ALASKA LEGISLATURE COMMITTEE FILES 1991-1992 8672
7400 SENATE HEALTH EDUCATION & SOCIAL SERVICES

TAXATION AS AN INSTRUMENTALITY OF THE STATE OF ALASKA

Statement of Law

Section 115 of the Code provides, in part, that gross income does not include income derived from the exercise of any essential governmental function that accrues to a state or political subdivision of a state.

Application of the Law

The University is considered an instrumentality of the State of Alaska and the income derived from its activities potentially exempt from taxation under Section 115 of the Code. The October 5, 1988 determination of the Internal Revenue Service denying the University's application for exemption under Section 501(c)(3) of the Code indicates that the University is an instrumentality of a state within the meaning of Section 115 of the Code and that exemption from Federal income taxation is provided by that section. This determination is consistent with the November 23, 1977 letter to the University from the Internal Revenue Service which confirmed that the University was exempt from federal income taxation as an instrumentality of the state, with contributions to the University being deductible under Section 170(b)(1)(A)(ii) of the Code.

The requirements for exemption are that the income is derived from an essential governmental function and accrues to the state. The private letter rulings issued by the Internal Revenue Service with respect to the Michigan and Indiana tuition prepayment programs denied exemption under Section 115 of the Code for failure to satisfy the second requirement, that the income accrue to the state.

No reference was made to the first requirement. The tacit approval by the Internal Revenue Service of the position that public tuition prepayment programs perform an essential governmental function has been confirmed by the Internal Revenue Service in several informal conversations.

One can also make a strong case under our facts that the Fund performs an essential governmental function. The University was established by the state constitution and it is responsible for higher education in furtherance of the constitutional mandate for public education in the state. Providing a system of public education for residents of the state is considered an essential governmental function, as evidenced by the unqualified statements of the Internal Revenue Service that the University is tax-exempt under Section 115 of the Code. The activity of the University with respect to the Fund may also be seen as an exercise of its essential governmental function. The activity provides a means to fund the cost of education for residents of the state. The program is designed to afford an opportunity for higher education for residents who might otherwise not continue or complete their education. The University's primary governmental function of providing education is dependent on there being students who are able to attend the University. Based on the position taken by the Internal Revenue Service in prior determinations, the University performs essential governmental functions within the meaning of Section 115 of the Code, including its activity with respect to the Fund.

The second requirement of Section 115 of the Code is that the income accrue to a state. The apparent concern of the Internal Revenue Service with respect to tuition prepayment programs is that the income from the programs benefits the private individuals who purchase the contracts and who are the beneficiaries of

those contracts, thereby not accruing to the state. The position taken by the Internal Revenue Service in the private letter rulings issued to Michigan and Indiana indicates that a certain amount of private economic benefit is permissible. In those rulings the Internal Revenue Service stated that:

> To qualify under section 115, it must be established that the income does not serve private interests ... Thus, even if the income serves a public interest, the requirements of section 115 are not satisfied if the income also serves a private interest that is not incidental to the public interest.

The issue then is not whether the University and the Fund perform an essential governmental function but whether the income of the fund accrues to the state. An informal conversation with the Internal Revenue Service indicated that the activities of an organization requesting exemption under Section 115 of the Code will be reviewed; and if it is determined that there is nonincidental private economic benefit in connection with any activity, the entire entity will be denied exemption under that section. It does not seem reasonable that the previously unqualified exemption of the University under Section 115 of the Code would change to non-exemption if a single activity such as the Fund were found to provide any nonincidental economic benefit to private individuals. This possibility, however, shows the importance of obtaining a ruling with respect to the Fund.

In both situations considered by the Internal Revenue Service in its private letter rulings, the tuition prepayment program was operated by a corporation, the sole activity of which was the administration of the program. The corporation was not an educational institution nor was it affiliated or associated with an educational organization The corporation issued contracts

under which a beneficiary would receive benefits in excess of the amount prepaid. All money received by the program was held and controlled by the corporation. Decisions as to the investment and disbursement of the funds of the program were in the sole province of the corporation. Unless or until tuition payments were made to a state college, the money received under the program did not enter the state coffers. While there are similarities between the benefits under the programs described in the private letter rulings and those provided by the Fund, there are important differences which distinguish the programs.

The Fund is established by state statute as an endowment fund of the University. The University has operated historically to provide educational opportunities for residents of Alaska and the Fund is one of many activities performed by the University in furtherance of the state's system of public education. The prepayment contracts are issued by the University and all payments are received directly by the University. Similarly, all other contributions or appropriations to the Fund are made to the University. After the income is received the state continues to have control and custody of those funds. By statute, the Commissioner of Revenue serves as the custodian of the Fund. Investment of the funds is determined by policies developed by the University and the earned income is maintained in the Fund. There is no legal entity separating the Fund and the income realized with respect to the Fund from the University. With certain exceptions, the income of the Fund remains with the University as tuition and other fees when the beneficiaries attend college. The income of the Fund "accrues" to the University in that the proceeds are received directly by the University which has an enforceable claim to the funds. Any federal income tax imposed on the Fund would be a charge to the University and payable from its revenues.

While the income of the Fund accrues to the University, it is also true that the Fund provides economic benefits to private individuals in the same respect as the tuition prepayment programs described in the private letter rulings issued by the Internal Revenue Service. To the extent the purchasers and beneficiaries benefit from earnings of the Fund or receive tuition credits which exceed the cost of their contract, there is private economic benefit. Similarly, the refund and redemption provisions which permit the beneficiaries to receive payments in excess of the principal paid under the contract or to attend a college other than the University would constitute private economic benefit. The private letter rulings show that the Internal Revenue Service looks not only at the entity which nominally receives the income of the program, but how that income is ultimately disbursed. Those entitlements under the Fund may result in a determination by the Internal Revenue Service that the exemption provisions of Section 115 of the Code do not apply. In applying Section 115 of the Code, the Internal Revenue Service will consider the University's activity with respect to the Fund and determine whether the economic benefit to the contract purchasers and beneficiaries is merely incidental to the public benefit served by the Fund. The analysis is a qualitative one. The economic benefit to particular individuals must be only coincidental to or a side-effect of the public benefit purpose of the Fund activity.

The Fund is established within the University as a means to further the University's essential purpose of providing higher education for the residents of Alaska. The Fund contributes importantly to assuring that the University continues to have a student body to instruct and that residents are both encouraged and enabled to complete their education. The overriding purpose and accomplishment of the Fund is making higher education more readily available.

In some situations, this may be the determining factor as to whether a student receives an education. By its very nature, education will always provide a direct benefit to particular individuals. Economic benefit to particular individuals arises from the normal operation of the University in that students receive an education and the tuition costs represent a small portion of the actual costs of the educational programs.

Colleges and universities provide low interest loans to current and prospective students with the economic benefit to the particular student being considered only incidental to the educational purpose being accomplished by the educational institution. Further, the Internal Revenue Service has taken the position in revenue rulings that organizations which are formed to provide low interest loans to individuals for completing their education qualify for exemption under Section 501(c)(3) of the Code as being operated exclusively for charitable and educational purposes. The Fund provides economic benefit to particular individuals, but that benefit should be considered only incidental to the furtherance of the University's educational function by that activity.

Recommendations

The University may wish to consider eliminating those portions of the program which entitle the participants to earnings of the Fund. In particular the Graduation Incentive Award could be eliminated. The existence of this Award may create an expectation of payment that may not be realized or create a sense among some prospective purchasers that the contract is overpriced.

These changes would support the position that the income of the Fund accrues to the University. It is possible, however, the Internal Revenue Service would not consider these modifications sufficient to eliminate the private economic benefit. The difference between the amount prepaid and the value of the tuition credit may always be great enough that the Internal Revenue Service will consider that there is more than incidental private benefit when the program is considered as a separate activity or function. The University may also feel that the possible tax benefit from the modifications would be outweighed by the cost of making the Fund less attractive to potential participants. If we receive indications from the Internal Revenue Service that the private benefit element of the Fund would result in the University losing its exempt status under Section 115 of the Code, the University will have to restructure the Fund.

The statute establishing the Fund contains language which clearly establishes the Fund as part of the University rather than a separate legal entity. The position that the Fund is integral to the University and the state may be strengthened if the statute provided that the tuition obligations are backed by the full faith and credit of the State of Alaska. This may also enhance the marketablility of the program.

There are several requests for rulings currently pending before the Internal Revenue Service regarding tuition prepayment programs. The requests, including ones from Florida and Ohio, have been submitted with respect to both governmental and non-governmental entities. The requests have been reviewed by the Financial Institutions and Products ruling branch of the Internal Revenue Service, which has prepared a comprehensive memorandum and submitted it to the

Associate Chief Counsel (Technical). It is expected, perhaps optimistically, that the review of the policy issues will be completed in April. There is some indication that the Internal Revenue Service is considering a current tax on the purchaser or beneficiary under the original issue discount provisions of the Code. There may be other changes in the position taken by the Internal Revenue Service in its treatment of these tuition prepayment programs. It is recommended that we wait until this review is completed before submitting a request with respect to the Fund. At that point it would be possible to meet with the Internal Revenue Service and obtain a clearer indication of how to structure the ruling request as well as how to restructure the Fund program to obtain the most favorable tax treatment.

We recommend that the request with respect to the Fund be for a ruling that the University is exempt from taxation under Section 115 of the Code. The request would not ask for a further ruling as to the application of Section 511 of the Code which might focus attention on the Fund as an unrelated trade or business of the University and raise the issue of the contracts being insurance. If exemption is allowed under Section 115 of the Code for the University and the Fund, there will be no question of the unrelated trade or business tax being imposed on the University. The request would refer to the prior determinations of the Internal Revenue Service that the University is exempt under Section 115 of the Code and describe in detail its activities with respect to the Fund.

TAXATION AS AN EXEMPT ORGANIZATION UNDER SECTION 501 (c)(3) OF THE IRC

Statement of Law

Section 501(c)(3) of the IRC exempts from taxation organizations which are organized and operated exclusively for charitable, educational and certain other specified purposes, provided that no part of the organization's net earnings inures to the benefit of any private individual.

Section 1.501(c)(3)-1(b)(1)(iii) of the Regulations provides that an organization is not organized exclusively for section 501(c)(3) exempt purposes if its articles of incorporation expressly empower it to carry on, other than as an insubstantial part of its activities, activities that do not further exempt purposes.

Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations provides that an organization is not organized or operated exclusively for exempt purposes specified in section 501 (c)(3) of the IRC unless it serves a public rather than a private interest.

Section 1.501(c)(3)-1(e)(1) of the Regulations states that an organization may satisfy the requirements of section 501(c)(3) of the IRC although it operates a trade or business, if operating the trade or business furthers its exempt purpose and if the organization is not organized or operated primarily to carry on an unrelated trade or business. In determining the existence of such a primary purpose, all circumstances are considered, including the size and extent

of the trade or business and the size and extent of the activities in furtherance of one or more exempt purpose.

Section 1.501(c)(3)-1(d)(2) of the Regulations defines "charitable" as including the advancement of education.

Section 1.501(c)(3)-1(d)(3) of the Regulations defines "educational" as relating to the instruction of an individual to improve or develop his capabilities or the instruction of the public on topics useful to the individual and beneficial to the community.

Section 501(m) of the IRC provides that an organization described in section 501(c)(3) of the IRC may be exempt from taxation only if no substantial part of its activities consists of providing commercial-type insurance.

Section 501(m)(2) of the IRC provides that an organization which provides insurance as an insubstantial part of its activities will be treated as an insurance company for purposes of applying Subchapter L of the IRC (taxation of insurance companies) with respect to that activity.

Section 501(m)(4) of the IRC states that the issuance of annuity contracts will be treated as providing insurance. Charitable gift annuities are specifically excluded under section 501(m)(3) from items that are considered commercial-type insurance.

Application of the Law

The Internal Revenue Service has taken the position that a state or an integral part of a state may not qualify for exemption under section 501(c)(3) of the IRC since a state's functions or purposes are not limited to those described in the statute. In a 1960 revenue ruling the Internal Revenue Service stated that "where a public school, college, university or hospital is an integral part of a local government, it could not meet the requirements for exemption under section 501(c)(3) of the IRC." However, the ruling goes on to state that an instrumentality such as a separately organized college or university may qualify for exemption if it is a clear counterpart of an organization described in that section and if it is organized and operated exclusively for an exempt purpose. The Internal Revenue Service has recognized that instrumentalities of a state which are otherwise exempt from federal income taxation may apply for exemption under section 501(c)(3) of the IRC because of particular tax treatment extended to such organizations by other sections of the IRC.

If the University is found to be an instrumentality of the state, it may apply for exemption under section 501(c)(3) of the IRC although that would not be necessary to assure its exemption from federal income taxation. An exemption under this section would subject the University to the provisions of section 501(m) of the IRC relating to the issuance of commercial-type insurance. In the Internal Revenue Service response to the application by the Michigan Education Trust for exemption under section 501(c)(3) of the IRC, the tuition prepayment contracts were characterized first as "commercial financial products" and then as annuity contracts subject to section 501(m) of the IRC.

Although the University would not lose its exemption status under section 501(c)(3) since its activity with respect to the Fund is not a substantial part of its total activities, subsection (m) would operate to make that source of income taxable under the IRC provisions governing insurance companies. If the prepayment contracts are characterized by the Internal Revenue Service as annuities, gross income from the activity would include the amount received as "premiums" and any investment income. The deductions allowed life insurance companies include additions to reserves required to meet future unmatured obligations under annuity contracts. Those reserve deductions may be beneficial to the University by minimizing its tax liability from this activity. However, this treatment may result in unfavorable tax consequences for participants since a 10% excise tax is imposed by section 72(q) of the IRC on a premature distribution under an annuity contract if certain conditions are not met.

There is also the potential that these contracts may be characterized not as annuities but as insurance protection against accelerating education costs, in which case the University would be taxed as a casualty insurance company. That treatment would be unfavorable to the University since it may result in the recognition of premium income in the year a contract is issued or, at best, allocated over the life of the contract. It would also be necessary to recognize 20% of the increases in unearned premiums as current taxable income. Investment income would also be included in gross income.

