Morgan Stanley

Understanding 529 College Savings Plans and Compensation

Exploring Cost and Tax Considerations

Summarized below is some important information that will help you understand 529 college savings plans including the various cost and tax considerations of investing in a 529 plan. This summary also explains how Morgan Stanley and your Financial Advisor are compensated when you make a contribution to a 529 plan. You can also visit the websites sponsored by the U.S. Securities and Exchange Commission (www.SEC.gov) and the Financial Industry Regulatory Authority (www.FINRA.org) to obtain additional educational information about 529 college savings plans.

Understanding 529 College Savings Plans

Before making a contribution to a 529 plan, we believe there are several things you should know.

What Are My Options for Funding Higher Education?

There are many investment vehicles available to help you save for higher education expenses — including 529 college savings plans, prepaid tuition plans, Coverdell Education Savings Accounts, UGMA/UTMA custodial accounts, U.S. savings bonds, mutual funds, stocks, bonds and traditional savings accounts. Each vehicle has different tax implications, risk factors, investment options and cost considerations. This document addresses only 529 college savings plans. Your Financial Advisor can provide you with information about the other options and can help you decide which vehicle(s) are most appropriate for you and your family.

What Is a 529 Plan?

The name “529 plan” comes from the section of the Internal Revenue Code that was enacted by Congress when the plans were created in 1996. 529 plans are officially known as Qualified Tuition Plans, a tax-advantaged investment vehicle designed to help families pay for future college and graduate school expenses. There are two types of 529 plans: college savings plans and prepaid college tuition plans. Both are generally sponsored by states or state agencies. Nearly all states sponsor one or more 529 plans. The tax advantages, investment options, restrictions and fees can vary a great deal. Understanding the differences between plan types and state-specific state tax benefits is important. Morgan Stanley Financial Advisors do not provide tax or legal advice and so we encourage you to consult your individual tax or legal advisor.

What Types of 529 Plans Are Available?

College savings plans are generally managed by investment management firms (e.g., mutual fund companies), and your contributions are generally invested in underlying investment options, such as mutual funds, that support the plan. Your investment will fluctuate in value so there is no guarantee that the amount contributed to the plan will equal the amount necessary for future education expenses. College savings plans may offer greater flexibility than prepaid tuition plans because they offer multiple investment options and you are not restricted to using the account balances for a specific educational institution (or group of institutions) or within the sponsoring state. You may also be able to apply the proceeds from a college savings plan to other expenses (e.g., room and board, textbooks, supplies and equipment) in addition to tuition and fees. Many states offer more than one savings plan, providing residents with a choice of investment management firms.

Morgan Stanley does not offer prepaid tuition plans. The information that follows relates to college savings plans only.

What Are the Federal Tax Considerations?

529 plans offer significant tax advantages for college-saving investors. Earnings grow tax-deferred and withdrawals from a 529 savings plan are not subject to federal income tax if utilized for qualified higher education expenses at an eligible educational institution. The term “qualified higher education expenses” generally includes tuition, required fees, books, supplies, certain required equipment and the cost of room and board (subject to certain limits). An “eligible educational institution” generally includes most community colleges, public and private four-year colleges, universities, graduate and postgraduate programs and certain vocational schools that are eligible to participate in federal student financial aid programs.

If you make a withdrawal for purposes other than to pay your beneficiary’s qualified higher education expenses, then the earnings portion of the withdrawal is subject to federal and possibly state income tax and an additional 10 percent federal tax penalty.

What State and Local Tax Benefits Apply?

You and/or your beneficiary’s state of residence may affect your ability to qualify for any applicable state and local tax benefits granted to 529 plan investments. Many states provide tax incentives and other benefits for state residents who invest in a plan sponsored by their home state, which may include:

- State tax deductions for contributions
- Deferral of state income taxes on earnings maintained in the plan
- State income tax-free qualified withdrawals
- Matching grants or scholarships
- Protection from creditors for certain assets

Additionally, so-called “in-state plans” often waive or rebate certain fees and expenses for state residents.

