The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

March 22, 2002

Comment Letter on Recordkeeping Requirements for Section 529 Programs, March 2002

By Hand Delivery

March 22, 2002

CC:ITA:RU (Notice 2001-81)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Recordkeeping and Reporting Requirements for Section 529 Qualified Tuition Programs

Ladies and Gentlemen:

The Investment Company Institute[1] appreciates the guidance issued in Notice 2001-81,[2] which sets forth recordkeeping and reporting requirements for Code section 529 qualified tuition programs. Institute members, who provide the investment vehicles in which many 529 plans invest and serve as program managers to such plans and their sponsoring states, commend the efforts of the Internal Revenue Service to provide administrable guidance in this area.

In particular, we support the Notice's guidance that a 529 program will no longer be required to verify how distributions are used for distributions made after December 31, 2001. This approach is not only consistent with the changes made to Code section 529 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),[3] but is also appropriate given that a 529 program administrator will not know how a taxpayer, during a given year, has chosen to allocate his or her "qualified" educational expenses among, for instance, 529 account distributions, Coverdell education savings account (ESA) distributions, the HOPE credit, or the Lifetime Learning credit. Furthermore, by adopting this approach, the guidance provides further consistency, coordination, and simplification among various education savings programs.

For the guidance in Notice 2001-81 to be administrable, however, certain changes must be made to the Notice's regime for determining the amount and character of rollover contributions. Specifically, Notice 2001-81 requires 529 programs to (1) ask whether a

contribution is a rollover contribution from a Coverdell ESA, a qualified U.S. Savings Bond, or another 529 program; and (2) treat the entire rollover amount as earnings unless the receiving program receives “appropriate documentation” showing the earnings portion of the contribution. For the reasons discussed below, we urge the Service to modify/clarify this regime in the following ways to ensure that operationally feasible rules are applied for effective communication of earnings information to 529 programs.

First, in lieu of the duty to inquire into the rollover status of all contributions, the receiving 529 program should be required, at the time the 529 account is opened, to ask whether the initial contribution is attributable to a rollover and to advise the account owner to notify the program if any subsequent contribution is a rollover. In addition, the 529 program should be required periodically thereafter to provide notice to account owners reminding them of their notification obligations with respect to rollover contributions.

Second, the scope of the default “earnings treatment” rule should be clarified to specify that the rule applies only where a 529 program knows that the contribution is a rollover contribution. Any default rule that is applied to each contribution for which an affirmative statement of “non-rollover status” was not received would create overwhelming operational issues.

Third, the definition of “appropriate documentation” with regard to rollovers from Coverdell ESAs should be modified to allow taxpayer certification of the earnings portion of a rollover.

Fourth, in cases where a rollover amount would be less than the basis in the distributing 529 program because of net investment losses, regulatory guidance should expressly provide that the basis in the distributing program carries over to the receiving program.

Finally, additional flexibility is requested on the timing rule for calculating the earnings portion of a distribution.

I. Duty to Inquire into Rollover Status of Contributions

The Notice’s requirement that a 529 program ask whether a contribution is a rollover contribution from a Coverdell ESA, a qualified U.S. Savings Bond, or another §529 program is simply not administrable if the inquiry must be made eachtime a contribution is received. This is because of: (1) the myriad of ways in which 529 program contributions can be made; (2) the frequency with which these contributions can be made; and (3) the accompanying difficulty in making an inquiry upon receipt of a contribution through many of these contribution methods.

The optimal time for engaging a 529 program account owner in any communication regarding the account (and the nature of contributions thereto) is when the account is opened. To open a 529 program account, the account owner is required to complete an account opening form that could include, for example, a question asking whether the amounts contributed have been rolled over from another education savings source. Materials accompanying the account opening documents also can assist the new account owner in understanding the owner’s responsibilities for providing rollover information to the program. Where the account is opened with the assistance of a financial consultant who is meeting directly with the account owner, the likelihood of effective communication may be even higher.