Application of section 501(m) of the IRC may be avoided if the tuition prepayment contracts were treated as charitable gift annuities. General Counsel Memorandum 39826 (1990) noted that the charitable gift annuities issued by a university which was exempt under section 501(c)(3) of the IRC were expressly

excluded from the operation of section 501(m) of the IRC. The Memorandum also indicated that the income realized by the issuing university from the proceeds received on the annuities was not taxable as unrelated trade or business income. To obtain this treatment, the University would have to make significant changes in the program. One of the consequences would appear to be that the 10% excise tax imposed by section 72(q) of the IRC would be applied to the participants.

Recommendations

The University should not reapply for exemption under section 501(c)(3) of the IRC unless there are compelling reasons unrelated to the Fund which, on balance, outweigh the tax consequences for the University of being an exempt organization under this section. The income from activity with respect to the Fund is as likely to be exempt from federal income taxation under section 115 of the IRC or the doctrine of intergovernmental immunity, without the concerns raised by section 501(m) of the IRC. With an exemption under section 501(c)(3) of the IRC, the University would continue to be subject to the tax imposed by section 511 of the IRC on unrelated trade or business income. If the University succeeded in avoiding tax liability under section 511 of the IRC on income of the Fund, it would still find itself potentially taxable under section 501(m) of the IRC solely because of the exemption under section 501(c)(3) of the IRC.

TAXATION AS A SUBCHAPTER C CORPORATION

Statement of Law

A taxpayer other than an individual, a partnership, a trust, or other specifically identified entity may be treated as an association deemed to be a corporation for income tax purposes. IRC Section 7701(a)(3) provides that the term "corporation" includes associations, joint-stock companies, and insurance companies.

As several commentators note, if a prepaid tuition program is not something else, it is probably a corporation for tax purposes. Actual status as a corporation for legal purposes is determined pursuant to state law.

Treasury Regulations Section 301.7701-2(a) discuss characteristics of a corporation as part of a discussion of associations:

> (1) The term "association" refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are (i) associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. ... The presence or absence of these characteristics will depend upon the facts in each individual case. ... An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust.

> (2) ... For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends upon whether there are associates and an objective to carry on business and divide the gains therefrom. ...
>
> (3) An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. ...

Regulations Section 301.7701-(4)(c) provides:

> (1) An "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. ...

The effects of being taxed as a corporation are myriad since corporate tax provisions permeate the Internal Revenue Code. Generally, the tax consequences of various transactions affecting a corporation are found in Subchapter C (Sections 301-386) of the Internal Revenue Code. Perhaps the most critical statutory language defines corporate taxable income. The definition of gross income is the same under Section 61 for corporations as for individuals. However, exclusions from income differ for corporations. For example, Section 243 provides a dividends received deduction. In addition, corporate capital gains are treated as ordinary income under Section 1222 while corporate capital losses may only be taken against gains per Section 1211. Once taxable income is determined, a corporation is subjected to tax at rates generally higher than those of individual taxpayers.

Application of the Law

The Fund is established as a program of the University of Alaska. As such, this prepaid tuition program is arguably a part of the State of Alaska and certainly is not a legal entity separate from the University. The program may voluntarily give itself separate entity status by declaration of trust. For some purposes, the program might also be modified in establishment so that the Fund is not part of the University of Alaska or the State of Alaska.

If, for whatever reason, the Fund achieves separate entity status, the tax laws will apply depending upon whether that entity is a partnership, a trust, or a corporation. Legal status does not necessarily control. Under Treasury Regulations at Section 301.7701, Federal income tax provisions may allow for the imposition of certain tax status despite legal status or form of entity. For example, Revenue Ruling 77-261, 1977-2 C.B. 45, notes that cities which formed a trust in order to make investments were deemed to have created a corporation under the regulations.

Thus, if the University of Alaska chooses to declare the Fund a trust or if a separate entity is desirable in the final analysis, the nature of that entity for tax purposes is likely to be determined according to the application of Treasury Regulations Section 301.7701-2.

Although the Alaska Educational Trust Fund has a title including the word "trust," tax treatment will likely depend upon whether or not the Fund has associates and is carrying on a business for profit. These are the two characteristics which distinguish a trust from a corporation for tax purposes.

The remaining characteristics may be presumed to exist (i.e., continuity of life and centralized management) or may arguably exist (i.e., limited liability and transferability of interests) for purposes of distinguishing between trust and corporate tax treatments. As the mix of investments may be altered by the governing body, Regulations Section 301.7701-(4)(c) should control on this issue and the Fund would be carrying on a business of making investments.

The final question to determine if the Fund is a corporation for tax purposes is whether or not associates are present. No clear criteria exist for this determination. Certainly rights consistent with corporate ownership would be one indicator. Evidence of such rights includes: beneficiaries may purchase their own contracts, the number of contract purchasers will significantly influence the operation of the program, and provisions are in place to allow for alternative beneficiaries and tuition pay-out periods. Persons participating in the program are associated in the Fund as that word is commonly used. Some question remains, however, as to whether beneficiaries participate enough to meet the Treasury Regulations standard for whether or not associates are present.

Even where specific ownership characteristics may be missing, as in the Michigan program, the IRS has apparently found that "associates" exist so that the organization is taxed as a corporation. The Michigan ruling does not directly state that the Michigan Educational Trust (MET) is a corporation, but the tax treatment of beneficiaries is consistent with corporate status. MET has filed corporate tax returns. The Michigan Ruling also noted that MET was created as a corporation in the enabling legislation. If one gives weight to all the language of the Private Letter Ruling, the IRS has found the Michigan program to

be an association taxed as a corporation. Whether or not the legal establishment of MET as a corporation controlled is open for question.

The Alaskan program has more incidents of an association than the Michigan program. The provision that a contract may be purchased to benefit the purchaser may arguably distinguish the two programs with regard to ownership characteristics. This distinction may be unnecessary given the IRS proclivity for finding taxable associations. In other words, if MET is a corporation for tax purposes based upon the evaluation of attributes under Regulations Section 301.7701-2, the Fund is also, provided the IRS is consistent.

A major hurdle for prepaid tuition programs taxed as corporations remains the question of whether or not tuition distributions are deductible to the extent taxable income is recognized by the beneficiaries. The Michigan ruling does not address this point. The Ohio request for ruling specifically raises the question and the Ohio Private Letter Ruling will hopefully state the view of the IRS on this matter. In the meantime, as the commentators have noted, the issue has been argued both ways.

If the deduction for the taxable tuition distributions is allowable, the Fund can neutralize the impact of being taxed as a corporation through its investment policies. Dividends received from investments in certain corporate stocks are 70% exempt from taxation. When this low effective tax rate due to the 70% exclusion is combined with a full deduction for the earnings when paid out to beneficiaries, the present value of the tax cost can be made very low.

Recommendations

The ruling request should ask that, in the event the Fund is taxable, the IRS clarify the type of entity that the Fund will be considered for tax purposes. The request should also seek a determination as to the deductibility of tuition payments for beneficiaries if the Fund is taxable as a corporation.

If corporate status were desired, making the Fund conform as nearly as possible to the Michigan program should have the effect of creating a corporation under the tax law. This would entail using the enabling legislation to create a program which was separate and "a body corporate and politic." Other modifications of the existing plan appear to be unnecessary. If the IRS approaches prepaid tuition programs consistently, the similarities to the MET program are enough to achieve corporate tax identity.

Corporate status may provide benefits if the Fund is deemed to be a taxable entity. This is especially true if corporate status is contrasted against trust status. However, the unsettled issue of deductibility of tuition payments prevents a true evaluation of corporate tax effects. The ruling anticipated in late 1991 for Ohio will allow a more complete recommendation.

TAXATION AS A TRUST

Statement of Law

An entity becomes a trust by filing a declaration of trust and establishing relationships sufficient to create a trust under local law. This legal determination of trust may or may not be supported under the tax provisions. A trust is generally considered a bundle of rights and duties in a fixed relationship rather than a specific type of operating entity. Legally, the Restatement of Trusts, Second, indicates that a trust is a fiduciary relationship where one person holds legal title to trust property subject to the obligation due to the beneficiary.

For purposes of Federal tax treatment, a trust is usually what one ends up with pursuant to Treasury Regulations Section 301.7701-2(a) if a corporation is not found and the organization has continuity of life, centralized management, limited liability, and interests are transferable. The IRS distinguishes trusts from corporations by evaluating the extent to which an entity is organized with a profit motive and has associates. These two tests are emphasized in the regulations supporting IRC Section 7701.

As discussed in this report under taxation as a subchapter C corporation, the IRS has found that prepaid tuition plans do have a profit motive in that the ability to change the mix of an investment portfolio is sufficient evidence per Treasury Regulations Section 301.7701-4(c)(1). That section, in fact, indicates that a trust does not exist if an active investment management role exists which has the effect of changing the interests of "investors." This profit motive factor alone has been held to indicate corporate treatment for taxes.

However, other regulatory provisions used by the IRS balance the number of corporate attributes against the number of attributes not indicating corporate status. Under this analysis, an organization may be a trust if "associates" are not found to satisfy the second leg of Regulations Section 301.7701-2(a). The IRS has acquiesced in two recent cases which found trusts rather than corporations where beneficiaries had little ability to directly influence the investment or management of amounts invested and their interests were subject to limits on transferability. These decisions, Elm Street Realty Trust v. Commissioner, 76 T.C. 803 (1981), and Estate of Bedell Trust v. Commissioner, 86 T.C. 1207 (1986), emphasize that associates must do more than make an investment in an entity if that entity is to be taxed as a corporation instead of as a trust. If the IRS issues rulings consistent with this position, lack of participation will defeat a finding of corporate taxable status for entities where investors' roles stop after assets are handed over to the organization.

Entities considered trusts for tax purposes generally compute taxes in the same fashion as individuals with certain stated exceptions. IRC Subchapter J (sections 641-683) governs the taxation of trusts. The central premise of Subchapter J is that income recognized by a trust will be taxed either to the fiduciary entity or to the beneficiary of the entity on a current basis. Taxable income for a trust thus includes a deduction for distributions to beneficiaries under IRC Sections 651 and 661. Other taxation differences for trusts (as compared to corporations) include the provision of an exemption, allocation of expenses by type for deduction limits, the lack of a dividends received exclusion, a slightly lower tax rate, and unlimited charitable deductions.

The distribution deduction depends upon the calculation of distributable net income (DNI) for the trust. Under IRC Section 643, DNI is the amount of trust net income available for distribution to income beneficiaries. DNI does not include taxable income not available for distribution. For example, if state law or the governing trust instrument deems gain from the sale of a capital asset to be part of the trust corpus, the capital gain is not income available for distribution. Deductible expenses incurred by the trust are deemed to reduce DNI. A trust's taxable DNI represents both the maximum income that may be taxed to beneficiaries and the maximum deduction for distributions available to the trust in computing its own taxable income pursuant to IRC Sections 651(b) and 661(c).

The actual flow of income from a trust to beneficiaries is determined by the governing instrument of the trust. That instrument determines whether or not a trust is a simple trust or a complex trust. Section 651 defines a simple trust as one (1) required to distribute all trust income currently, (2) without charitable contributions in the current year, and (3) no distributions are made currently from trust corpus. All taxable DNI of a simple trust is taxed to the beneficiaries based upon the relative income distributable to each whether or not cash or other assets are actually paid to the beneficiaries.

A trust which does not meet the requirements of a simple trust is a complex trust. This determination may be made on a year-by-year basis. The tax computation for a complex trust is made more difficult by the potential for distributions in excess of or of less than DNI. If a trust distributes less than its amount of DNI, any taxable DNI remaining in the trust is taxed to the trust. When distributions exceed a trust's DNI, the entire taxable portion of

DNI will be reported as income to the beneficiaries and this amount will be deductible to the trust. In this case, the only amount taxable to the trust would be capital gains if the gains are allocable to trust corpus.

In addition, a complex trust may also have to abide by the provisions of IRC Section 663(c). That section provides that if a trust contains "substantially separate and independent shares" held by the different beneficiaries, then the trust is treated as though comprised of many separate trusts for purposes of determining DNI. This complicated rule is not elective.

This "separate share and trust" treatment is imposed solely for purposes of fixing the amount of DNI available. Essentially, the threshold for such treatment is whether or not distributions to more than one beneficiary have the effect of imposing a tax burden on certain of the beneficiaries to the extent one is taxed on income built up to cover the costs/distributions of the others. If contributions within one of the deemed separate "shares" do not cover expenses after taking earnings into account, the separate share rule may not apply.

Application of the Law

As noted in the discussion of taxation as a Subchapter C corporation, the question of whether the Fund may be a trust or a corporation for tax purposes, hinges upon an evaluation of whether or not the Fund carries on a business for profit and has associates.

Regulations Section 301.7701-4(c) notes that an ability to alter the mix of investments may be interpreted as an attempt to maximize return; the profit motive test is presumed satisfied if such an ability exists. The Fund is not, however, in the business of maximizing profit for its "investors." Instead, the Fund has contracted to provide certain educational benefits whether or not investment return is optimized or investments are re-mixed. Contract purchasers do not buy tuition credits in order to maximize investment return. The ownership right, prepaid tuition, does not change despite manipulations of the investments. This fact of unvaried ownership rights may rebut the profit motive presumption.

Even if the Fund is found to be carrying on a business for profit, the second question of whether or not the Fund has associates may allow trust treatment. An entity will be treated as a corporation instead of a trust only if associates are found to participate in the undertaking. The IRS appears to accept the proposition that a mere investor (outside the context of an investment trust which is subject to special rules) is not an associate. According to the IRS' position in the recent caselaw, some participation in the inception or operation of a program is necessary in order to find associates. The cases noted also consider the free transferability of interests as evidence of associates. The Fund contract purchasers and beneficiaries do not have participation attributes. Operations of the Fund will be carried out without the direct influence of purchasers or beneficiaries. Contract interests are transferable to only a limited extent under the Alaskan plan. Given the limited role of purchasers and beneficiaries under the Fund plan, the IRS could find no associates present to create a taxable corporation under Treasury Regulations Section 301.7701-2 based on its acquiescences to recent caselaw.

