6]

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[6]Representative Christopher Harris, sponsor of HJR 35 that was the impetus for this report, requested that the author look at prepaid tuition plans in states similar in population to Montana.

## HURLEY CAP RATINGS

Joseph Hurley, a certified public accountant, has been studying and learning about Section 529 college tuition plans since 1997. He has written a book and authored numerous articles on the subject. In May 2000, he established a website, www.savingforcollege.com, to help people learn about Section 529 plans and choose a plan that is best for them. Hurley now devotes much of his time to researching, writing, speaking, and consulting on Section 529 plans, and is considered the foremost expert in the country.

As a result of his research, Hurley has developed a rating system for state 529 plans. The "5-Cap Ratings" represent his opinion of the overall usefulness of a state's 529 plan. He bases his ratings on a set of criteria: flexibility, liquidity and availability, ownership rights, investment approach and safety, program resources, financial aid impact, and state benefits. However, he stresses that selection of a 529 plan is an individual choice and people should weigh these criteria based on their own circumstances. The ratings are as follows:

> **1-Cap:** "A program that contains too many unnecessary restrictions, uncertainties, investment downsides, or other problems so that changes are necessary (in our opinion) in order for the program to compete effectively against other alternatives."
>
> **2-Cap:** "A program that will work for many people who fit the 'target' profile but that contain potentially significant problems or uncertainties that can hurt the unsuspecting investor."
>
> **3-Cap:** "A very good program that offers valuable benefits but may have some limitations or concerns that investors need to be aware of."
>
> **4-Cap:** "An excellent program with many benefits for the participant and positive investment attributes. If it has any significant weaknesses then it also has some particularly good things to recommend it."

**5-Cap:** "This is essentially a four-cap program that adds some significant extra benefit demonstrating a real commitment by the state (such as tax deductions or tax exemption), and has no big weaknesses."

Of the 18 states offering prepaid tuition plans, two (Pennsylvania and Virginia) have earned 4 caps. (No state has earned 5 caps.) What do these plans offer that make them so attractive? Are there components of these state plans that can benefit Montana?

Pennsylvania

The Pennsylvania Tuition Account Program (TAP) is one of the most flexible state plans available. Pennsylvania has designed a plan that is very attractive to contributors. Some of the more attractive aspects include:

**Contract Options:** There are five tuition levels that people can select ranging from 2-year community colleges to Ivy League institutions. Tuition levels can be changed at any time and the change is retroactive for each contribution made to the account. If a student chooses a private or out-of-state institution, the student receives full value based on the selected tuition level.

**Payment Options:** There is no fixed contribution schedule. Deposits can be made at any time in any amount from $5 up. Contributions can be made by check, money order, automatic deduction from a bank account, or payroll deduction. Anyone, not just the account owner, can make contributions to an account.

**Qualified Expenses:** A TAP account can be used for tuition; room and board; mandatory fees; required books, supplies, and equipment; and services for special needs.

**Enrollment:** TAP has an open enrollment period. There is a $50 enrollment fee, but discounts are available.

**Refunds:** If an account owner terminates a contract, TAP will refund the amount contributed plus 100% of the growth on the contribution, provided the

contribution was in the account for at least 12 months prior to termination. For contributions held less than 12 months, only the contribution is refunded. Partial refunds are also available. Refunds for termination due to death or disability or to receipt of a scholarship by the student are calculated to provide the greatest refund possible.

**Financial Aid:** A TAP account does not affect a student's eligibility for state financial aid, primarily state grant programs available through the Pennsylvania Higher Education Assistance Agency.

In addition, there are other aspects of TAP that make it very attractive to contributors.

- TAP will pass out additional funds to individual accounts each year if the trust fund determines that it has excess actuarial reserves.
- Pennsylvania offers a Family Savings Account (FSA) program to help low-income families save for college. The state provides a 100% government match up to a certain level. If a family places its savings into a TAP account, the state match can also be placed into the TAP account.

