The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

December 21, 2001

Comment Letter on IRS Section 529 Program Guidance, December 2001

December 21, 2001

CC:ITA:RU (Notice 2001-55)

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Notice 2001-55 Section 529 Qualified Tuition Programs

Ladies and Gentlemen:

The Investment Company Institute[1] commends the Service for issuing Notice 2001-55,[2] which provides guidance regarding the restriction on investment direction applicable to qualified tuition programs under section 529 of the Internal Revenue Code. The flexibility provided by the Notice will give program participants an opportunity to respond to changing market conditions, changes in account beneficiaries, and other circumstances under which individuals would reasonably seek to reallocate their investments. Coupled with the enhancements made to 529 programs by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Notice 2001-55 will help many Americans meet their higher education savings needs.

Specifically, Notice 2001-55 provides that a 529 program does not violate the restrictions of Code section 529(b)(5) if it permits a change in the investment strategy selected for a 529 account once per calendar year and upon a change in the designated beneficiary of the account. This opportunity to change investment strategy is not available, however, unless the program is limited to broad-based investment strategies designed exclusively by the program.[3]

The regulatory regime that governs 529 programs is of particular interest to Institute members as they provide both the funding vehicles for many 529 programs and administrative services to such programs and their sponsoring states. Our specific comments below, which seek further clarification of the section 529 regulatory scheme, are designed to further advance the goal of enhancing savings opportunities for higher education.[4]

First, we urge the Service to clarify, through a safe harbor, that an investment company that meets the regulated investment company (RIC) qualification requirements under Subchapter M of the Internal Revenue Code—including the asset diversification requirement in Code section 851(b)(3)—constitutes a "broad-based investment strategy." As the Service already has ruled that RICs may be the investment vehicles for 529 programs,[5] our request is essentially that final regulations reflect the Service's existing position.

Second, we urge the Service to clarify that the phrase "designed exclusively by the program" is to be interpreted by providing deference to states in their determination of investment strategies made available under their 529 programs. In this regard, consistent with previously issued letter rulings,[6] the Service should confirm that a preexisting investment vehicle determined by the state to be an appropriate investment strategy for its 529 program may be offered as such, so long as it meets otherwise applicable requirements.

Third, we urge the Service to clarify when, if at all, accounts must be aggregated in determining whether the once-per-calendar-year investment change limit has been reached. As a general matter, we believe that the Service should not require aggregation, which can lead to compliance difficulties for program administrators and inequitable or otherwise inappropriate treatment of beneficiaries and account owners.

I. "Broad-Based Investment Strategy"

The Notice requires that the investment strategies offered by a 529 program be "broad-based." We believe that the final regulations should include a safe harbor for investment vehicles offered by 529 programs that meet the definition of "broad-based investment strategies." Specifically, the safe harbor should provide that RICs, which must meet the asset diversification test of Subchapter M of the Code, are "broad-based investment strategies."[7]

Code section 851(b)(3) requires RICs to meet specified diversification requirements that are designed to ensure that the performance of a RIC is not tied to the success of a few issuers. To meet the asset diversification test on each testing date: (1) at least 50 percent of the RIC's total assets must be invested in (a) cash, cash items, U.S. Government securities and shares of other RICs and (b) securities of issuers in which the RIC has an investment of no more than 5 percent of the RIC's assets and no more than 10 percent of the outstanding voting shares of the issuer; and (2) no more than 25 percent of the RIC's assets may be invested in the securities of any single issuer.

The purpose of the Subchapter M diversification test is "to assure that a regulated investment company is not closely tied to the success of a few issuers."[8] Although the term "broad-based" is not defined in the statute, the proposed regulations, or the Notice, the term presumably is intended to ensure that contributions to 529 programs, like investments in a RIC, are invested in a diversified pool of assets, rather than a very small number of individual securities. While diversifying assets does not eliminate risk, diversification can play an important role in minimizing the risk of large losses; such losses, of course, could impair the ability to save for higher education expenses.