The special rule for investment trusts may result in taxable status as a corporation even if the Fund is established as trust for legal purposes. Under Regulations Section 301.7701-4, corporate status is conferred due to a presumed profit motive if investments may be varied. As discussed above, this presumption may be rebuttable. The "associates" requirement is apparently inferred for investment trusts. Thus, if the Fund is found to be an investment trust and the rebuttal argument distinguishing a prepaid tuition program from a "for profit" investment trust is not supported, even the lack of associates will not impede a finding of corporate taxable status. Provided the Fund is not classified as a corporation for tax purposes, the program is probably a trust. The trust would be treated as a complex trust given the payout terms and the nature of the beneficiaries' interests. Since the Fund is designed as an individual account plan, the possibility of using earnings on one person's investment to cover expenditures made on behalf of another is remote. Thus, the separate share/trust rules will apply.

The imposition or adoption of the separate share rule leaves the Fund with practical difficulties should taxable trust status exist. If separate shares must be maintained to calculate DNI on an individual basis, the accounting burden is onerous. If two thousand beneficiaries exist, two thousand tax returns may be filed when DNI exceeds the one hundred dollar exemption for each trust. A tax rate of fifteen percent would be applied, leading to a small tax liability for each trust. If a tax is due, individual checks are required from each trust to pay the tax.

If separate share treatment is not applicable, the Fund would not want to be treated as a trust for tax purposes. DNI would be computed on an aggregate basis and taxes paid at thirty-one percent. All amounts distributed to beneficiaries would carry out DNI of the trust. There would be no distiction between principal and interest; no recovery of basis is possible. In other words, the aggregation of contract accounts would allow funds to be paid from pooled earnings while individual account earnings would not necessarily be sufficient to have made those payments. To that extent, individual account corpus is really being taxed.

Recommendations

As this report is written with nontaxable status in mind, no specific revenue ruling requests pertaining to taxable status as a trust are necessary and none are made. Further ruling requests would probably be required if the Fund is deemed taxable by the IRS in the initial ruling.

If trust status were desired, the Fund should take the appropriate steps to achieve legal status as a trust. This would include making a declaration of trust sufficient under Alaskan law and making provisions in the enabling legislation which speak in terms of "trustees" and the like instead of "custodians." Care should also be taken to avoid being found to be an investment trust subject to taxation as a corporation; language rebutting a profit motive may or may not be sufficient under the regulations. This issue would require further analysis.

The Fund as a trust would probably be required to account and report separately for tax purposes on each contract as a unique trust arrangement. For this reason we would not recommend seeking trust status for the Fund unless the program is taxable and not permitted a deduction for payments on behalf of or to beneficiaries. We would then recommend seeking complex trust status and clarifying that position with the IRS via ruling request. Tax treatment as a complex trust under the separate share rules would probably allow benefit of a lower effective tax rate when all tax on the separate accounts is considered. That effective rate should be about 15% percent as compared to a corporate rate of 34% percent. Denial of a corporate deduction for tuition payments would increase the effective rate benefit for the Fund as a trust.

TAXATION OF CONTRACT BENEFICIARIES AND PURCHASES

Statement of Law

A taxpayer receiving a "net accretion to wealth" under IRC Section 61 is generally deemed to have increased adjusted gross income. That accretion is derived by subtracting any basis in the underlying assets from the amount of a distribution.

From a trust, current distributions or amounts required to be distributed are taxed to a beneficiary when the distribution is required even though no assets may be actually distributed. IRC Sections 652(a) and 662(a) control as well as the Regulations at Section 1.662(a)-3(a). Throwback rules require that beneficiaries be taxed on income accumulated by a trust before a year of actual distribution (or taxation) as though the income had been distributed in the years earned pursuant to IRC Section 666 and Regulations at Section 1.665(a)-1A(a). However, the Regulations also provide that the throwback rules do not apply to amounts accumulated before the trustee reaches 21 years of age. A beneficiary takes the trust income into his adjusted gross income for tax purposes.

Per IRC Section 101, payments made to a beneficiary from "life" insurance contracts may result in taxable income. The amount of any income would represent the excess of amounts paid over a proration of "premiums" paid to obtain the contracts.

If property/casualty insurance contracts are present, a beneficiary may have income to the extent amounts received are greater than the basis in the contract (which is arguably the amount paid for the contract).

Annuity payments are generally broken down into two parts. A beneficiary would be the recipient of taxable interest income and a return of capital under the rules of IRC Section 72. The amount of the return of capital would probably be determined under the "annuity rule" which applies an exclusion ratio to payments received. The exclusion ratio is determined based upon the expected rate of return to be garnered from the annuity arrangement according to Treasury Regulations at Section 1.72. Once the ratio is determined, that percentage of the distributions escapes income taxation. The ratio may require recalculation based upon events subsequent to contract purchase. The effect of the ratio is simply to exclude the amount of "basis" in the contract from income taxation. In addition to the income tax, an annuity arrangement may give rise to a liability for an excise tax of ten percent on distributions pursuant to IRC Section 72(q). These provisions address situations where a beneficiary receives annuity distributions at a rate higher than what would have been received had payments been structured periodically over a specified lifetime. These provisions have yet to be applied to prepaid tuition programs.

Original issue discount (OID) rules may apply to prepaid tuition programs according to informal statements from the IRS. Essentially, OID application would result in taxable income equal to a pro rata amount of the difference between the contract purchase amount and the tuition payout amounts in the years prior to actual payout. Thus, the difference between the amount paid for a contract and the amounts received as tuition would be taxed currently rather than being deferred until schooling begins.

Application of the Law

If the Fund is determined to be a corporation for tax purposes, its situation is analogous to that of the Michigan program. The IRS, as evidenced by its Michigan Ruling, recognizes that corporate status for the prepaid tuition program allows beneficiaries to pay tax only to the extent each year's disbursements for tuition exceed prorated basis. Basis is the amount paid by a purchaser for the contract. Thus, a beneficiary would not have income until tuition payments are made and basis recovery reduces the payment portion subject to income taxes.

Trust rules would result in treating the Fund as a complex trust. Each beneficiary's actual or deemed trust would generate distributable net income (DNI). This amount would act as the cap on an amount the Fund could pass to each beneficiary as taxable income during distribution years when tuition payments are made. Thus, only the DNI of the separate trust, rather than the full amount of the distribution would be included in a beneficiary's taxable income.

If the Fund is deemed to be an insurance company (or Section 501(m) applies to The Fund as a Section 501(c)(3) entity), insurance proceeds to the beneficiaries are analogous to corporate distributions. The amount invested in a contract is arguably recovered tax-free on a pro rata basis against the tuition payments made.

Annuity treatment for the contracts issued by the Fund will not result in adverse income tax consequences. In fact, the standard recovery of basis appears to be available under a general application of the rules. However, the

potential for a ten percent excise tax does make this form of contract investment or payment less favorable as excise tax cost must either be paid by the Fund or passed on to the beneficiaries.

The income under any of these alternatives would be taxable to the owner of the contract. When benefits are paid, the owner receives those benefits and any income accretion. Under the Michigan Ruling, the IRS gave contract ownership to beneficiaries. Payment of tuition benefits therefore results in income to the beneficiary to the extent the payments exceed prorated basis in each contract. Under the Michigan Ruling, the contract purchaser then has no tax consequences since no benefits accrue to the purchaser.

The IRS is currently determining whether or not to apply OID provisions to prepaid tuition contracts. Such an application could result in current tax consequences. Whether or not the contract purchaser would be liable depends upon whether or not a completed gift may be made at the time the contract is purchased. If a completed gift is made, the beneficiaries remain liable for taxes. Otherwise, the purchaser could be held liable up until the time of gift completion.

rdless of who bears the burden, imposition of OID treatment results in taxable income from the date of contract purchase. Taxable income is a pro rata annual share of the difference between the amount paid for the contract and the amount expected to be paid out under the contract. This calculation must be made on a per contract basis. The amount of income would be treated as a payment of interest and would be taxed as such. OID treatment would be instead of any of the other considerations listed above (i.e., insurance, corporate,

etc.). The disadvantage is that the taxpayer will not be receiving any funds while being liable for taxes. The amount of the tax should not differ appreciably from the taxes eventually due on a deferred basis (as under the Michigan ruling). This is of course subject to change with the tax rates.

Recommendations

Regardless of the treatment rendered the Fund as a result of a ruling request, the taxable positions of the contract purchasers and beneficiaries should be clarified. This is the best opportunity to safeguard the interests of individuals in the prepaid tuition program. We recommend that the Fund ask the IRS to define the tax position of purchasers and beneficiaries.

We recommend that the Fund go beyond earlier requests to the extent necessary to obtain better guidelines regarding the payout period and related proration of basis. For example, the Michigan Ruling references a four-year payout period over which to presumably allocate the contract purchase price as basis. Under the terms of the Michigan contracts, the payout may occur over a term of nine years. Clearly better matching dictates use of a method of proration allowing basis to be spread over the same term as benefits.

We recommend using examples in the ruling request to state these facts and ask the IRS to provide a mechanism to correct the reporting difficulties. We anticipate that the four-year basis allocation of the Michigan Ruling was an oversight appropriate for clarification in the Alaskan ruling request. Clarification of means to report actual income over basis for the full term of a

beneficiary's schooling is also appropriate for inclusion in the ruling request because relief is not available elsewhere under the information reporting requirements.

With regard to the implications of original issue discount applications to prepaid tuition programs, we must await further action on the part of the IRS before clarifying the effects upon the Fund. Once the IRS acts, further ruling requests may be necessary to secure the best treatment for individuals under the Alaskan program.

GIFT TAXATION

Statement of Law

Section 2501(a)(1) of the Code imposes a tax on the transfer of property by gift.

Section 2511(a) of the Code provides that the Federal gift tax shall apply whether a transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-2(b) of the Regulations provides that a gift become complete, and thus subject to the gift tax, at such time as the donor has so parted with dominion and control as to leave the donor no power to change the disposition of the transfer.

Section 2503(e)(2)(A) of the Code excludes from the application of the gift tax any amounts paid on behalf of an individual as tuition to an educational organization described in section 170(b)(1)(a)(ii) for the education or training of such individual.

Section 2503(b) of the Code excludes from the application of the gift tax the first $10,000 of gifts of present interests in property made to any person during the calendar year. An interest constitutes a present interest in the transferred property only if the beneficiary is entitled to an unrestricted right to the immediate use, possession, or enjoyment of the property under the terms of the transfer, Section 25.2503-3(b) of the Regulations.

Application of the Law

Two critical factors in assessing the gift tax implications of the plan are the date on which the gift is completed and whether the gift is of a present or future interest. The date of completion of the gift determines the date of taxation under the principles set out in Regulation Section 25.2511-2. Whether the gift is of a present or future interest determines the eligibility of the gift for the present $10,000 per donor per donee annual exclusion under IRC Section 2503(b).

Plan Section 6.1 provides that the purchaser may substitute beneficiaries under the plan at any time subject to the approval of the Plan Administrator. Substitutions after the Redemption Period Start Date will be approved only in unusual circumstances. These rights of the purchaser to effect substitutions of beneficiaries under the plan will preclude a completed gift. A gift is not complete until the donor has parted with dominion and control over the transferred property as provided in Regulation Section 25.2511-2. It is uncertain whether the restricted rights of substitution after the Redemption Period Start Date will effect a completed gift on that date based upon the language of the plan. If the restriction is determined sufficient to pass control from purchaser, the gift will be completed at the Redemption Period Start Date. Should this restriction not serve to complete the gift, completion would occur under Regulation Section 25.2511-2 as the credits are redeemed. In no event will a gift under the plan be completed until the rights to a refund are unavailable or accrue to the beneficiaries.

A completed gift may be excluded from taxation in whole or in part depending on its value if it is of a present interest. Under the law as in effect on this date, an annual $10,000 per donor per donee exclusion is available for gifts of a present interest. Generally, a present interest is represented by an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property as outlined in Regulation Section 25.2503-3. It is possible to have a present interest in a future benefit, for example, a bond or life insurance policy. However, it is generally not possible to have a present interest where the use of the property is restricted, for example, restricting the right to sell the bond or cash in the policy.

The redemption and transfer provisions of the plan are indicative of a future interest and not a present interest. The beneficiary does not have the unrestricted right to immediate enjoyment of the property by sale, gift, or redemption of the contract rights. The fair market value of the contract will therefore be subject to gift tax without the benefit of the annual exclusion on the date the gift is completed.

The interrelationship of these two gift tax principles is potentially severe under the present plan. If the cummulative contract credits represent a completed gift on the Redemption Period Start Date, the fair market value of the entire contract would be subjected to gift tax without benefit of the annual exclusion. This could have significant tax repurcussions to certain participants. If the transfer restrictions are not sufficient to complete the gift, the gift will be completed as the credits are redeemed. The redeemed credits would in this instance be of a present interest qualifying for the above mentioned $10,000 annual gift tax exclusion to the extent of the tuition value.

The value attributable to the graduate incentive award component will remain a future interest. This result is less severe in that the taxable gift, if any, would be spread out over the period of redemption. Still, a significant tax and or reporting burden may result on the entire future interest portion of redeemed credits and the for tuition value of the redeemed units over the annual exclusion amount, if any, in effect at such time.

Under the terms of the plan, the credits are redeemed by the primary beneficiary. As such, the redemptions will not represent a direct transfer to an educational institution for purposes of the Section 2503(e) exclusion. Rather, the redemption will be a transfer of the credits by the donor to the donee followed by a redemption by the donee. For this reason, as well as others, it is unlikely that transfers under the plan will qualify for the exclusion from gifts under Section 2503(e).

It must be stated that the actual tax cost of a taxable gift under the plan will be zero for most participants due to the presently available $192,800 unified credit against gift tax under IRC Section 2505 (equivalent to a $600,000 lifetime gift exclusion). Taxable gifts, however, will require the filing of gift tax returns which may discourage participation.