TAP is administered by the Pennsylvania Treasury Department under the guidance of a TAP Advisory Board. TAP is professionally managed by the Treasury Department's Chief Investment Officer and is evaluated by an independent investment advisor and actuary. Contributions are placed in the Tuition Account Guaranteed Savings Program Fund. The Fund guarantees that the growth in each account will be at least as much as the percentage increase in tuition at the tuition level chosen by the account owner. TAP is not guaranteed by the state, but any shortfalls in earnings can be offset by the Fund's reserves or by increases in future TAP rates.

Virginia

The second program with a 4-cap rating is the Virginia Prepaid Education Program (VPEP). VPEP is not as flexible as TAP. VPEP offers only two plans: the Community College Plan and the University Plan. Qualified expenses are limited to tuition and mandatory fees. The enrollment period lasts only 3 months each year. However, the

plan is backed by the state[7] and offers outstanding tax benefits. A VPEP purchaser can deduct up to $2,000 per year per contract or the amount paid during the year, whichever is less, with unlimited carryforward until the full price of the contract has been deducted. The $2,000 annual cap does not apply to VPEP contract purchasers who are 70 years of age or older. They may deduct the entire amount paid for a contract at one time or in any future tax years. In addition, if a refund is made because of the death, disability, or receipt of a scholarship by a beneficiary, the earnings and interest from the contract are tax exempt.

## STATES WITH SIMILAR POPULATIONS

Only two states with populations similar to Montana's offer prepaid tuition plans: New Mexico and West Virginia. Wyoming, with less than 60% of Montana's population, does have a prepaid tuition plan, but since 1995, the plan has not accepted any new contracts.

### New Mexico

The New Mexico Education Plan's Prepaid Tuition Program is a fairly basic prepaid tuition plan. A contract must be purchased at least 5 years prior to the anticipated college enrollment date and must be used within 10 years of that date. Plans can be purchased for a community college, a comprehensive university, or a research university. The contract covers tuition and mandatory fees only unless the beneficiary receives a scholarship or a grant that reduces the tuition payment. In that case, the contract can be used to pay room and board and books, supplies, or equipment. One year of undergraduate education is the minimum amount that can be purchased, while the maximum amount is 5 years of undergraduate education. A contract may be used at an out-of-state institution, a private in-state institution, or for graduate school. The value of a contract used at one of these institutions is the lesser of the contract tuition value or the total contract payments plus a reasonable rate of interest. Refunds are available, and the amount on deposit is excluded from the calculation of a beneficiary's eligibility for financial aid from the state of New Mexico. Contributions are fully deductible from state income tax, and earnings are totally exempt from state income tax, provided that the money is used to cover qualified higher education expenses. The

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[7]The governor of Virginia is required to include an appropriation in the budget to cover any shortfall in the plan. 23-38.78 Code of Virginia.

New Mexico plan rates 2 caps from Joseph Hurley. Hurley likes the state income tax benefits but dislikes the fact that the contracts are not guaranteed and that the fund earns a rate based on a national index of public tuition that may be less than New Mexico tuition increases.

West Virginia

The West Virginia SMART529 Prepaid Tuition Plan is very similar to the New Mexico plan in tax benefits, contract and payment options, financial aid eligibility, qualified expenses, and minimum and maximum contributions. The biggest difference between the two plans is the refund policy. In West Virginia, cancellation of a contract will result in a refund of your payments only without any interest earnings and less a $150 administrative fee. It is the refund policy that Joseph Hurley likes least about the plan, resulting in a 2-cap rating.