Subsequent contributions to 529 programs are made in many ways. For example,

contributions may be made: (1) by check—either sent through the mail, delivered in person at a financial institution's branch office, or provided to a financial consultant serving as an intermediary; (2) by wire transfer—where the contribution could arrive via an automatic payroll deduction or an automatic withdrawal from a savings or checking account; (3) through the Automatic Clearing House (ACH) process (also possibly originating from a payroll deduction or from a savings or checking account); and (4) by a contribution via the internet (perhaps from an existing account at a financial institution).4

None of these contribution methods provide as practical an opportunity for communication with the account owner as arises at the initial account opening. Subsequent contributions made by check may or may not be accompanied by written documentation. Typically, a "deposit slip" is not required and even if it is, it is not unusual for an individual to fail to provide one. A wire transfer generally is accompanied by even less communication than the typical written check. To the 529 program, the wired cash often looks the same; the identifying information could be limited to the number on the account into which the money is to be deposited. Furthermore, the amount of information that can accompany a wire transfer may be very limited.Finally, it is important to note that because of the account owner's desire to be invested in a particular investment as soon as possible, most, if not all, 529 programs will deposit a contribution as soon as the account owner's intention can be discerned.

Given the variety of contribution methods that currently exist, coupled with the frequency with which contributions may be made, it would be extremely burdensome to 529 programs to make inquiries concerning the status of each contribution as a rollover. Separate mailings, subsequent to the receipt of the contribution and its allocation to the investment option, generally would be required and could be quite frequent. For instance, separate mailings apparently would be required every other week in the case of a biweekly automatic payroll deposit. The cost of making these mailings (for the moment disregarding the cost of processing any responses and applying any potentially-applicable default rule in the case of non-response) could become staggering. Moreover, repeated requests to account owners for non-rollover certification would be both burdensome and confusing to them, perhaps undermining the objectives of the rule and their interest in the program.

In ascertaining whether the compliance burdens may be justified by some compliance benefit, the scope of the rollover market and the magnitude of any earnings as a percentage of rollover amounts also must be considered. Based upon discussions with our members, it would appear that the percentage of contributions that is attributable to rollovers is very low. Moreover, given the relatively recent development of most 529 programs and the investment performance of most major markets during this period, it appears unlikely that any significant amount of earnings is being rolled over to 529 programs from other savings vehicles.5

We also would note that a separate rule in Notice 2001-81 already provides an effective communication regime for earnings information with respect to a significant subset (perhaps even a significant majority) of today's rollover transactions. In the case of a "direct transfer" (i.e., trustee-to-trustee rollover) between 529 programs, a distributing program must provide to the receiving program a statement setting forth the earnings portion of the rollover within 30 days of the distribution. Thus, accurate earnings information already will be properly communicated in what will likely constitute a large portion of rollovers.

Recommendation

Accordingly, we recommend that the Service adopt the following two-pronged approach in lieu of the rule provided in the notice. First, a 529 program should be required to ask at the time of the initial contribution into a particular 529 program whether the contribution consists of rollover assets. Thus, for example, the program's enrollment application (whether in paper or electronic form) could expressly ask whether the initial contribution is a rollover from a Coverdell ESA, a U.S. Savings Bond, or another 529 program. If the individual responds in the affirmative, additional information about the "appropriate documentation" requirement would be provided to the individual. Also at the point of the initial contribution, the 529 program would advise the account holder to notify the program if any subsequent contribution is a rollover and if so, to provide appropriate documentation containing earnings information to the program.

Second, following the initial contribution, a 529 program should be required to remind account owners that they must inform the 529 program whenever a rollover contribution has been made. The notice could be provided, for example, with/on account statements, which, for 529 savings programs, are generally provided to account owners on a quarterly basis, or with/on confirmations[6] provided to account owners. We note that due to the substantial time and effort that would be required to modify systems and procedures under these rules, regulatory guidance should provide program managers with sufficient time to implement such requirements.

In our view, this proposal would appropriately target the situation where a rollover contribution is most likely to occur—at the initial account opening—and regularly remind individuals of their responsibility to provide rollover-related information to their 529 programs. Moreover, in conjunction with the "direct transfer" rule for 529-to-529 rollovers already provided in the notice, this approach should address policy concerns that the Service may have about rollover contributions, while minimizing administrative complexity and taxpayer confusion.