Recomendations

The worst case result under the plan is where the substitution restrictions arising on the redemption period start date serve to complete the gift at that date. The value of the contract may be substantially appreciated on this date. The portion of the contract not used during the calendar year in which this date

falls will be a future interest as well as the graduate incentive award portion of the credits redeemed during that year. In order to avoid this result, the gift must be completed either upon purchase of the contract or upon redemption of the units. Freely allowing substitutions under the contracts at any point in time would hold open the completion of the gift until the date of redemption. Then, only the graduate incentive award value would represent a taxable gift. We recommend that the substitution restrictions either be eliminated in their entirety, or be effective upon purchase. In any event, the conditions of substitution, if substitutions are deemed necessary in the final plan, should be stated unequivocally in order to determine the date of completion of the gift. Should restricted substitution rights be retained in the plan, it will be imperative to obtain a ruling on the specific issue of the date of completion of the gift as effected by these rights.

The ideal result from a gift tax perspective is to create a completed gift of a present interest on the date of purchase. It could be expected that in most cases the gift would be fully excludible under the annual exclusion. Achieving this result within the plan language however, will pose important policy issues to the University. In order to complete the gift on the date of purchase, the various provisions vesting control of the beneficial interests in the plan with the purchaser would have to be deleted. The purchaser will not be able to retain the right to substitute or otherwise change the interests of the beneficiaries.

It is possible for a donor to retain limited rights under the contract while effecting a completed gift. For example, a donor may have the power to affect the beneficial interests under the contract subject to the consent of persons having a substantial adverse interest in the contract, such as the primary

beneficiary. The elimination of these rights of substitution held by the purchaser are not outwardly in conflict with the overall goals of the plan at this stage as they will merely reinforce the stated goals of the plan of promoting secondary education by locking in the participants. However, the completion of the gift upon purchase begs the need to fall within the annual exclusion and avoid potentially taxable gifts in order to encourage participation. This will require that the gift be of a present interest.

In order to create a present interest within the terms of the plan, the plan would have to be amended in such a way as to allow the beneficiaries immediate use and enjoyment of the contract. Meeting this requirement would directly conflict with the policy objectives of the plan to lock participants in. Tuition credits would necesarily be transferable, that is expendable immediately at the discretion of the primary beneficiary. There are a number of possible mechanisms which will result in a present interest. However, each falls back to a point where the tuition credits will be convertible in some fashion so as to provide for the possibility of immediate enjoyment by the beneficiary. Transferable units would present the University with the financial risk of honoring the contract, yet leave the basic goal of the program unfulfilled when the participants cash out of the program during adolescence.

The Section 2503(e) exclusion for tuition paid directly to the educational institution could be employed to exclude the transfer from being a taxable gift. However, this approach would also conflict with the overall plan objectives. In order to fully qualify under this exclusion, the plan would necessarily be restricted to tuition without allowing for non-tuition expenses or for graduate

incentive awards. It is theoretically possible that this exclusion from taxable gifts could be employed partially for the tuition component of the contract while retaining the non-tuition and or graduate incentive award components of the plan. However, we believe it would be impractical to develop a strategy along these lines which would avoid a completed gift of a future interest at some point in the process if the graduate incentive awards are retained. There is no way to structure a graduate incentive award as a present interest. Additionally, this approach would raise extremely complicated issues of identification and valuation given the contingencies of receiving the graduate incentive award, the potential effect of windfalls under plan section 8.3, and in determining the units to be characterized as tuition.

A practical solution to the dilemma of matching plan objectives with gift tax considerations can be accomplished outside of the plan for those purchasers using the Alaska Permanent Fund Dividend distributions and using the provisions of the Uniform Gifts to Minors Act. Where a donor gifts cash, the gift is presumably complete, and of a present interest. The gift will therefore be taxable subject to the $10,000 annual exclusion per donor per donee. The donee then may purchase tuition credits under the terms of the contract. We believe that this approach will fix the gift tax treatment at the date of the gift. Additionally, the basic structure of the plan may be left intact in support of the policy goals which it is designed to achieve. The simplicity of this approach may present problems for unwary participants. The cash transfer should be made under the Alaska Uniform Gifts to Minors Act to an account with a financial institution. The parent or other donor as custodian may then enter into the tuition credit contract with the University. The University's exposure, if any, under contracts with custodians on behalf of a minor should be addressed with legal counsel.

Drawbacks to this approach are that it requires additional effort on the part of participants and may intimidate some potential participants despite its simplicity. Legal counsel should also be consulted in drafting instructions to potential participants under the Act in terms which will ensure compliance yet be simple enough so as not to discourage participation using the uniform gifts to minors provisions. This complication however is fundamentally a one-time event. Subsequent purchases will require a simple deposit into the account set up for prior purchases followed by the purchase from that account. This approach will be less complicated over a period of time than applying the lifetime transfer exclusion to gifts of a future interest. While initial gift tax returns can be quite simple, subsequent filings can become very complicated.

As we understand it, the Alaska Permanent Fund Dividend checkoff procedure is expected to be the principle means of participation in the plan. Purchases under this procedure will be treated as if effected by a cash transaction. Purchases by an individual on his own behalf will not represent gifts. However, purchases on behalf of another will be a gift by the dividend recipient to the named beneficiary. The completion and nature of the gift will be determined under the same principles previously discussed with one important exception. The technical requirements of the Uniform Gifts to Minors Act arrangement discussed above will not be satisfied as no account will have been set up through which the transfer is accomplished. A solution to this technical problem must be found in order to facilitate purchases on behalf of others under the checkoff program without creating gift tax complications which might affect participation negatively. Consideration should be given to providing a mechanism for satisfying the Uniform Gifts to Minors Act requirements within the checkoff procedure or obtaining statute changes which deem such checkoffs to be

within the act. It must be kept in mind however, that based upon the substance of the entire transaction, the Internal Revenue Service may disregard the form of this transaction to deny a completed gift of cash.

Our analyis thus far has focussed on the gift tax issues between the purchaser and primary beneficiary. Important issues also exist with respect to the alternate beneficiaries' interests in the contract. The timing and nature of a gift to the alternate beneficiaries under the plan will follow that of a gift to the primary beneficiary discussed above. The completion of the gift will occur when the donor no longer controls the beneficial interests of the alternate beneficiaries. The nature of the completed gift will be a future interest. The fundamental difference will be the inability to control the completion and nature of the gift with the use of the uniform gifts to minors account. The entire analysis, however, will be complicated further by the necessity to value the alternative beneficiaries' interest in the contract. The value of an alternate beneficiary's interest upon the initial purchase of a contract will likely be negligible and not subject to a reasonable valuation. Valuation will become reasonably possible at such point where the primary beneficiary has excess credits which may accrue to the benefit of the alternate beneficiaries. Even at such point however, the valuation may be extremely complicated and a hindrance to participation.

In an effort to encourage and simplify participation, we recommend that the plan be amended to eliminate the need for periodic valuations arising from the completion of gifts to alternate beneficiaries. Consideration should be given to allowing the free substitution of alternate beneficiaries at any time. This would defer the completion of the gift until the alternate beneficiary becomes

the primary beneficiary. Another approach would be to retain beneficial ownership with the original primary beneficiary and allow for the assignment of excess credits to alternate beneficiaries only as they are actually used by the alternate beneficiary. This approach would allow for gift tax planning where the credits would be gifted as present interests and could be limited by the parties to remain within the $10,000 annual exclusion. Either of these approaches however will result in a gifted future interest to the extent of the graduate incentive award rights transferred. Consideration should be given to leaving the graduate incentive awards with the original primary beneficiary in order to avoid valuation and reporting complications under either of these proposals. This approach would merely require that a primary beneficiary be allowed to redeem his credits toward the tuition of an alternate beneficiary. Substitutions of alternate beneficiaries should be allowed at any time under this approach in order to retain control over the timing of the gift of a present interest.

Finally we recommend that individual purchasers of contracts be prohibited or discouraged from purchasing contracts under Plan Section 3.3 with unnamed beneficiaries. There appears to be no practical means to effect a completed gift of a present interest under this purchase option.

The successful use of the Uniform Gifts to Minors Act provisions is dependent upon the form of the transaction being respected. The transaction taken as a whole may be viewed as a direct gift of the contract rights under the step transaction doctrine. The principle defense against this view is that a gift under the Uniform Gift to Minors Act is irrevocable under Alaska statute, and that the Alaska statute therefore will control the nature of the gift for federal gift tax purposes as a gift of cash followed by a purchase by the

tax purposes as a gift of cash followed by a purchase by the custodian for the minor. The ruling request should include a specific request for determination of the character of the transaction accomplished through the Uniform Gifts to Minors Act.

This issue may be more troublesome for purchases under the dividend checkoff program on behalf of others. The insertion of technical procedures into the transaction in order to qualify under the Uniform Gifts to Minors Act, for example setting up momentary accounts for participants which satisfy the technical requirements of the act, will likely have less authenticity in the view of the Internal Revenue Service. A ruling request should include a specific request as to whether the form of this transaction will be respected whether accomplished by means of momentary financial accounts or state statute provisions as the case may be.

ALASKA PERMANENT FUND DIVIDEND CHECKOFF PARTICIPATION

Statement of Law

Alaska Permanent Fund Dividends are taxable income (D.J. Greisen, CA-9, 87-2 USTC 9608). A taxpayer in contructive receipt of income realizes income in the year in which the income is made available without reduction for amounts diverted at the request of the taxpayer under principles outlined in Regulation 1.451-2.

Application of the Law

The application of permanent fund dividends by purchasers of contracts under the program will not affect the income tax treatment of the dividends. The purchaser will be taxed on the full dividends by reason of having constructive receipt of the entire dividend. This treatment will be applicable to the individual entitled to receive the dividend irrespective of the beneficiary named under the Advance Tuition Payment Contract.

Recommendations

There are no means by which the plan can affect the income tax treatment of Alaska Permanent Fund Dividends. In order to prevent potential misunderstandings, we recommend that the dividend checkoff procedure directions or explanations provided to potential participants clearly explain that participation will not affect the taxability of the gross dividends payable to the participant. Additionally, consideration should be given to clearly stating

the taxable dividends on the vouchers or substitute Form 1099-MISC provided to dividend recipients in an effort to prevent unwary participants from underreporting income on their individual income tax returns. It can be expected that some participants might, with honest intentions, report only the net dividend received.

REPORT TO THE UNIVERSITY OF ALASKA
ADVANCE COLLEGE TUITION PLAN
(RFP No. SW 91-07)

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TABLE OF CONTENTS

Page

I. EXECUTIVE SUMMARY AND RECOMMENDATIONS 1

II. SECURITIES REGULATION ISSUES 3
- A. Introduction 3
- B. Exemptions from Federal Securities Regulation 4
  - 1. Exemption from Registration under the Securities Act of 1933 4
  - 2. Exemption from the Securities Exchange Act of 1934 5
  - 3. Exemptions from Other Federal Securities Laws 6
- C. Exemptions under the Alaska Securities Act . 6
- D. Status of Contracts as Securities 7
  - 1. Introduction 7
  - 2. Federal Securities Laws 7
- E. Changes to the Plan to Reinforce Exemption From Securities Regulation 10
- F. Recommendations Concerning No-Action Submissions 11

III. PRACTICAL AND LEGAL ISSUES 12
- A. Enforceability of Contractual Relationship with Minors 12
- B. Compatibility with the Uniform Gifts to Minors Statutes 13
- C. Protection of Benefits from Claims of Creditors of the Purchaser or Beneficiary 14
- D. Prohibition of the Right to Transfer 17
- E. Constitutionality of Residency Requirement . 17
  - 1. Comparison to Other States' Tuition Plans and Statutes 17
  - 2. Equal Protection: Case Law 18
  - 3. Due Process: Case Law 19
  - 4. Analysis 19
- F. Definition of Eligible Institution 22

IV. COMMENTS ON TEXT OF DRAFT PLAN 22
- A. Introduction 22
- B. Definitions 23
  - 1. Beneficiary and Qualified Beneficiary . 23
  - 2. Resident 23
- C. Participation 24
- D. Purchase of Tuition Credits 24

TABLE OF CONTENTS
(Continued)

Page

E. Redemption 24
F. Waiver 26
G. Refunds 26
H. Transfer of Benefits 26
I. Prepaid Tuition Scholarship 27
J. Contracts 27
K. Administration of the Plan 27
L. Fiduciaries 27
M. General 28
N. Reports and Notices 28

V. RECOMMENDATIONS CONCERNING AMENDING LEGISLATION . 28

VI. PURCHASE CONTRACT 28

VII. ANALYSIS OF TAX ISSUES 29
A. Introduction 29
B. Exemption as "Integral Part" of the State or a Political Subdivision of the State 29
C. Establishing Fund as an Integral Part of the University 31
D. Exemption under Section 115 of the Code . . . 33
E. Conclusion 34

Exhibit A - Investment Policy
Exhibit B - Actuarial Review
Exhibit C - Revision of Senate Bill
Exhibit D - Draft Contract
Exhibit E - Draft Plan

I. EXECUTIVE SUMMARY AND RECOMMENDATIONS

This memorandum is a comprehensive response to the outline of work and questions set forth in the University's Request for Proposal. It includes an extensive discussion of securities regulation issues, practical and legal issues including issues with respect to minors, and protection of the plan from creditors' claims, and includes comments on the text of the draft plan and the legislation, and an analysis of tax issues. In addition, attached to the memorandum are exhibits outlining an investment policy, a statement of required actuarial review, a proposed revision of the draft legislation, as well as a copy of a draft contract and of a draft plan. We recognize that some of our recommendations are tentative since they depend on the analysis being undertaken by Coopers & Lybrand into the areas which were the subject of their work. In addition, we have, no doubt, spoken on practical issues of the Plan which already have had extensive consideration by the University. We have not had an opportunity to discuss most of our suggestions with Jim Lynch or others at the University. When that discussion occurs, it will no doubt cause a revision of some of these suggestions.

We look forward to further discussion and meetings to clarify practical and legal issues which we have addressed. After review by the University of our submission and that of Coopers & Lybrand, we would expect to meet with Jim Lynch and others to finally refine our suggestions and to revise the Plan and legislation.