The benefits of purchasing an in-state plan generally apply only if you or your beneficiary live or pay state income taxes in the 529 plan sponsor's state. If you invest in a 529 plan sponsored by a different state than where you live or pay state income taxes, typically, you will not receive the state tax or other benefits provided to residents. In addition, your state or locality may seek to recover the value of any previously taken state or local tax benefits if you roll over or transfer account assets from an in-state plan to another state's 529 plan. If your home state offers tax and other incentives, then it is important to speak with your financial advisor or tax professional about the details of your in-state 529 plan.

Before investing in a 529 plan, you should consider whether the state(s) where you or your beneficiary reside or pay state income taxes sponsors an in-state plan and whether the tax and other benefits afforded state residents are significant to you based on your particular circumstances. Your Morgan Stanley Financial Advisor can direct you to information about in-state plans and select out-of-state 529 plans and the availability of state or local income tax or other benefits offered. Other factors to consider include the variety of investment options available, including the range of investment objectives and strategies offered, risk factors related to the variety of investment options or the lack of variety, relative performance, fees and services.

Where Is My Money Invested?

Your contribution to a 529 savings plan is invested in a portfolio(s), generally consisting of underlying mutual funds. Although very similar to mutual funds in design and structure, a college savings plan's portfolios are issued by state governments, and in most cases, are not directly regulated under the federal securities laws applicable to mutual funds, but rather the Municipal Securities Rulemaking Board.

Most savings plans offer the following types of investment options:

- **Static Investment Portfolios** — Your contributions will be invested in a portfolio that does not change, remaining "static" over time in a specific combination of underlying mutual funds. The specific underlying mutual funds are combined to achieve a specific risk/reward relationship. You should speak with your Financial Advisor to determine if a static portfolio is appropriate for you.

- **"Age-Based" or "Years-to-Enrollment" Investment Options** — Your contributions will be invested in a portfolio that will automatically change over time depending on the age of your beneficiary or the number of years left before your beneficiary enrolls in college (also known as the date of matriculation). The investment manager adjusts the allocation of specific underlying mutual funds and their relative weighting within the portfolio over time, generally growing more conservative over time.

- **Individual-Fund Investment Options** — Your contributions will be invested entirely in one or more portfolio(s) consisting of a single underlying mutual fund and, like static (multifund) portfolios discussed above, will not change unless you or your Financial Advisor make an exchange.

What Fees and Charges Apply With 529 Plans?

529 savings plans' fees and charges are used by the 529 plan sponsor to support the plan and compensate firms for selling interests in the plan. Some of those fees are based on the amount of assets in your plan account. Other fees are assessed on a transactional or periodic basis.

- **Program Management Fees** — The program manager of each 529 savings plan generally receives a program management fee. The program management fee compensates the manager for providing investment advisory, distribution, marketing, accounting and other services to the plan. The fee is generally assessed as a percentage of portfolio assets.

- **State Administration Fees** — To help pay for the operation of the plan, some state sponsors of 529 savings plans charge a state administration fee assessed as a percentage of portfolio assets.

- **Annual Maintenance Fees/Enrollment Fees/Termination Fees** — These fees are generally imposed as a specific dollar amount, and apply at specified times or upon certain events (e.g., initial purchase, termination or on the account anniversary).

Plan management fees and state administration fees may vary by unit class within a particular plan.

- **Underlying Mutual Fund Expenses** — Each investment portfolio indirectly bears a proportional share of the fees and expenses incurred by the underlying mutual fund(s) (e.g., investment management fees and other expenses).

- **Sales Charges, Distribution and/or Service Fees** — Depending upon the Share/Unit Class selected (see discussion below), a front-end sales charge may be assessed on your purchase. In addition, annual distribution and/or service fees may apply. These fees, similar to the “12b-1” fees charged by some mutual funds, generally range between 0.25 percent and 1.25 percent of your investment, annually. Your Financial Advisor receives a portion of these sales charges and distribution fees as ongoing compensation for selling and servicing the 529 plan.

529 Plan Share/Unit Class Differences

Most 529 plans offer different “unit” class pricing options similar to the share class pricing arrangements offered by open-end mutual funds. For these purposes, the terms “unit class” and “share class” are interchangeable. Each unit or share class of a particular investment option within a plan has an expense and sales charge structure based on the various types of asset-based fees, other fees and expenses, and sales charges assessed.