II. Scope of Default Earnings Treatment Rule

We request confirmation that Notice 2001-81's default rule—which treats as earnings the entire amount of a rollover contribution, absent appropriate documentation—applies (in accordance with the Notice's literal language) only to contributions that are, in fact, rollovers. The requested confirmation is necessary because, while Notice 2001-81 provides that a 529 program manager will be required to inquire as to the rollover nature of each contribution, the Notice does not expressly provide the consequences for either a failure of the 529 program to ask about the rollover nature of the contribution or a failure of the account owner to respond to that inquiry. For the following reasons, a 529 program contribution should be treated as earnings under a default rule only where the program manager knows that the contribution is a rollover.

Most importantly, the many benefits of the proposal that we make in Part I above—to require that 529 program managers ask at the account opening whether any portion of the initial contribution is a rollover (and remind the account owner periodically thereafter of their responsibility to notify the 529 program manager of a rollover)—effectively would be nullified if the default rule applied to every contribution that was not accompanied by an affirmative declaration that no portion of the contribution was a rollover. As discussed in Part I, a significant portion (perhaps even a majority) of all contributions to 529 programs are made without accompanying written instructions.

As most contributions made today are not rollovers and hence have no earnings component, a broad default rule that theoretically could apply to every 529 program contribution would be a very harsh rule indeed. Even those few rollovers that exist today are composed largely, if not exclusively, of basis. Thus, inclusion in the regulations of a default rule with such broad applicability would maximize the number of instances in which contributions were inaccurately characterized as having earnings. The extent and frequency of erroneous tax characterizations further underscores why any default rule should be limited in scope.

Any broadly-applicable default rule also would create significant administrative complexity by effectively requiring 529 program managers to repeatedly recharacterize significant numbers of contributions. The continuous “undoing” and “rebooking” of transactions upon subsequent receipt of rollover information would be extremely burdensome. Moreover, any regime leading to repeated recharacterizations (which may involve manual intervention) could be subject to a high error rate. These recordkeeping/reporting errors, in turn, could create other tax compliance burdens for 529 program managers, account owners and the Service.

Finally, because of the various methods described above through which 529 account contributions can be made, any broadly applicable default rule might, in turn, require additional specific rules for each such contribution method, which would specify the types of acceptable appropriate documentation and the manner in which the documentation must be submitted. For example, different rules might be necessary for contributions that are made by payroll deduction rather than by check.

III. Appropriate Documentation of Rollovers from Coverdell ESAs

We urge the Service to modify the definition of appropriate documentation in the context of rollovers from Coverdell ESAs to eliminate any requirement for documentation from a Coverdell trustee or custodian. Notice 2001-81’s standard—that appropriate documentation means (in the case of a rollover contribution from a Coverdell ESA) “an account statement issued by the financial institution that acted as trustee or custodian of the education savings account that shows basis and earnings in the account”—is not consistent with current law and practice. Coverdell trustees and custodians are not required to, and generally do not, track basis.

Since the creation of the Education IRA, the predecessor to the Coverdell ESA, it has been the taxpayer’s responsibility to track basis. Indeed, the instructions to IRS Form 8606 specifically provide a worksheet to assist taxpayers in calculating basis in their Coverdell ESAs, as well as information on the records that should be kept by individuals to verify the nontaxable part of their ESA distributions.7 In this regard, Coverdell ESAs are very similar to regular IRAs; while not “retirement” savings vehicles, Coverdell ESAs are governed by rules that are similar in many respects to those for IRAs. Moreover, the recordkeeping systems used for Coverdell ESAs are often substantially similar to those used for IRAs. Regulatory rules, therefore, should not require financial institutions to provide an “account statement” containing basis information with regard to a Coverdell ESA.

Recommendation

Accordingly, because the taxpayer/account owner is generally the only party with the basis and earnings information for a Coverdell ESA, we urge that a statement or certification from

the taxpayer regarding the earnings portion of a Coverdell rollover qualify as “appropriate documentation.”