Our recommendations are as follows:

1. Securities Regulation Issues. If the University is to achieve a Tuition Contract exempt from securities regulation and/or excluded from the definition of security, we recommend that the legislation provide that tuition contract obligations be a general obligation of the University and that it also contain a provision requiring the University to seek legislative appropriations to make up a deficiency in Plan funds. In addition, in the Plan, we recommend that the Board of Regents establish the Administrative Committee explicitly to carry out the Plan and require it to make periodic reports to the Board of Regents. We also recommend a recital clause establishing the character of the Administrative Committee to carry out the day-to-day administration of Plan. In connection with the securities regulations issues we recommend that the University seek interpretive rulings or no-action

letters from the staff of the Securities Exchange Commission and the securities regulators of the various states where Contracts will be offered.

2. Practical and Legal Issues. To avoid problems arising from the possibility of a minor disaffirming the contract, we suggest that the University redefine purchasers so as to exclude minors. With respect to claims of creditors, we suggest an addition to the legislation exempting from execution tuition credits or accounts established under the legislation.

   With respect to the residency and the other requirements of the beneficiary under the Plan, it is our opinion that these do not present problems under the Alaska Constitution.

3. Comments on the Text of the Draft Plan. Many of our substantive comments on the text of draft Plan really await comments of Coopers & Lybrand on the actuarial issues. For example, we note that the Plan contains a definition of Cash Value which apparently includes market value of investments. It provides for distribution of excess of Cash Value over Tuition Value on an annual basis to both a scholarship account available generally to students to be selected by the Board of Regents and to the beneficiary on graduation. We assume the actuaries will speak to this feature of the Plan, along with the issue of whether an unlimited number of tuition credits may be purchased. We note that some other plans do not provide for Cash Value refunds as does this Plan in certain instances. Under Transfer of Benefits we question whether the Plan's provision for three alternate beneficiaries is administratively workable.

4. Legislation. Under our suggestions for legislative changes, we suggest an addition to AS 14.40.809 to provide for legislative appropriation to the University for any deficiencies in the fund on an annual basis. In AS 14.40.811, we suggest that the statute not mandate an installment purchase plan but leave the adoption of such a plan to the Board's discretion.

5. Tax Exemption. Finally, with respect to our tax recommendations, we suggest, similarly to our recommendations under the securities analysis, that

the obligation to pay benefits be made a contractual obligation of the University and that it also be supported by the moral obligation of the State. We further suggest making the Plan a general asset of the University and minimizing its trust attributes. This suggestion is not imported into the legislative draft at this time because we need to discuss it with you and Coopers & Lybrand, who we understand has recent, direct experience with representation before the Internal Revenue Service on these matters. We also wish to confer with you and Coopers & Lybrand before suggesting a course of action with respect to possibly requesting a private letter ruling from the Internal Revenue Service.

II. SECURITIES REGULATION ISSUES

A. Introduction

Activities related to the offering and sale of securities are regulated both by the federal government and by each of the states. The state securities laws that should be addressed include, at a minimum, the Alaska Securities Act, because the University, which will offer the Contracts, is located in Alaska. The securities laws of any state in which a Purchaser of a Contract or Beneficiary under a Contract resides also must be addressed, because the Contract may be considered to have been offered to them in their respective states of residence.

Under both federal and state securities law, the Plan raises two basic issues: (i) whether a Contract is a security, and (ii) if a Contract is a security, whether it is exempt from regulation. This discussion treats first the issue of exemption from regulation, because it appears that a Contract will be exempt from regulation under the federal securities laws and under the Alaska Securities Act. Of course, before offering Contracts to Purchasers or Beneficiaries in states other than Alaska, the exempt status of the Contract in those states also must be established. We have not undertaken a survey of the securities laws of the other 49 states, the District of Columbia, Guam, or Puerto Rico for this purpose as part of this report. Instead, we examine the law in Alaska as an example of the analysis that may be necessary in other jurisdictions. In addition, we note that most state securities laws are patterned after a

Alaska Securities Act should have similar counterparts in many other states.

B. Exemptions from Federal Securities Regulation

1. Exemption from Registration under the Securities Act of 1933

Under Section 3(a)(2) of the Securities Act of 1933 (the "Securities Act"), contracts are exempt securities that are not subject to the registration requirements of the Securities Act. Section 3(a)(2) of the Securities Act states in pertinent part as follows:

> "Except as hereinafter expressly provided, the provisions of this title [Securities Act] shall not apply to any of the following classes of securities...(2) any security issued or guaranteed by...any State of the United States, or by any political subdivision of a State...or by any <u>public instrumentality</u> of one or more States...or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States...." [Emphasis added.]

The legislative history of Section 3(a)(2) indicates that the term "public instrumentality" in this section would be construed broadly enough to include both the University and the Plan. As originally enacted, Section 3(a)(2) exempted securities issued by "any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories "<u>exercising an essential government function</u>" (emphasis added). In 1934, the section was amended to delete the phrase "exercising an essential government function." The conference report concerning that amendment indicates that it was adopted to extend "the scope of the public instrumentality exemption to expanding activities in which governments are engaging." H.R. Rep. No. 1838 (Conference Report), 73rd Cong. Sd. Sess. 40 (1934). Education, the

function served by the Plan, long has been recognized as a function of state government, and, indeed, as an essential governmental function. For example, Brown v. Board of Education, 483 U.S. 493 (1954), describes education as "perhaps the most important function of state and local governments." Moreover, the Alaska Supreme Court has determined the University to be an instrumentality of the State. University of Alaska v. National Aircraft Leasing, Ltd., 536 P.2d 121 (Alaska 1975).

Therefore, it is our opinion that the University qualifies as a "public instrumentality" of the State of Alaska for purposes of Section 3(a)(2) of the Securities Act. The essential nature of the education function would have caused the University to be considered a "public instrumentality" under Section 3(a)(2) even before its 1934 amendment. At least under the amendment, the Plan also should be considered a "public instrumentality." Regardless of the form of the Plan (i.e., as a separate legal entity such as a corporation or trust, or an integral part of the State or the University), it is a vehicle through which the University will carry out its responsibilities under the Alaska Trust Fund Act and more generally assist in carrying out its functions as a state University.

2. Exemption from the Securities Exchange Act of 1934

The Securities Exchange Act of 1934 (the "Exchange Act") regulates certain securities brokers and dealers. Section 3(d) of the Exchange Act provides as follows:

> "no issuer of municipal securities or officer or employee thereof acting in the course of his official duties as such shall be deemed to be a "broker", "dealer", or "municipal securities dealer" solely by reason of buying, selling, or effecting transactions in the issuer's securities."

Section 3(a)(29) of the Securities Exchange Act defines "municipal securities" as follows:

"The term 'municipal securities' means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States,...."

For the same reasons as those stated above with regard to exemption from the Securities Act, it is our opinion that the Plan is an instrumentality of the State of Alaska. Because Contracts are direct obligations of the Plan, they are municipal securities under the Exchange Act, and officers or employees of the University who sell Contracts in the course of their official duties are exempt from the Exchange Act.

3. Exemptions from Other Federal Securities Laws

Because of the status of the University and the Plan as public instrumentalities, we also are of the opinion that the Plan, its operation, and the offering and sale of Contracts under the Plan are exempt from the provisions of the Trust Indenture Act of 1939, the Investment Company Act of 1940 and the Investment Advisors Act of 1940.

C. Exemptions under the Alaska Securities Act

AS 45.55.070 of the Alaska Securities Act requires the registration of certain securities before their offer and sale in Alaska. However, AS 45.55.140(a)(1) provides the following exemption from this requirement:

"The following securities are exempted from AS 45.55.070: (1) a security, including a revenue obligation, issued or guaranteed by the United States, a state, a political subdivision of a state, or an agency or corporate or other instrumentality of one or more of the foregoing; or a certificate of deposit of any of the foregoing;"

As discussed above, both the University and the Plan are instrumentalities of the State of Alaska, and therefore Contracts are exempt from the securities registration requirements of the Alaska Securities Act under this provision.

AS 45.55.030(a) of the Alaska Securities Act requires the registration of securities broker-dealers who offer securities for sale in Alaska. However, under AS 45.55.130(3)(B), the issuer of a security is excluded from the definition of "broker-dealer" under the Alaska Securities Act. Therefore, officers and employees of the University, as the issuer of Contracts under the Plan, may offer and sell contracts without registering as broker-dealers under the Alaska Securities Act.

D. Status of Contracts as Securities

1. Introduction

In addition to being exempt from regulation under federal securities law and the Alaska Securities Act under exemptions for securities of public instrumentalities, Contracts may be exempt from registration and other securities regulatory requirements because they are not considered to be "securities" for purposes of those requirements. Because the structure of the Plan may change in ways that would cause Contracts not to be exempt from securities regulation under the above analysis of statutory exemptions, it is worthwhile to briefly consider under what circumstances Contracts would not be considered "securities" for purposes of federal and state securities laws.

2. Federal Securities Laws

Section 2(1) of the Securities Act broadly defines the term "security" to include the term "investment contract." The term "investment contract" is not further defined under the Securities Act or regulations adopted pursuant to that Act. In <u>Securities and Exchange Commission v. W. J. Howey Co.</u>, 328 U.S. 293, at 298 (1946), the Supreme Court of the United States set forth what has become the generally accepted definition of an investment contract:

> "A contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."

In SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, at 477 (5th Cir. 1974), the court summarized the Howey test as consisting of three elements: (i) that there is an investment of money; (ii) that the scheme in which an investment is made functions as a common enterprise; and (iii) under the scheme, profits are derived solely from the efforts of individuals other than the investors.

An investment typically involves parting with money for the purpose and in the reasonable expectation of making a profit. See, SEC v. Energy Group of America, Inc., 459 F. Supp. 1234 (S.D. NY 1978). A Purchaser of a Contract under the Alaska Plan does not primarily seek a profit in the ordinary business sense. Nonetheless, the Purchaser does seek an economic benefit by entering into the contract: to secure and quantify the expense of college tuition for the benefit of the Beneficiary.

The requirement of a common enterprise means that there must be an enterprise "in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties." SEC v. Glenn W. Turner Enterprises, 474 F.2d 476, 482 n.7 (9th Cir. 1978), cert denied, 414 U.S. 821 (1973). The commonality required is vertical (between the investor and the promoter) rather than horizontal (among multiple investors). Under the Plan, the Purchaser receives no direct return from the Plan except in the event of a refund of Cash Value under Section 5.1.a of the Plan if the University cannot meet its obligations under the Plan. Otherwise, Cash Value or Tuition Value is payable for the benefit of a third party.

It is not clear whether the requirement that profits be derived solely from the efforts of

a promoter or third party applies to the Plan. Although the principal benefit under the Plan, Tuition Value, is independent of the investment performance of the Plan, the Beneficiary may receive profit from Cash Value increases.

3. State Securities Laws

Section 130(12) of the Alaska Securities Act, AS 45.55.130(12), defines the term "security" broadly to include the term "investment contract." The term "investment contract" is not further defined under the Alaska Securities Act. However, in Hentzner v. State, 613 P.2d 821 (Alaska 1980), and Wheeler v. State, 659 P.2d 1241 (Alaska 1983), the Alaska Supreme Court interpreted the term in the same manner as the term was interpreted for purposes of federal securities law in Securities and Exchange Commission v. W.J. Howey Company, 328 U.S. 293 (1946), and SEC v. Glenn W. Turner Enterprises, 474 F.2d 476 (9th Cir. 1978). The application of the criteria for an investment contract under these cases to Contracts under the Plan is addressed in the discussion above of the status of Contracts as securities under federal law.

The definition of a security under the Alaska Securities Act also includes a risk capital test as follows:

> "...investment of money or money's worth including goods furnished or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decision of the venture;"

This portion of the definition of a security has not been interpreted by the Alaska Supreme Court. However, the risk capital test has been used in other jurisdictions interpreting securities laws similar to that of Alaska. See, AMFAC Mortgage Corporation v. Arizona Mall of Tempe, Inc., CCH Fed. Sec. L. Rep. 96,588 (9th Cir. 1978).

One may use the arguments stated in the context of the federal definition of an investment contract to distinguish the Plan from the elements of the risk capital test set forth in AMFAC Mort-

gage. For example, there is no "investment" of money as that term is normally interpreted. See, SEC v. Energy Group of America, supra. The funds provided by a Purchaser are not "at risk," provided the University, at all times throughout the duration of existence of the Plan, has the financial ability to refund those funds to the Purchaser. While the Purchaser does not under the Plan have any control over the University and its investment policy regarding the Plan, the expectation of the Purchaser is not a profit but rather Tuition Credits which may be used by the Beneficiary. While there is "some benefit" to be derived here, i.e., cost savings, it is not the sort of benefit normally associated with risk capital ventures. See, United Housing Foundation v. Forman, supra.

For the reasons stated above, it is our conclusion that the Plan and the Contracts will not be investment contracts, and will not meet the risk capital test of the Alaska Securities Act. Therefore, the Plan and the Contracts should not be securities for purposes of the Alaska Securities Act.

E. Changes to the Plan to Reinforce Exemption From Securities Regulation

Although we believe that a Contract should be exempt from securities regulation and, indeed, should not even be considered a security for that purpose, we propose several changes to the Plan to reinforce this conclusion. The first set of changes addresses exemption from regulation; the second set of changes addresses exclusion from the definition of security.

1. Exemption from Regulation

(a) Modify the University Legislation to provide for a general obligation guarantee of the Alaska Plan by the University, and a requirement that the University seek legislative appropriations to make up any deficiency in Plan funds (a "moral obligation" pledge). Such changes will reinforce the argument that the Plan is an instrumentality of the state for purposes of exemption from securities regu-

lation. Our draft legislation, Exhibit C, incorporates these provisions.