Wyoming

In 1987, Wyoming established the Advance Payment of Higher Education Costs Program to be administered by the University of Wyoming. It was a fairly basic prepaid tuition program involving the University and the state's community colleges. The contracts covered tuition and room and board for resident and nonresident beneficiaries. The major drawback to the program, however, was that it only accepted lump-sum payments; there was no provision for installment payments. In the beginning, a contract could be purchased for as little as $6,000. By 1995, however, the cost had risen to $30,000, putting the plan out of reach for most Wyoming residents. Those already in the plan began to lose confidence in the plan's ability to predict costs and earn enough from investments to cover costs. More people began cashing out their contracts than were buying contracts. As a result, in 1995 Wyoming discontinued offering prepaid tuition contracts. Wyoming has since established a college savings program, and there are no plans to resurrect the prepaid tuition program.[8]

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[8]Janet Lowe, University of Wyoming, interview by author, telephone, 4 June 2002.

## CURRENT STATUS OF PREPAID TUITION PLANS

The events of September 11, 2001, negatively impacted the American economy as well as the financial well-being of individual states. As a result, prepaid tuition plans are also reeling from the effects of 9-11. The success of a prepaid tuition plan is dependent upon the plan earning a sufficient return on its investments to cover its liability for future tuition payments. But the current volatility of financial markets, coupled with double-digit tuition increases at many public colleges and universities (the Montana University System included), poses a threat to the financial health of many prepaid tuition plans. As a result, many plans have had to shore up their finances either by using their reserves built up during the bull market of the 1990s or by increasing the price of a prepaid tuition contract. The older plans (established in the early 1990s) have relied on their reserves, but once the reserves are depleted, other protections will have to be implemented. The newer plans (established since the mid-1990s) are more financially stressed because they have not had the opportunity to build up large cash reserves. These programs are either increasing the price of their contracts or suspending enrollment until financial prospects improve.

The Ohio Tuition Trust Authority has raised the price of its contracts three times in the past year: 10% in October, 6% in January, and 16% in April. The increases are in response to the Ohio Legislature's decision to remove tuition caps to allow public colleges to handle a reduction in state support. Tuition had been capped at 5% annually. With the cap removed, tuition is expected to rise by more than 10% in each of the next 4 years.

In Washington, the prepaid tuition plan fell victim to the state's financial crisis when, in 2001, the state legislature mandated that the state's public research universities not increase tuition by more than 6%. The prepaid tuition program priced and advertised its contracts accordingly. But 1 year later, the state's financial crisis prompted the legislature to cut spending on higher education and allow the universities to raise tuition by 16%. Unable to change its prices and contracts in the middle of the enrollment period, the prepaid tuition program was flooded with new enrollees buying in at the "bargain basement" prices. While this proved good for the enrollees, it will force the program to burn up its cash reserves to keep the program afloat.

As of August 1, 2002, Colorado has stopped taking new contributions into its prepaid tuition program until the plan can be restructured. Tennessee also considered suspending enrollment when tuition costs far outstripped investment returns.[9] However, the state legislature stepped in and capped tuition increases, allowing the program to ride out the financial storm. At least one other state is looking at locking the gate on its prepaid tuition program.[10]

Are there other alternatives to enrollment suspensions or price increases that will help keep a prepaid tuition program afloat? Yes. A program could decide to trim its benefits, increase its annual fees, or even liquidate and ration the remaining assets to participants. Are there any protections in place to keep a program from going under? Some programs have the full faith and credit backing of the sponsoring state (Florida, Mississippi, Ohio, Texas, and Washington). In addition, it seems unlikely that a state would allow its prepaid tuition program to sink without stepping in to bail it out. However, there is no guarantee that a state will do this.

Does all of this mean that prepaid tuition plans are no longer a good investment? No. Because most of the plans are fairly new and contract payouts are not due for several years, there should be plenty of time to overcome the current financial problems. Over the long term, most experts predict that the stock market will regain its strength. This should favorably impact state financial pictures, which in turn may hold down tuition increases. In addition, the current combination of rising tuition and lackluster financial markets may create more interest in prepaid tuition plans over college savings plans. Besides, the purpose of prepaid plans is to help families with future college costs in exactly the type of economic environment we are now experiencing. However, before jumping into a plan, people should read the enrollment materials very carefully, inquire about the current financial condition of the plan, and find out what protections the plan offers.