Class A Units — Class A units are subject to a sales charge or front-end load that is deducted as a percentage of the amount of your initial contribution. The net amount of the contribution (after the deduction of the initial sales charge) is invested in units of the plan’s portfolio(s). For example, if you invest $10,000 in a plan and the front-end load is 5 percent, you would be charged $500, and the remaining $9,500 would be invested in the chosen fund. Typically Class A units have the lowest ongoing expenses (generally 0.25 percent or $25 per $10,000.00 of fund assets per year).

You may be eligible for sales charge reductions or “breakpoints” based on the size of your investment in the 529 savings plan. In addition, you may qualify for “rights of accumulation.” These are further discounts when the amount of your 529 plan investment is combined with other assets which you and your immediate family members already have invested in the plan and/or in certain mutual funds managed by the manager for that plan. Specific rules for achieving breakpoints vary from plan to plan. Clients who currently hold 529 plan accounts at Morgan Stanley may be eligible to aggregate their 529 plan investments offered by the same 529 plan sponsor to qualify for breakpoints on new purchases. When making any new 529 plan purchase, please inform your Financial Advisor of any 529 plan purchases or holdings in the same 529 plan. If you have any questions about the availability of sales charge discounts on any 529 plan purchases, please ask your Financial Advisor.

Class B Units — Class B units are not subject to an initial sales charge or front-end load. However, distributions of Class B units are subject to a contingent deferred sales charge ("CDSC"), which is a percentage charge deducted from withdrawals from the plan if they are made within a certain number of years. The CDSC gradually declines to zero over a period of years — typically six to eight. Class B units are subject to higher ongoing asset-based fees such as higher distribution or service fees, plan management fees and/or state administration fees as compared to Class A units of the same plan, but generally convert to the less expensive Class A units after being held for eight years.

Class C Units — Similarly to Class B units, Class C units do not have a front-end sales charge. However, Class C units have a lower CDSC than Class B units (generally 1 percent), and the period during which the Class C CDSC can be imposed is shorter (generally one year). However, like Class B units, Class C units are subject to higher ongoing asset-based fees (generally 0.25 percent or $25 per $10,000.00 of fund assets per year). These fees remain in place for the life of the investment since Class C units typically do not convert to Class A units as is the case with Class B units.

How Can I Choose a Unit/Share Class?

Your Financial Advisor is available to help you decide which unit or share class is generally the most economical for you. The principal considerations are the size of your investment and the anticipated holding period. Over time, you may end up paying higher fees and expenses and may experience lower investment returns with Class C units than you would with Class A units because of the accumulated impact of higher ongoing asset-based fees. For that reason, investors generally should purchase Class A units (the initial sales charge alternative) or Class B units (the deferred sales charge alternative) if they expect to hold the investment over the long term (typically, five years or more). Class C units (the level sales charge alternative) are generally appropriate for shorter-term holding periods. In addition, investors anticipating large purchases should consider Class A units since they typically offer sales-charge reductions ("breakpoints") beginning at $25,000 that increase as the size of your investment increases.

In order to understand what your investment will cost, you should carefully review with your Financial Advisor or tax professional the 529 plan offering materials, which describe all the fees and expenses associated with a particular plan.

How Can I Purchase a 529 Plan?

Typically, 529 savings plans are managed by investment management firms. They may be offered directly to investors ("direct-sold") through a toll-free number and website or through your Financial Advisor ("advisor-sold").

Most states offer more than one 529 plan. Some states offer both advisor-sold and direct-sold savings plans while other states only offer direct-sold savings plans. The cost of investing in an advisor-sold savings plan is generally higher than a direct-sold savings plan because of the amounts that are payable to the selling firm.

Morgan Stanley does not offer every state's 529 plan. It is important for you to investigate what your home state has to offer in addition to speaking with your Financial Advisor or tax professional.

What Restrictions Are Placed on 529 Plan Investments?

Your ability to contribute to a 529 plan is not limited by your household income. However, each state limits the total amount of contributions made on behalf of a particular beneficiary. The purpose is to prevent contributions on behalf of a particular beneficiary in excess of the amount necessary to provide for his or her qualified higher-education expenses. The contribution limits on 529 savings plans are generally quite high and are much higher than those available for some other college saving options (e.g., Coverdell Education Savings Accounts). These limits vary by plan and do not necessarily mean that this option is best for you and your family.