(b) Clarify the University's control over the administration of the Plan to reinforce the argument that the Plan is an instrumentality of the state, or an integral part of the University (which itself is an instrumentality of the state), by making the following changes to the Plan:

(i) Add language in Section 10.1 of the Plan that the Board of Regents establishes the Administrative Committee to carry out the administration of the Plan and delegates to the President the responsibilities and duties as set forth in that section;

(ii) Require within Section 10 of the Plan that the Administrative Committee make periodic reports to the Board of Regents on the finances and actuarial status of the Plan and otherwise respond to inquiries from that Board;

(iii) Add a "WHEREAS" clause at the beginning of the Plan providing that the University through the Board of Regents establishes an Administrative Committee to carry out the day-to-day administration of the Plan at the direction of the President.

2. Exclusion from Definition of Security

Ensure that no promotional materials for the Plan promise directly or indirectly any profit to the Purchaser or Beneficiary from the payment of funds under a Contract.

F. Recommendations Concerning No-Action Submissions

We recommend that the University seek an interpretive ruling or no-action letter from the staff of the Securities Exchange Commission concerning the Plan. Other states have sought and obtained no-action letters

concerning their plans. However, each of those letters addresses only the terms of a particular plan, which are not identical to those of the Plan. Such an interpretation or no-action letter would indicate that the staff of the SEC will not recommend enforcement action under the various federal securities laws in connection with the offering of Contracts to Purchasers and the administration of the Plan.

We further recommend that the University seek an interpretive ruling or no-action position by the Alaska Administrator of Securities pursuant to the Alaska Securities Act. Such an interpretation or no-action letter would indicate that the staff of the Division of Banking and Securities will not recommend enforcement action under the Alaska Securities Act in connection with the offering of Contracts to Purchasers. We also recommend that the University consider seeking similar letters from the securities regulator in each state where Purchasers or Beneficiaries may reside.

III. PRACTICAL AND LEGAL ISSUES

A. Enforceability of Contractual Relationship with Minors

The Plan authorizes Contracts between the University and a "Purchaser". Section 1.17 of the Plan defines Purchaser as "a person or other entity who makes or is obligated to make payments under an Advance Tuition Contract". Minors (persons less than 18 years of age in Alaska) are not precluded from being Purchasers under this definition.

The University may enter into a Contract with a minor. However, the minor may avoid his or her obligations under the Contract by claiming that he or she lacked the capacity to contract. Restatement (Second) of Contracts, Section 14 (1981). To the same effect, Webster Street Partnership, Ltd. v. Sheridan, 368 N.W. 2d 439 (1985), and Bobby Floars Toyota, Inc. v. Smith, 269 S.E. 2d 330 (1980).

In Alaska, a minor who is at least sixteen years old and who satisfies other statutory requirements may be emancipated if the court finds that it is in the best interest of the minor. AS 09.55.590. If the court permits a minor to be emancipated, the minor then has the

capacity to contract. AS 09.55.590(g). Therefore, a Contract with an emancipated minor is enforceable.

There are other limited circumstances where a minor may enter into a contract which may not be subsequently disaffirmed. These include the following: (a) the minor is at least sixteen years old and married (AS 25.20.020); and (b) a minor is liable for the reasonable value of necessaries conferred under a contract, Webster Street Partnership, Ltd. v. Sheridan, 220 Neb. 9, 368 N.W. 2d 439 (1985); Warwick Municipal Employees Credit Union v. McAllister, 399, 293 A. 2d 516 (R.I. 1972). However, the latter exception would not apply to an Advance Tuition Payment Contract because a college, university or professional education generally is not considered a necessary. 42 Am Jur 2d 73, Section 71.

To avoid a minor's disaffirming a Contract, the University may consider the following alternatives:

(1) Redefine Purchaser so as to exclude minors.

(2) Redefine Purchaser so as to exclude minors generally, but include emancipated minors.

(3) Redefine Purchaser so as to require an adult co-signer of Contract with an unemancipated minor Purchaser.

These recommendations are similar to the approach taken in Alabama. To be an eligible purchaser under the Alabama program, one must be 19 years of age or older, or be represented by a court appointed conservator or guardian, trustee, or designated custodian.

We amend the definition in our draft Plan (Exhibit E) consistent with (1) above.

B. Compatibility with the Uniform Gifts to Minors Statutes

Alaska has adopted the Alaska Uniform Transfers to Minors Act, AS 13.46, to replace the Alaska Uniform Gifts to Minors Act. AS 13.46 provides a simple procedure by which an adult may make a gift of securities or money to a minor, with the power of management reserved in a custodian. The custodian's authority and duties under these custodial arrangements are prescribed by statute, and include discretionary expenditures of custodial property for the benefit of the minor. AS 13.46.130.

It is not intended, nor advisable, to have the Alaska Uniform Transfers to Minors Act govern the roles and responsibilities of the respective parties under the Plan. The Plan itself should determine and authorize all duties necessary to supervise the administration of the Plan and to control its operation. We believe the Plan, as amended, does accomplish this.

C. Protection of Benefits from Claims of Creditors of the Purchaser or Beneficiary

As the Plan presently is structured, judgment creditors of the Purchaser will have no claim to benefits under a Contract. The only creditors of concern will be those of the Beneficiary. Because most Beneficiaries will be minors, creditors seeking to execute on their Plan benefits probably should be few in number. Thus, while creditor execution may be a nuisance, it is not likely to impair the operation of the Plan. The problem may be eliminated altogether by legislation exempting benefits under Contracts from execution.

Whether a judgment creditor may levy upon benefits under a Contract depends first upon whether they are property of the judgment debtor. Benefits under a Contract may be the property of either the Purchaser of the Contract or a Beneficiary under the Contract, depending on the Contract terms. As the Plan presently is structured, it does not appear that the Purchaser has any continuing interest in a Contract that would cause benefits under the Contract to be considered property of the Purchaser. Of course, if the benefits are not the property of the Purchaser, they cannot be levied upon for debts of the Purchaser.

In most cases, the Beneficiary will be a minor with no debts of a type that would be the subject of a judgment creditor's execution. If a Beneficiary has incurred such a debt, the Beneficiary's interest under a Contract may be subject to execution, because the Contract allows refunds to or redemptions by the Beneficiary on demand or after a designated time period.

Whether a judgment creditor may levy upon benefits under a Contract also depends upon whether those benefits are considered property subject to execution under Alaska law. Insofar as benefits under a Contract are property rights, they likely will be found to be within Alaska's broad definition of personal property, and thus subject to execution.

AS 09.35.070 describes the property that is subject to execution by a judgment creditor as follows:

> All goods, chattels, money, or other property, both real and personal, or an interest in the property of the judgment debtor not exempt by law, and all property and rights of property seized and held under attachment in the action are liable to execution.

AS 01.110.060(9) defines personal property to include money, goods, chattels, things in action, and evidences of debt. Money held in escrow also is subject to execution where the judgment debtor possessed rights to the escrowed funds. H. Von Gemmingen v. First National Bank of Anchorage, 789 P.2d 353 (Alaska 1990). There the court held, "...that 'property' liable to execution includes not only funds within named escrow accounts, but also the rights of and duties owed to judgment debtors, pursuant to the terms of those accounts." Id. at 356. See also, Anchorage Helicopter Serv. Inc. v. Anchorage W. Hotel, 417 P.2d 903, 906 (Alaska 1966), where the court recognized earned contract rights to wages as "debts" for purposes of A.S. 09.40.040.

Cases in Alaska do not address specifically whether interests similar to those under a Contract are subject to execution. At common law, trusts received protection from execution absent a specific statute allowing execution. However, certain equitable actions could be used to reach a trust interest. Judicial decisions on this question vary considerably among different jurisdictions. For example, in Texas no part of a spendthrift trust estate may be taken on execution or garnishment by creditors of a beneficiary. Bank of Dallas v. Republic National Bank, 540 S.W.2d 499 (Tex. Civ. App. 1976), while in Maryland the right to trust income subject to a spendthrift clause is a property right upon which creditors may levy a claim. United States v. Riggs National Bank, 636 F. Supp. 172 (D.D.C. 1986). A judgment creditor in New York was able to execute on a retirement profit sharing account despite onerous tax consequences and penalties to the judgment debtor on withdrawal. Learner v. Williamson Savings Bank, 386 N.Y.S.2d 906 (N.Y. Civ. Ct. 1976). In Massachusetts, the power to revoke a trust was held not to be property and could not be reached by creditors. George v. Kitchens by Rice Bros., Inc., 665 F.2d 7 (1st Cir.

1981). In other instances the surplus income of a spendthrift trust has been reached by creditors.

AS 09.38 provides many exemptions from execution, including several exemptions for benefits similar in kind to those under Contracts. AS 09.38.015 exempts longevity bonus payments, limited entry permits, and benefits held in a teachers' or public employees' retirement system. AS 09.38.025 exempts unmatured life insurance and annuity contracts. However, there is no exemption that would cover benefits under a Contract. We recommend that the proposed amendments to the statutes governing the Plan include a provision to exempt benefits under Contracts from execution. The exemption could be established by adding to the list of exempt property in AS 09.38.015, a paragraph (9) designating "tuition credits or accounts established pursuant to AS 14.40.80-3." The draft bill (Exhibit C) contains this provision.

A statutory exemption of Contract benefits from execution could be accompanied by a statement in the Plan itself that benefits under the Plan are exempt from execution. Where retirement plans, which in some respects are analogous to the Plan, specifically have stated that they were not subject to execution and state laws also provided an exemption, the courts have upheld the exemption statute as achieving a valid legislative purpose. By analogy, it is likely an exemption for benefits under the Plan would survive a similar challenge because of the legitimate legislative purpose of promoting education. The exemption also would be consistent with the public policy supporting the existing exemptions of other governmental entitlements that were described above.

In the absence of a statutory exemption, whether benefits under a Contract are subject to execution also may depend on how the Plan is structured and the restrictions placed on cash conversion. Restrictions upon appointment of Alternate Beneficiaries, the transfer of rights between Beneficiaries, and cash redemption, may help to fend off attempts at execution. However, adding restrictions to the assignment of rights under the Plan and to the redemption of credits solely to thwart execution may interfere with the accomplishment of more important objectives of the Plan. The Michigan plan includes a clause stating that it is the intent of the parties that the contract is not subject to judgments or attachments. However, such clauses may not be effective absent statutory support. For example, New York courts

have held ineffective a clause seeking to restrict or exempt trust funds from creditors. National Bank of North America v. International Brotherhood of Electrical Workers Local #3, 400 N.Y.S.2d 482 (N.Y. Sup. Ct. 1977). As stated above, we recommend legislation to establish a statutory exemption as the most effective means of protecting benefits under Contracts from execution by judgment creditors.

D. Prohibition of the Right to Transfer

We understand the issue here to be the extent to which a Beneficiary should be allowed to transfer his or her interest as Beneficiary under a Contract to another party. This is principally a question of policy rather than a legal issue. However, it should be borne in mind that the more freely transferable a Beneficiary's interest is, the more likely that interest will be considered a property right subject to execution by the Beneficiary's creditors (see discussion under III.C above). Certainly if there is no statutory exemption from execution for a Beneficiary's interest, and that interest is transferable in exchange for consideration (for example, if the interest may be sold or used as collateral for a loan), it is highly likely that the Beneficiary's interest will be subject to execution by the Beneficiary's creditors.

E. Constitutionality of Residency Requirement

1. Comparison to Other States' Tuition Plans and Statutes

Each of the three states whose materials we reviewed in this respect -- Florida, Michigan, and Ohio -- generally requires that a person, in order to be a "qualified beneficiary" for purposes of their tuition payment plan, must be a resident of the state at the time the purchaser enters into the advance payment contract.

Florida's plan identifies a "beneficiary" under its "Master Covenant" as a qualified beneficiary as defined in Section 240.551(2)(e), Florida statutes (1989). A "qualified beneficiary" means a resident of Florida at the time a purchaser enters into an advance payment contract on behalf of the resident. However, Florida is the only state of the three that goes beyond the pure residency standard; it permits the inclusion as a qualified

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beneficiary of any non-resident who is a child of a non-custodial parent when the non-custodial parent is a resident of Florida at the time such parent enters into an advance payment contract on behalf of the child.

Ohio defines "beneficiary" under its Policies and Procedures as an individual who is a resident of Ohio and is designated in a contract as the individual entitled to apply tuition credits purchased under the contract to the payment of his or her tuition. Under Section 3334.01(B) of the Ohio statutes, beneficiary is defined as a resident of Ohio designated in a tuition payment contract as the person entitled to apply tuition credits. Under the 1990 Program Description - Residency Requirements, a beneficiary must be an Ohio resident at the time of the acceptance of the contract, and tuition credits may only be purchased for the beneficiary while he or she is an Ohio resident. Further, purchase of tuition credits does not guarantee status as a resident at a state institution of higher education.

In Michigan according to the purchase plan contract, a beneficiary must be a Michigan resident at the time the contract is signed. Michigan residents who are living outside the state of Michigan due to a military assignment remain Michigan residents until they indicate an intent to abandon their domicile in Michigan and establish a new one elsewhere.

Residency of the beneficiary at the time of purchasing the contract is mandatory as a condition to qualification in each of the three states, except to the extent noted above for children of non-custodial parents who are Florida residents. None of the three states otherwise allow any individual who is not a resident to participate as a qualified beneficiary.

2. Equal Protection: Case Law

Alaska has adopted a sliding scale of review ranging from relaxed scrutiny to strict scrutiny which was established under State v. Ericson, 571 P.2d 1 (Alaska 1978). "The applicable standard of review for a given case is to be determined by the importance of the individual rights

asserted and by the degree of suspicion with which we view the resulting classification scheme". Harrison v. State, 687 P.2d 332, 340 (Alaska 1984). "As the level of scrutiny selected is higher on the Ericson scale, we require that the asserted governmental interest be relatively more compelling and that the legislation's means-to-ends fit be correspondingly closer. On the other hand, if relaxed scrutiny is indicated, less important governmental objectives will suffice and a greater degree of over/or underinclusiveness in the means to ends fit will be tolerated. As a minimum, we require that the legislation be based on a legitimate public purpose and that the classification 'be reasonable, not arbitrary, ... rest upon some ground of difference having a fair and substantial relation to the object of the legislation....'" Id at 340, citing State v. Ostrosky, 667 P.2d 1184, 1192-93 (Alaska 1983).