IV. Negative Earnings in Rollovers

Neither Notice 2001-81 nor the 1998 proposed regulations[8] explicitly address the situation where a rollover contribution, due to investment losses, is less than the basis in the original 529 account. Thus, the question arises whether the original basis would apply to the new account upon rollover, or alternatively, the actual dollar amount transferred constitutes the basis in the new account.

Recommendation

We submit that the basis in a 529 account that is rolled over into a new account should carry over, even if the basis exceeds the amount rolled over. A taxpayer should not be penalized with a reduced basis simply because he or she, after having incurred investment losses, transfers 529 assets to another program. For example, where an individual contributed a total of $10,000 to Program A, but because of investment losses, the balance of the account when it is rolled into Program B is $8,000, the initial basis in the Program B account should be $10,000.[9]

Form 1099-Q issued by the Service in December 2001 could accommodate this rule. Where the rollover amount is less than the basis in the distributing program, the 1099-Q issued by the distributing program could identify in Box 1—Gross Distribution—the actual dollar amount of the rollover; in Box 2—Earnings—a negative number because the account experienced a cumulative investment loss; and in Box 3—Basis—the total contributions that had been made to the distributing program.

V. Timing of Earnings Calculations for Distribution Purposes

Lastly, the Institute seeks additional flexibility with regard to the timing of earnings calculations upon distribution. For “direct transfer” rollovers between 529 programs, Notice 2001-81 requires programs to determine the earnings portion of a distribution as of the date of distribution, rather than as of year-end (pursuant to the 1998 proposed regulations). This contemporaneous calculation-of-earnings requirement for direct transfers became effective January 1, 2002. For non-direct transfer distributions, in contrast, the notice provides that the contemporaneous calculation of earnings is required for distributions made after December 31, 2002.

Recommendation

We request clarification that 529 programs, at their option, may make contemporaneous earnings calculations for all distributions—beyond just direct transfers—in advance of the delayed effective date. While we are pleased with the delayed effective date provided for non-direct transfer distributions (which gives 529 programs an opportunity to re-program and update their recordkeeping systems), 529 programs should have the option of providing contemporaneous earnings calculations during 2002 for non-rollover distributions, as well as for rollover distributions, if they are able to do so. For those programs that can perform earnings calculations as of the time of distribution, the contemporaneous calculation option would produce more accurate distribution balances to distributees and avoid the administrative difficulties that arise from year-end calculations.

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The Institute commends the Service's interest in providing administrable guidance in this area. If we can provide you with any additional information regarding these comments or respond to any questions you may have, please do not hesitate to contact me at (202) 326-5837, or Keith Lawson, the Institute's Senior Counsel for tax and pension matters, at (202) 326-5832.

Sincerely,

Thomas T. Kim
Associate Counsel

cc: Monice Rosenbaum, Esq., Internal Revenue Service
Susan Brown, Esq., U.S. Department of the Treasury

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,039 open-end investment companies ("mutual funds"), 486 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.951 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

2 Notice 2001-81, 2001-52 I.R.B. 617 (December 26, 2001).

3 EGTRRA, among other things, repealed former Code section 529(b)(3), thereby eliminating the requirement that states impose a "more than de minimis" penalty on distributions that are not used for qualified higher education expenses.

4 As the education savings market develops, other methods of making contributions also may emerge.

5 Whether the number of rollovers and the amounts rolled into 529 programs will be significant in the future is unclear. Nonetheless, current policy should not be based on speculative projections, particularly in light of the enormous burdens that the rule provided in the Notice will place on 529 programs and individuals.

6 See Municipal Securities Rulemaking Board (MSRB) Rule G-15—Confirmation, Clearance, Settlement and Other Uniform Practice Requirements with Respect to Transactions with Customers.

7 See Instructions to Form 8606, Nondeductible IRAs and Coverdell ESAs.

8 63 Fed. Reg. 45019 (August 24, 1998).

9 To the extent that a partial distribution is taken (i.e., where the distributing account is not fully liquidated) and rolled over to another 529 program, we believe it would be appropriate for a pro rata portion of the basis to carry over to the new account.