Federal gift taxes may also influence 529 plan contributions. In general, a gift of more than $14,000 to a single person in a single year is subject to the tax. A special tax law permits individuals to aggregate five years of the allowable $14,000 annual gift tax exclusion and contribute up to $70,000 ($140,000 per married couple) to an account for a designated beneficiary in one year without triggering the tax. Various conditions and filing requirements apply. You should consult with a tax advisor for more information on the potential tax ramifications of 529 plan contributions and investments. For most 529 savings plans, there are no residency requirements. In general, most U.S. citizens or permanent residents are eligible to set up a 529 plan for any beneficiary, including themselves. You must satisfy the age requirement for the applicable plan. Each plan has its own eligibility requirements, so please consult your Financial Advisor or the plan offering documents for more information.

How Are Morgan Stanley and My Financial Advisor Compensated When I Buy a 529 Plan?

Sponsors of 529 plans pay Morgan Stanley compensation when we sell their 529 plans. A 529 plan sponsor's dealer-compensation practices are described in its program offering materials. Typically, for front-end sales charge classes, the plan's distributor pays Morgan Stanley most of the initial sales charge you pay. For back-end sales charge unit/share classes, the distributor pays Morgan Stanley a selling fee at a rate set by the plan. We also receive account-servicing payments (sometimes referred to as trails) as long as you continue to maintain your account and we act as your "broker of record."

The amount of the compensation that Morgan Stanley receives is a function of the unit/share class that you purchase, and for certain classes, the amount of your purchases. We pay a portion of the compensation to our Financial Advisors based on our standard compensation formulas. These formulas are the same regardless of which plan you purchase. However, some plans may impose higher sales charges than others, which can affect the amount paid to your Financial Advisor. In addition, because plan sales charges are different for their different unit/share classes, the choice of unit/share class can significantly affect the compensation your Financial Advisor receives. Clients are encouraged to ask their Financial Advisor how he or she will be compensated for any 529 plan sale.

Revenue Sharing and Administrative Service Fees

Morgan Stanley charges mutual fund families a support fee, also known as revenue sharing, based upon Morgan Stanley clients' mutual fund holdings, including some Section 529 plan holdings. The amount that Morgan Stanley earns from these fees is substantial. Revenue-sharing fees are paid from the assets, revenues or profits of the fund or plan's investment manager and/or other service providers — not from the fund or plan itself.

We also receive fees for administrative support services provided to mutual fund families and plans. However, since Morgan Stanley does not currently collect revenue-sharing or administrative support fees on all 529 plans available at the firm, these facts present a conflict of interest that could lead Financial Advisors to focus on the 529 plans that do provide such support when recommending a college savings plan investment to clients. In order to mitigate this conflict, Financial Advisors and their Branch Office Managers do not receive any part of these fees.

Our 529 plan managers have access to branch offices and Financial Advisors for educational, marketing and other promotional efforts. Although all 529 plan managers are provided with such access, some managers and their affiliates devote more staff and resources to these activities and therefore may have enhanced opportunities to promote their 529 plans to our Financial Advisors. Some college savings plans benefit from certain administrative synergies with Morgan Stanley. These facts present a conflict of interest for Morgan Stanley and our Financial Advisors to the extent that they lead us to focus on those programs when recommending 529 plan investments that benefit from administrative synergies or are sponsored by related fund families that commit significant financial and staffing resources to promotional and educational activities. In order to mitigate this conflict, Financial Advisors and their Branch Office Managers do not receive additional compensation for recommending such programs. Further information regarding mutual fund revenue-sharing (including a list of revenue sharing fund families) and administrative service fees is available on our website at: http://www.morganstanley.com/wealth/investmentsolutions.mutualfunds.asp or by calling your Financial Advisor.

For more information on how Morgan Stanley and your Financial Advisor are compensated when you invest in a 529 college savings plan, please review the program offering documents or speak with your Financial Advisor.

Disclosures

The 529 Plan Program Disclosure contains more information on investment options, risk factors, fees and expenses, and potential tax consequences. Investors can obtain a 529 Plan Program Disclosure from their Financial Advisor and should read it carefully before investing.

Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates and Morgan Stanley Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for legal matters.

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