"[T]he mere fact that a regulation and statute impose a classification does not in and of itself violate equal protection." Wickersham v. State Commercial Fisheries Entry Commission, 680 P.2d 1135, 1141 (1984).

The intensified rational basis test adopted in Alaska is a more stringent state equal protection test and is therefore permissible under the Federal equal protection test.

3. Due Process: Case Law

Substantive due process is denied under the Alaska constitution when a legislative enactment has no reasonable relationship to a legitimate governmental purpose. State v. Rice, 626 P.2d 104 (1981).

4. Analysis

There are no cases on point with respect to the issue of allowing certain nonresidents to be beneficiaries (such as sons and daughters of alumni) of a state program such as the advance tuition payment program. Our analysis, in the absence of any such case, leads us to conclude that such classification would not violate either the Alaska or United States equal protection or due process clauses.

The interest in question (i.e., the ability to participate in a plan for the payment in advance of the cost of tuition at a state university) does not appear to constitute a fundamental right, and the classifications involved (i.e., distinguishing between two classes of nonresidents -- those who are children of alumni of the university and those who are not -- and distinguishing between two classes of residents -- those who are alumni and have children who are nonresidents and those who are not alumni and have children who are nonresidents) do not fall within the categories of suspect or quasi-suspect classifications for equal protection purposes. Therefore, under federal equal protection analysis, the "rational basis" test would apply.

Is there any rational basis to support the classifications described above? The answer to this question must come from the creators of the plan. However, it might be suggested that the classification rewards alumni and thereby provides additional encouragement for attendance at the university. Supporting the state university is a legitimate state interest, and providing awards and incentives for attendance there is a means toward achieving that interest. It is also a legitimate state interest to encourage graduates from the university to remain in the state; this interest was expressed and furthered through the use of the forgiveness feature that previously applied to the state's loan program. Again, providing awards and incentives for alumni to remain in the state is a means toward achieving this interest. Under the federal equal protection analysis, we believe that there would be sufficient connection between the state interests involved and the classifications created to demonstrate a rational basis for such classifications.

The Alaska equal protection analysis is somewhat more difficult. The individual rights involved, from a constitutional point of view, are relatively slight. These classifications do not bear upon issues of liberty, protected freedoms, or fundamental needs for survival. The classifications do not even determine any individual's right to attend the state university. The individual rights involved are no more than the ability to participate in a financing plan. From a constitu-

tional point of view, we suggest that the court would analyze any impact on these rights from the minimum scrutiny level described in Harrison, supra. Accordingly, it would be necessary under Alaska's equal protection analysis to demonstrate that the classifications are reasonable, not arbitrary, and that they rest upon some ground of difference having a fair and substantial relation to the object of the plan. Less important government objectives will suffice, and a greater degree of over or underinclusiveness will be permitted.

As discussed above, government objectives might be stated to include support for attendance at the state's university and encouragement for alumni to remain in the state after graduation. Each of these is a legitimate government objective. The individual rights involved are relatively slight. Weighing the importance to the government of the objectives involved against the relatively slight individual rights affected, we believe the court would uphold the classification under an Alaska equal protection analysis. The classifications involved appear to be tailored to promote the interests stated and, therefore, could be said to be reasonable and not arbitrary and to rest upon some ground of difference having a fair and substantial relation to the interests served.

For the same reasons noted above under the Alaska equal protection analysis, we would conclude that the residency classifications proposed for the plan would survive a substantive due process challenge.

Despite our conclusions that the proposed classifications would survive constitutional challenge, we suggest deleting the special allowance for nonresident children of resident alumni although we believe that the classification would survive a constitutional challenge, it does nevertheless raise an issue. We are of the opinion that a challenge on constitutional grounds would fail, but we cannot guarantee that result. It would be advisable to avoid the entire issue unless the plan administrators and creators consider the objectives served by the classification to be sufficiently important to warrant the risk of a challenge.

As a final matter, we note that the residency provisions of the advance tuition payment plan do not contain any durational residency provisions (i.e., provisions requiring that a person live in the state for a certain period of time before being able to qualify as a resident). We encourage the plan administrators and creators to keep durational residency provisions out of the plan. State and federal courts have repeatedly stricken these provisions as violative of equal protection. If any other residency definitions are to be considered, we strongly urge that the durational residency aspects of them, if any, be deleted.

F. Definition of Eligible Institution

The definition of Eligible Institution used in the Alaska Plan is "a non-profit, postsecondary institution approved by the U.S. Department of Education for receipt of Title IV funding." This definition appears to be very broad. A copy of the list of such approved institutions should be obtained by the University and reviewed to ensure that it is compatible with the general purpose of the Alaska Trust Fund Act and the Plan. It is our understanding that Jim Lynch of the University is in the process of obtaining that list. We would like to review it as well in this context.

IV. COMMENTS ON TEXT OF DRAFT PLAN

A. Introduction

In addition to the analyses of legal issues related to the Plan that appear in other sections of this report, we have reviewed the text of the Plan for clarity and internal consistency. This has been done with awareness that the Plan will function as a legal document, creating rights and obligations among Purchasers, Beneficiaries and the University. Some of the following comments recommend specific changes to the Plan text. Others identify issues raised by apparent contradictions, ambiguities or omissions in the Plan text, whose resolution may require policy choices by the University. We are available to assist in reviewing and commenting on subsequent drafts of the Plan, as the University may require. Exhibit E, attached to this report, is a copy of the draft Plan, marked with specific amendments based

upon our comments in this section. Additional revisions may be required to reflect the resolution of issues identified in our comments.

B. Definitions

1. Beneficiary and Qualified Beneficiary

It appears that these definitions are intended to address two concepts: (i) a person identified as a beneficiary in a Contract, and (ii) a person who is eligible to receive benefits under a Contract. We recommend that the definition of Qualified Beneficiary be deleted.

2. Resident

Section 1.22 defines the term "Resident". The definition of Resident is made operational by Section 2.1 a., which states that eligible participants under the Plan include purchasers of Contracts for the benefit of a "Resident" or an individual who is expected to become a "Resident" prior to receipt of benefits under the Contract, or a son, daughter or legal ward of a "Resident". Ultimately, the purpose of the definition of "Resident" is to provide part of the criteria for determining who may receive benefits under a Contract. We recommend consideration of deletion of the concept of eligibility based either upon future residency or having a parent or guardian who is a resident from the definition of Resident or elimination of the eligibility requirement altogether. A concise, conventional and legally defensible definition of residency would be one modeled on the definition in AS 43.23.095 for purposes of Permanent Fund dividend eligibility: an individual who is physically present in the state with the intent to remain permanently in the state. The University may wish to consider whether, as for residency for purposes of the Permanent Fund dividend, certain permissible categories of absences from the state should be permitted under the Plan (the most obvious being attendance at an Eligible Institution outside the state).

Having said all this, our Plan amendment nevertheless incorporates existing concepts rearranged under the definition of Beneficiary.

C. Participation

With the change to the definition of Beneficiary recommended above, the only purpose that this section seems to serve is providing for benefits to participants under reciprocating states' or institutions' plans. We recommend that this section be revised to read as follows:

> Participants in prepaid tuition programs of other institutions or states which have reciprocal advance tuition payment plan agreements approved by the Board may be awarded Tuition Credits under terms approved by the Board.

The term Participant is not used elsewhere in the Plan, so the definition of Participant in Section 1.11 should be deleted.

D. Purchase of Tuition Credits

We would suggest consideration of a limit on the number of purchasable Tuition Credits for a Beneficiary here. See the disc .ssion of redemption below.

We also recommend the addition of a subsection in Section 3 providing that the purchase of Tuition Credits is subject to the terms and conditions of both the Plan and the Contract between the University and the Purchaser.

E. Redemption

We believe that Section 4.1.b is intended to apply during attendance at an Eligible Institution other than the University. If that is the case, it should be stated explicitly in this subsection.

Section 4.1 c. provides that excess Tuition Credits over the amount necessary for obtaining of a degree during a semester may be redeemed for an amount not to exceed room and board, fee and book costs. Ohio chooses at the initiation of its plan not to permit an excess tuition credit buildup. The actuaries will no doubt comment on the ability to purchase Tuition Credits on an unlimited basis. As a practical matter conservatism might suggest limiting the amount that may be purchased, at least initially.

Section 4.1 e. provides for the excess of "Cash Value" over "Tuition Value" to be distributed equally to the Graduation Incentive Award Account for the benefit of the Beneficiary who redeemed the Tuition Credit and to the Prepaid Tuition Scholarship Account. The definition of "Cash Value" at 1.5 is principal "...plus net earnings and applicable forfeitures, less expenses of the Plan." The redemption requirements are extremely important as they will presumably be made the subject of contracts with individual beneficiaries. We assume that increase in market value investments in an individual account is part of "Cash Value." Can an account have a surplus if the Fund overall is not actuarially sound? If an overall fund requirement of 'actuarial soundness' is considered necessary, the following is suggested:

> The Board may from time to time provide for an annual distribution of any surplus in the Fund. Surplus shall be the amount the actuary annually determines is the excess in the Fund over the amount required to be maintained therein to ensure the actuarial soundness of the Plan. The surplus shall be allocated pro rata to each Tuition Credit redeemed in the year following determination of the surplus and shall be distributed equally to a Graduation Incentive Award account for the benefit of the Beneficiary who redeemed the Tuition Credits and to the Prepaid Scholarship account.

The actuaries would need to determine whether overall actuarial soundness will require the formula set out above. Our revisions to the Draft Plan do not contain this provision. We felt that it would be premature to include it in the Plan until we had discussed the subject with Coopers & Lybrand and the University.

Section 4.1 h. should provide that an Alternate Beneficiary may not redeem Tuition Credits unless the Alternate Beneficiary presents proof satisfactory to the Plan Administrator that all prior Beneficiaries are deceased, with the determination of the Plan Administrator conclusive. Alaska's experience may be that Alternate or Primary Beneficiaries frequently simply cannot be found.

F. Waiver

In all instances of waiver of Benefits, the waiver should be required to be writing, in a form approved by the Plan Administrator, bearing the acknowledged signature of the waiving Beneficiary.

G. Refunds

Section 5.1 a. should be amended to provide that a refund should be made to the Purchaser at any time the University or its successor determines to terminate the Plan for whatever reason. These reasons could include adverse tax rulings.

We wonder whether it was intended that Section 5.1.b provide for Cash Value to be refunded to the Beneficiary upon disability whether or not an Alternate Beneficiary is present. This seems inconsistent with the other refund provisions, which provide for refund only if there is no Alternate Beneficiary.

We recommend that the University consider abandoning the Cash Value concept for refunds entirely. In Florida the maximum refund is Refund Value which is money paid plus 5% compounded interest (See Florida Master Covenant). In Michigan it appears to be a Weighted Average Tuition Cost. In both cases a fee is provided for or permitted.

In respect of Refunds and Redemption there is the policy issue of whether the Plan, and therefore the legislation, should provide for State liability to the extent possible without a vote, i.e., by a statement of legislative intent to replenish any deficiencies in the Fund.

H. Transfer of Benefits

The right to substitute beneficiaries should be clarified. We assume virtually unlimited substitution is desired up to the Redemption Start Date. We would suggest consideration of limiting Alternate Beneficiaries to one or two at most to avoid clerical problems latter of deceased or ineligibility of prior beneficiaries.

In all instances of Substitution of Beneficiary, the substitution should be required to be writing, in a form approved by the Plan Administrator, bearing the acknowledged signature of the Purchaser. No substitution

should be effective until it has been received by the Plan Administrator.

The Plan and Contract should provide that if no Beneficiary can be located, the Plan Administrator may designate a Beneficiary or terminate the Contract.

I. Prepaid Tuition Scholarship

Under Section 4.1 e., the Prepaid Tuition Scholarship fund will receive one half of the excess of Cash Value over Tuition Value of Tuition Credits redeemed (the reference to Section 4.1 b. in Section 7.1 should be 4.1 e.).

At this time the whole concept of dealing with surplus, as in 4.1 e., which provides for the excess of the Cash Value over Tuition Value to go to the two accounts, may not be appropriate. There is no doubt Coopers & Lybrand as actuaries will speak to the subject matter. To the extent that the State or the University initially fund the start-up costs of the Plan or the State guarantees the Plan through, for example "moral obligation" language, it may be that the surplus should be paid either to the University or to the State. It may also be that the actuaries determine that surpluses in individual account balances should be held in the Plan or not distributed mandatorily outside the Fund.

J. Contracts

The statement in Section 9.2 b. that an Alternate Beneficiary may not claim a refund for Tuition Credits is inconsistent with Section 5.1.g which says that an Alternate Beneficiary may not claim a refund unless certain prior acts have occurred.

K. Administration of the Plan

We recommend that administrative expenses under Section 10.5.a be determined by the Administrative Committee. In Section 10.5.e, we suggest omitting exclusive venue in Fairbanks for litigation arising out of the Plan.

L. Fiduciaries

We recommend omitting the indemnity provisions in Section 12.2 and 12.3 or providing that they be activated latter at the University's option. The draft

Plan provides for latter activation. If these provisions are deemed necessary they should be left to a contract with the fiduciary. A fiduciary will no doubt have a format which the University will have to contend with.

M. General

The Plan needs to establish investment objectives for the Fund (see Exhibit A). In addition it would appear to be appropriate to provide in the Plan for an annual actuarial review of the soundness of the Fund (see Exhibit B).

N. Reports and Notices

Provision should be made in Section 10 for periodic notice to a Purchaser of the status of the Purchaser's account with the Plan. Provision also should be made for notice to a Purchaser of the end of the period allowed for naming a Beneficiary, and notice to a Beneficiary of the end of the period allowed for the use of tuition credits.

It is also very important that the Purchaser be made responsible for notifying the Plan of any change in address of the Purchaser or a Beneficiary, and that the Plan provide that notice mailed to the most recent mailing address of a Purchaser or Beneficiary in the records maintained by the Plan Administrator be deemed sufficient for all purposes.