Given the apparent common purpose of the diversification standards in Subchapter M and Code section 529, we believe that RICs should qualify as broad-based investment strategies. Indeed, as noted above, because RICs are diversified and the Service already has approved the use of RICs as investment vehicles under 529 programs,[9] establishing a

safe harbor based on the RIC diversification requirement, in effect, would simply articulate currently applicable standards.[10]

II. "Designed Exclusively By The Program"

The Notice also requires that the broad-based investment strategies available under 529 programs be "designed exclusively by the program." As this exact phrase was used in the 1998 proposed regulations,[11] its use in the Notice presumably does not suggest any requirement beyond that imposed under the proposed regulations.

We understand that the purpose of the phrase is to ensure that a sponsoring state, in light of its objectives, has seriously considered the investment options offered under its 529 program and has made an affirmative decision to select them. In effect, the requirement appears to be subsumed by the statutory provision mandating that a 529 program be "established and maintained by a State or agency or instrumentality thereof."[12] Additionally, looking at the requirement from the perspective of the account owner, the phrase "designed exclusively by the program" may simply have been intended to ensure that the program—rather than the individual—"designed" the investments under the 529 program.[13]

Accordingly, we offer two clarifying recommendations in interpreting the phrase "designed exclusively by the program." First, because the principal purpose of this phrase apparently was to ensure a substantial level of state involvement in the design of the investment strategies made available under a 529 program, the Service should give the states deference with regard to the investment options selected for their programs, so long as the program has been "established and maintained by a State or agency or instrumentality thereof." Such deference would provide significant flexibility, for example, with regard to a state's review of the number and types of investment options that it may offer under a 529 program.

Second, consistent with the Service's approval of RICs as investment strategies under 529 programs,[14] we seek express confirmation that a broad-based investment strategy may consist of a preexisting investment vehicle, such as a RIC, so long as it meets otherwise applicable requirements. Programs should not be required to establish separate and distinct investment vehicles created solely for a particular 529 program, given that additional administrative costs would be incurred and the 529 program could not benefit from any economies of scale provided by an existing vehicle.

III. Aggregation Under "Once Per Calendar Year" Restriction

Finally, we urge clarification on the extent to which accounts must be aggregated, if at all, for purposes of determining whether the once-per-calendar-year limit has been reached.[15] For the reasons discussed below, we do not believe that aggregation generally would be feasible or appropriate.

Clearly, requiring aggregation across different states' 529 programs would be completely unadministrable, as each individual state program's recordkeeping system could only track and verify investment changes made within its own program.[16] We note that the Service has recognized such difficulties in recent guidance.[17]

Furthermore, aggregation of either (a) accounts with the same account owner but different beneficiaries, or (b) accounts with the same beneficiary but different account owners would often result in inequitable or otherwise inappropriate treatment of beneficiaries and/or account owners. For example, where one person has set up 529 accounts for more than one beneficiary, the account owner should be allowed to make a separate investment change with respect to each beneficiary; to require otherwise could favor one beneficiary over another because only one investment change could be made for a single beneficiary in a calendar year. As beneficiaries may well have different years of expected matriculation, there may be very different investment considerations for each beneficiary. In addition, where one person is a beneficiary of 529 accounts set up by more than one individual, each account owner should be allowed to make an investment change each year for a particular beneficiary. To require aggregation of such accounts could effectively remove control from an account owner if a second account owner—perhaps unknown to the first owner—already has made an investment change for the same beneficiary.18

Thus, aggregation for purposes of the once-per-calendar-year rule would appear to be both administrable and acceptable from a policy perspective only for those accounts within the same 529 program that have the same owner and the same designated beneficiary.19 However, given that this aggregation limit could be avoided merely by opening 529 accounts for the same beneficiary in different state programs, we question whether any level of aggregation is appropriate in light of the resulting administrative burdens and costs.