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[9]When Tennessee set up its prepaid plan in 1997, the assumption was made that public college tuition would rise by 6% annually and investments would rise 7.5%. In reality, tuition rates have risen over 11% annually while investments have risen only a little over 4%. "Tennessee Tuition: Assumptions and Reality," *Chronicle of Higher Education*, 21 June 2002, A22.

[10]Joe Hurley, "If it sounds too good to be true. . . ," available from http://www.savingforcollege.com; Internet; accessed 14 August 2002.

## IS A PREPAID TUITION PLAN FEASIBLE FOR MONTANA?

With the exception of Wyoming, prepaid tuition plans have been successful in those states in which they have been established. The success of these plans lies in the number of participants, the ability to predict future tuition costs, and ensuring that earnings will be sufficient to cover the costs. It is interesting to note that there is no state with a population under 1 million that offers a prepaid tuition plan. Montana's neighbors all offer college savings plans, as does Montana, but even Idaho with a population of 1.3 million does not offer a prepaid tuition plan. Population aside, the design of a prepaid tuition plan will depend upon the answer to a series of questions as follows:

Eligibility Requirements:

1. Should there be a residency requirement for a purchaser and/or a beneficiary?
2. Should the plan be fully open to nonresidents?
3. Who should be allowed to open an account?
4. Who should be allowed to contribute to an account?

State Tax Benefits:

1. Will there be a state tax deduction for contributions?
2. Will qualified withdrawals be exempt from state income tax?
3. Will qualified withdrawals from other states' plans be exempt from income tax in this state?

State Backing:

1. Should the plan be guaranteed or backed by the state?

Time or Age Limitations:

1. Should there be a minimum period before qualified withdrawals may be taken?
2. Should there be a time limit on how long an account can stay open?
3. Should there be maximum grade or age limits imposed on an enrollee?

Enrollment Period:

1. Should enrollment be open year-round or should it be limited to a set number of months each year?
2. If enrollment is time-limited, should newborns be allowed to enroll at any time?

Contract Options:

1. Should the plan cover both 2-year and 4-year institutions?
2. Should the plan be limited to undergraduate school?
3. Should the contract be purchased based on semesters or years or based on tuition units or credits?
4. Should the plan offer a private college option?

Portability and Transfer:

1. If the contract is used at an out-of-state institution or an in-state private institution, what will be the value of that contract?

Qualified Withdrawals:

1. Should the plan cover only tuition and mandatory fees or should other college expenses be covered as well?
2. Should there be a separate plan for room and board?
3. If the beneficiary receives a scholarship or grant that covers or reduces tuition, should the contract cover other legitimate college expenses?
4. If a beneficiary chooses a less expensive college that what was anticipated at the time of enrollment in the plan, can the excess money be applied to other college expenses?

Limitations on Contributions:

1. Should there be a limit, different from the federal limit, on the amount of money that can be contributed to an account for a single beneficiary?
2. Should there be a minimum amount that must be contributed?

Payment Options:

1. What payment options should be available?
2. Should payroll deductions and automatic bank account transfers be allowed?

Cancellations and Refunds:

1. Should a purchaser be allowed to cancel a contract and request a refund at any time?
2. How much of a refund should be allowed?
    a. contributions only
    b. contributions plus all or part of an account's earnings
    c. contributions plus reasonable rate of interest
    d. some other amount
3. Should the amount of the refund depend upon the length of time a contract has been in effect?
4. Should there be a cancellation fee?