V. RECOMMENDATIONS CONCERNING AMENDING LEGISLATION

Proposed amendments to the Alaska Act are attached as Exhibit C. They consist primarily of providing that the obligation of the University under the Plan is an unlimited, general obligation and language creating a moral obligation of the State. We also have considered Jim Lynch's suggestion of a continuing or blanket appropriation to the Fund of all earnings to pay benefits and expenses. We recommend such an appropriation.

VI. PURCHASE CONTRACT

As per our discussions with Jim Lynch and because we shall not have a copy of the tax analysis and actuarial analysis being prepared by Coopers & Lybrand prior to our required submission to you by February 25,

1991, and because those analyses will have a critical bearing on the structure of the Contract, only a preliminary draft of the Contract has been prepared at this time. Once we have had the opportunity to review the analyses from Coopers & Lybrand and have had further direction from the University as to our comments and recommendations regarding the draft Plan and the University Legislation, we shall prepare a definitive draft of the Contract for the review of the University. A copy of the preliminary draft of the Contract is attended to this memorandum as Exhibit D.

VII. ANALYSIS OF TAX ISSUES

A. Introduction

An important objective of the Alaska education trust fund (the "Fund") is to maximize the investment return of the Fund by employing a structure that will cause income of the Fund to be exempt from federal income taxation. The following part of this report addresses whether the income of the Fund as presently structured will be exempt from federal income taxation. It also identifies changes to the structure of the Fund that could increase the probability of its achieving tax exempt status.

There are two potential sources of income tax exemption for the Fund. The first is the exemption from federal income taxation of an "integral part" of the state or a political subdivision of the state. The second is exemption from taxation under Section 115 of the Internal Revenue Code of 1986 ("the Code").

B. Exemption as "Integral Part" of the State or a Political Subdivision of the State

Since 1913, the Internal Revenue Service has treated the direct income of a state or municipality, whether derived from essential or nonessential activities, as exempt from federal income taxation. GCM 14407, XIV-1 C.B. 103 (1935), as superseded by Rev. Rule 71-131, 1971 C.B. 28; GCM 37657. To be exempt under this rule, income must be of an "integral part" of a state or a political subdivision of the state. GCM 39006; GCM 37657; GCM 34535.

The Fund is established as a trust fund separate from the general fund of the state. AS 14.40.8-

03. The Commissioner of Revenue is the trustee of the Fund. AS 14.40.805. The Board of Regents of the University is authorized by AS 14.40.809 to enter into contracts for the advance payment of tuition, with the advance tuition payments made under such contracts being paid into the Fund under AS 14.40.803.

To determine whether a state government instrumentality is an "integral part" of a state or a political subdivision, the Internal Revenue Service has referred to general counsel memoranda concerning whether a state instrumentality was a separate entity eligible to be a Section 501(c)(3) organization. GCM 34502; GCM 34535. GCM 34502 concluded that a state instrumentality would have separate existence for purposes of Section 501(c)(3) if it were a corporation, a trust or an association. Thus, neither a corporation nor a trust is considered to be an integral part of the state for purposes of tax exemption. GCM 37657; GCM 34704. In contrast, GCM 34535 concluded that an unincorporated state division of mental health, created by statute as a unit within a state governmental department, and subject to managerial control by that department could not be considered an organization described in Section 501(c)(3) of the Code.

Based upon the analytical approach adopted in the general counsel memoranda cited above, we believe it unlikely that the Internal Revenue Service would find that the Fund, as presently established, is an integral part of the state. The Fund is established as a trust, and therefore is likely to be considered an entity separate from the state for purposes of tax exemption. More specifically, the Internal Revenue Service determined that the Michigan Education Trust, a corporation created by the State of Michigan to implement and administer a college tuition prepayment program, was not an integral part of the State of Michigan. Private Letter Ruling 8825027. Although the Michigan entity was established as a corporation rather than as an unincorporated trust like the Fund, the salient characteristics of the Fund are analogous to those of the Michigan Education Trust cited in Private Letter Ruling 8825027: an autonomous trustee, funds separated from the state's general fund, and restrictions on the use of Fund moneys. These similarities make it most likely that the Internal Revenue Service would reach the same conclusion in the case of the Fund.

Although a state instrumentality may be an entity separate from the state and thus not an integral

part of the state, the entity nonetheless may qualify for tax exemption as a political subdivision of the state. An entity is a political subdivision for this purpose if it meets the criteria determining whether an entity is a political subdivision under Reg. 1.103-1(b) for purposes of Section 103 of the Code. GCM 36994. Those criteria are that the entity be delegated a substantial portion of one of the following sovereign powers: taxation, eminent domain or police power. The Fund has not been delegated any of these powers. Indeed, such a delegation seems inconsistent with the Fund's purposes. Therefore, it does not appear possible that the Fund could qualify for tax exemption as a political subdivision of the State.

C. Establishing Fund as an Integral Part of the University

If the Fund is to be restructured to improve its qualification for tax exemption as an integral part of the state or a political subdivision, we expect that the option of placing the Fund under the administration of the University instead of in the Department of Revenue will be considered. The University itself has not been delegated any of the attributes of sovereignty that would it cause it to be considered a political subdivision of the state. Compare GCM 36994; GCM 37657. Thus, placing the Fund under the administration of the University will not increase the probability of the Fund being considered an integral part of the state or a political subdivision, unless the University itself would be considered an integral part of the state.

The University is created under Article VII, Sections 2 and 3 of the Alaska Constitution, which provide:

> Section 2. State University. The University of Alaska is hereby established as the state university and constituted a body corporate. It shall have title to all real and personal property now and hereafter set aside for or conveyed to it. Its property shall be administered and disposed of according to law.
>
> Section 3. Board of Regents of University. The University of Alaska shall be governed by a board of regents. The regents shall be appointed by the governor, subject to confirmation by a majority of the members of the legislature in joint session. the board shall, in accordance with law,

formulate policy and appoint the president of the university. He shall be the executive officer of the board.

While Article VII, Section 2 establishes the University as a "body corporate," the Alaska Supreme Court has determined the University to be an integral part of the State for purposes of several statutes outside the taxation context. These include procedures governing lawsuits against the State, University of Alaska v. National Aircraft Leasing, Ltd., 575 P.2d 121 (Alaska 1975); federal civil rights statutes, Brown v. wood, 575 P.2d 121 (Alaska 1978); statutes governing public access to government documents, Carter v. Alaska Public Employees Association, 663 P.2d 916 (Alaska 1983); and open meetings laws, University of Alaska v. Geistauts, 666 P.2d 424 (Alaska 1983).

The earlier two of the above authorities were cited to the Internal Revenue Service in support of a request for a Private Letter Ruling that interest on bonds of the University of Alaska Heating Corporation was exempt from federal income taxation because the bonds were issues "on behalf of" the State of Alaska. To reach this conclusion, it was necessary for the Internal Revenue Service to determine that the University was an integral part of the State. The Internal Revenue Service granted the requested ruling, stating its reasoning as follows:

> The following factors indicate that the University acts as part of the State in this transaction: the University lacks the independent power to borrow money or issue debt obligations in its own name; prior to any construction or expansion of the plant, the State Legislature adopts a resolution authorizing the non-profit corporation to sell and issue the bonds; and the State Attorney General's letter dated March 13, 1979, stating that legal title to the land upon which the heating plant is built must always be held by the State for use by the University.

Private Letter Ruling 7928064, April 12, 1979, p. 5. However, one important premise for this ruling, the University's lack of independent power to borrow money, has been removed by subsequent legislation granting the University that power. AS 14.40.040(5). Even without this change in the University's powers, we are not certain that the Internal Revenue Service would

adhere to its conclusion in Private Letter Ruling 7928064 that the University was part of the State when it addressed the question of tax exemption of a tuition prepayment fund controlled by the University. Placing the fund under University administration may serve other purposes; however, we do not recommend this change be undertaken if its principal purpose is to enhance the fund's qualification for tax exemption.

D. Exemption under Section 115 of the Code

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential governmental function accruing to a state or any political subdivision thereof. If an entity is not an integral part of a state or a political subdivision, it may be tax exempt under Section 115(1).

For income (other than income derived from a public utility) to be excluded from gross income under Section 115(1) of the Code, it must be (i) derived from the exercise of an essential governmental function, and (ii) accrue to a state or a political subdivision. While the requirements of essential governmental function and accrual are not independent, either may be so lacking that the test of Section 115(1) is not met. Maryland Savings-Share Insurance Corp. v. United States, 308 F. Supp. 761, 765 (D. Md. 1970), reversed on other grounds, 400 U.S. 4 (1970).

Analyzing the application of Section 115(1) begins with the statement of the purpose of the statute in Maryland Savings-Share Insurance Corp.:

> While no legislative history was cited by either party it seems fair to say that the purpose of the exemption enacted in [Section 115(1)] was to insure that local governments, state, county and municipal, would not be hampered in the performance of their functions by the imposition of federal income taxes. Thus construed, the determination that the [Section 115(-1)] exemption should be extended to a taxpayer requires the weighing of how central the activity sought to be taxed is to the operation of state government and of how directly taxation of the in-

come of the activity will burden the state treasury."

308 F. Supp. 761, 765. The court concluded that the entity at issue failed the accrual test in Section 115(1) because (i) no reduction in the earnings of the entity due to federal income taxation would cause the state to pay anything out to the entity or its creditors, and (ii) no state funds are part of the capital that produces the entity's income. 308 F.Supp. 761, 766. The court also found that the lack of any state investment in the entity indicated that the entity did not perform an essential governmental function. Id.

From Maryland Savings-Share Insurance Corp. and other authorities, it appears that the accrual to the state or political subdivision required under Section 115(1) will not be found where state liability to support the fund is limited or absent, and where amounts in the fund are contractually payable to private parties. See also GCM 39006, GCM 34704. Both of these factors supported the ruling that the Michigan Education Trust was not exempt under Section 115(1), although in reaching this conclusion the Internal Revenue Service expressly relied solely on the fact that income of the trust served private interests. Private Letter Ruling 8825027.

E. Conclusion

The major impediments to tax exemption for the Fund are the legal segregation of the fund from other state government assets (which precludes the exemption of the fund as an integral part of the state or a political subdivision), and the lack of commitment of the credit of the state or the University to the Fund's obligations and the contractual commitment of fund assets to a limited, identifiable class of beneficiaries (which preclude the exemption of the Fund under Section 115 of the Code). Given the objectives of the Fund, the conflict between a structure that will secure tax exemption and a structure that will meet those objectives may be irreconcilable. To the extent they are consistent with the objectives of the fund, the following changes would aid tax exemption:

-- make the obligation to pay benefits a general contractual obligation of the University, not contingent on the investment performance of the fund. This obligation also might be supported by the moral obligation of the state.

-- do not dedicate the fund to beneficiaries, but make the fund a general asset of the University, i.e., minimize the trust attributes of the fund. Of course, the University still would manage the fund under appropriate actuarial principles to assure the financial viability of the program.

Exhibit A

INVESTMENT POLICY
[adopted from Standard & Poor's "AA" criteria]

1. Obligations of, or guaranteed as to principal and interest by, the U.S. or any agency or instrumentality thereof when such obligations are backed by the full faith and credit of the U.S.

2. Federal Housing Administration debentures.

3. Obligations of government-sponsored agencies which are not backed by the full faith and credit of the U.S. government.

4. Federal funds, unsecured certificates of deposit, time deposits, and banker's acceptances (having maturities of not more than 365 days) of any bank the short-term obligations of which are rated in the second highest rating category of a national rating service.

5. Deposits which are fully insured by the Federal Deposit Insurance Corp. (FDIC).

6. Debt obligations rated in the highest rating category of a national rating service. Excluded are securities that do not have a fixed par value and/or whose terms do not promise a fixed dollar amount at maturity or call date.

7. Commercial paper (having original maturities of not more than 365 days) rated in the second highest rating category of a national rating service.

8. Investment in money market funds rated in the highest rating category of a national rating service.

9. Repurchase agreements:

A. With any institution with debt rated in the highest rating category of a national rating service or commercial paper rated in the second highest rating category of a national rating service.

B. With any corporation or other entity that falls under the jurisdiction of the Bankruptcy Code provided that:
   a. The term of such repurchase agreement is less than one year or due on demand.
   b. The trustee or a third party acting solely as agent for the trustee has actual possession of the collateral.
   c. The market value of the collateral is maintained at acceptable levels (see box for example).
   d. Failure to maintain the requisite collateral levels will require the trustee to liquidate the collateral immediately.
   e. The repo securities must be either obligations of, or fully guaranteed as to principal and interest by, the U.S. agency, certificates of deposit or bankers' acceptances.
   f. Repo securities are free and clear of any third-party lien or claim.

C. With financial institutions insured by the FDIC or any broker-dealer with "retail customers" which falls under the jurisdiction of the Securities Investors Protection Corp. (SIPC):
   a. The market value of the collateral is maintained at acceptable levels.
   b. The trustee or a third party acting solely as agent for the trustee has actual possession.
   c. The trustee has a perfected first priority security interest in the collateral.
   d. Collateral is free and clear of third-party liens and in the case of SIPC broker was not acquired pursuant to a repo or reverse repo.
   e. Failure to maintain the requisite collateral percentage will require the trustee to liquidate collateral.

Collateral levels for U.S. government securities*

Frequency of valuation	Remaining maturity 1Yr or Less	5Yrs or Less	10Yrs or Less	15Yrs or Less	30Yrs or Less
Daily......	103	106	107	109	116
Weekly.....	104	112	114	120	125
Monthly....	107	123	130	133	143
Quarterly..	108	125	135	140	150

*Acceptable levels for other collateral available upon request.

Assumptions: (1) On each valuation date the market value of the collateral will be an amount equal to the requisite collateral percentage of the obligation (including unpaid accrued interest) that is being secured. (2) The following restoration periods are required: one business day for daily valuations, two business days for weekly valuations, and one month for monthly and quarterly valuations. (3) Failure to maintain the requisite collateral percentage after the restoration period will require the trustee to terminate the repo and, if not paid by the counter party in federal funds against transfer of the repo securities, liquidate the collateral.

The trust shall be administered in a manner reasonably designed to be actuarial sound such that the assets of the trust will be sufficient to defray obligations of the trust.