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The Institute appreciates the Service's ongoing commitment to issuing guidance that will enhance the ability of Americans to save for higher education costs. Please do not hesitate to contact me at 202/326-5837 or Keith Lawson, ICI Senior Counsel, at 202/326-5832, if we can provide you with any additional information regarding these comments or our views on 529 programs generally.

Sincerely,

Thomas T. Kim
Associate Counsel

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

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,063 open-end investment companies ("mutual funds"), 485 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.598 trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

2 Notice 2001-55, 2001-39 I.R.B. 299 (September 24, 2001). The Notice invited comments "on the matter described in [Notice 2001-55] and any other comments relating to section 529, including the amendments made by the Economic Growth and Tax Relief Reconciliation Act of 2001."

3 The Notice states that final regulations under Code section 529 are expected to provide these rules. Pending issuance of final regulations, 529 programs and their participants may rely on the Notice.

4 These comments supplement the Institute's recommendations submitted to Treasury and IRS officials earlier this year. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mark A. Weinberger, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, dated July 27, 2001.

5 The Service has issued favorable private letter rulings to 529 programs that offer participants the choice of investing in one or more mutual funds. See, e.g., PLR 200123065, PLR 200030030. The mutual funds in these rulings presumably were RICs, because the fund-level tax on any fund not qualifying as a RIC would impair investment returns and effectively preclude their inclusion in a 529 program.

6 See PLR 200123065, PLR 200030030.

7 It is our understanding that, by using the term "broad-based" in the Notice, the Service did not intend to heighten the standard it has applied to date. See Prop. Reg. § 1.529-2(g), 63 Fed. Reg. 45028 (August 24, 1998).

8 See GCM 37233 (August 25, 1977).

9 See PLR 200123065, PLR 200030030.

10 Establishing this safe harbor, of course, would have no effect on the Service's ability, as previously exercised, to determine that other investment vehicles are eligible to be offered under 529 programs. See, e.g., PLR 200134032, PLR 200030030.

11 See Prop. Reg. § 1.529-2(g), 63 Fed. Reg. 45028 (August 24, 1998).

12 Code section 529(b)(1).

13 The proposed regulations appear to contrast the role of the program (in designing the investment strategies) from the limitation placed on individuals to direct—in effect, "design"—their investments under the program: "A program shall not be treated as a QSTP unless it provides that any account owner in, or contributor to, or designated beneficiary under, such program may not directly or indirectly direct the investment of any contribution to the program or directly or indirectly direct the investment of any earnings attributable to contributions. A program does not violate this requirement if a person who establishes an account with the program is permitted to select among different investment strategies designed exclusively by the program . . . ." Prop. Reg. § 1.529-2(g), 63 Fed. Reg. 45028 (August 24, 1998). Thus, the phrase "designed exclusively by the program" appears to place limits on the account owner, rather than on the types of vehicles that may be selected as investment options for a 529 program.

14 The mutual funds offered under programs that were the subject of two private letter rulings appear to have been preexisting funds. See PLR 200123065, PLR 200030030.

15 The Notice provides that a program will not violate Code section 529(b)(5) if it permits a change in the investment strategy "once per calendar year."

16 Similar issues arise in aggregating investment changes across different programs

administered by the same state, particularly if different third parties are administering the programs. Thus, where a state offers multiple 529 “savings” programs, aggregation across vendors would be very difficult to implement and monitor.

17 Notice 2001-81 provides that for purposes of computing the earnings portion of a distribution from a 529 account, programs are neither required to aggregate across different state programs nor between a prepaid 529 program and a savings 529 program maintained by the same state.

18 Here too, Notice 2001-81, in the context of earnings calculations, has recognized the operational difficulties and potential inequities of imposing aggregation at either the account owner or beneficiary level.

19 The Service has adopted this approach for purposes of earnings calculations in Notice 2001-81. To the extent that the Service requires this level of aggregation under the once-per-calendar-year rule, we suggest that the Service clarify the period (e.g., one day) during which all investment change directions for the account owner’s accounts must be transmitted to the 529 program.