Financial Aid:

1. How should a prepaid tuition account be treated when a beneficiary applies for state-funded financial aid?

Plan Manager:

1. Should the prepaid tuition plan be managed by the state or by a private investment firm?
2. If the state manages the plan, which state agency should have that responsibility?
    a. Student Assistance Foundation
    b. Board of Investments
    c. separate board under the Commissioner of Higher Education

The newest prepaid tuition plan in the nation is the Kentucky Affordable Prepaid Tuition (KAPT) plan established in 2001. The plan is housed in the State Treasurer's Office. Jo Carole Ellis, Executive Director of KAPT, in a phone interview with the author, offered some suggestions for establishing a plan in Montana. KAPT was authorized to borrow $1 million from the state's abandoned property account to be used for startup funds. The loan is to be paid back within 3 years. The startup funds were necessary to hire personnel, set up the office, prepare the actuarial projections, and market the program. Ms. Ellis stated that $1 million was sufficient to cover start-up costs. Eventually, KAPT will be self-funded but will be backed by the abandoned property account. The KAPT budget for 2003 is $1.3 million and for 2004 is $1.4 million. Of those amounts, approximately $750,000 will be spent on marketing. In the first year, the plan signed up 4300 accounts. KAPT is managed by a private investment manager. In addition, KAPT has outsourced marketing, record keeping, actuarial services, legal counsel, and the call center for enrollment. Ms. Ellis made the following recommendations for establishing a plan in Montana:

- The plan should be self-funded but should also be guaranteed or backed by the state.
- The plan should offer a state income tax deduction.
- The plan should be aggressively marketed.
- The plan should be based on sound actuarial projections.
- The plan should have sufficient start-up funds.

The Montana Legislature just completed a special session in which $57 million worth of budget cuts and fund transfers were necessary to erase a revenue shortfall. By June 30, 2005, that shortfall is predicted to reach almost $250 million. The Legislature will be

forced to look at scaling back or eliminating state programs in order to ease the crisis. The Board of Regents has mandated a 12% increase in tuition in the Montana University System for the 2002-2003 academic year. In addition, a tuition surcharge that could amount to an additional $160 for a full-time student next spring semester has also been implemented for the upcoming academic year. If state support for higher education continues to drop, if tuition increases continue at double-digit rates, and even if the stock market rebounds, a prepaid tuition plan may not be able to guarantee a rate of return to cover future tuition costs, unless the plan is limited to the enrollment of very young students, thus allowing for the stabilization of the state's budget picture. Even then, an appropriation for plan start-up costs would have to be made this coming session and that may not be possible. Does this mean that Montanans will not have access to a prepaid tuition plan for their children? No. Montanans can open a prepaid tuition plan in another state. Before doing so, however, it would be wise to consult a financial expert on what other state plans are open to nonresidents and what tax liabilities or benefits there might be.

## CONCLUSION

As tuition at both public and private postsecondary institutions continue to rise, it will become more difficult for families to provide for their children's education without some savings program. Section 529 plans are an excellent vehicle for families. Every state offers either a college savings plan or a prepaid tuition plan, or both. Montana offers the Montana Family Education Savings Program, a college savings program that has earned 4 caps from Joseph Hurley of savingforcollege.com.

Is one type of plan better than another? Not necessarily. It depends upon the investment needs and goals of the family. There is some market risk in a savings plan, though most plans tailor their investments to the age of the beneficiary child. A prepaid tuition plan offers more certainty but is usually tied to tuition at a public institution and may not be enough to cover tuition at a private or out-of-state institution. In addition, if tuition increases at a double-digit rate, a prepaid plan may not be able to provide the necessary guarantee or may have to increase contract prices to the point where they are unaffordable. The stock market can also affect your choice. In the current market,

a prepaid tuition plan is more attractive because of the guarantee that contributions will match tuition inflation.  However, in a bull market, a college savings plan will produce greater returns.

For Montana, the issue right now is can the state afford to establish a prepaid tuition plan given the financial crisis that it faces, the volatile stock market, and the double-digit tuition increases?  If a source of revenue can be found to cover start-up costs and if the state can provide some sort of protection for the plan, then a plan is feasible.  If these two requirements cannot be fulfilled, the 2003 legislative session may not be the time to establish a prepaid tuition plan in Montana.

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PO Box 201706
Helena, MT 59620-1706
PHONE: (406) 444-3064
FAX: (406) 444-3036
http://leg.mt.gov/