The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

August 25, 2006

Institute Letter to Treasury on Split Refund Project; IRS Releases Draft Form 8888 (pdf)

August 25, 2006 Mr. W. Thomas Reeder Acting Benefits Tax Counsel Office of Tax Policy Department of the Treasury 1500 Pennsylvania Avenue NW Washington, D.C. 20220 Ms. Dianne Grant Senior Advisor to the Deputy Commissioner Internal Revenue Service 1111 Constitution Ave. NW Washington, DC 20224 Re: Split Refund Program Dear Mr. Reeder and Ms. Grant: Thank you for meeting with Investment Company Institute members and staff regarding the split refund project, which will allow taxpayers to split the direct deposit of their federal tax refunds into up to three financial accounts. The Institute1 shares with the Treasury Department and the Internal Revenue Service the goal of increasing Americans' opportunities to save. The split refund program is of direct interest to Institute members. Almost 54 million US households own mutual funds today and 47 million households own an Individual Retirement Account (IRA). Currently, 70 percent of IRA households invest at least some of their IRA in mutual funds. Under the split refund proposal, fund shareholders may direct portions of refunds to purchase mutual fund shares held in an IRA or held as a fully-taxable investment. To follow-up on our meeting, this letter provides the results of an informal survey we conducted of Institute members regarding their capacity to accept direct deposit of income tax refunds. We hope it will assist you in implementing the split refund project. In addition, we offer several recommendations regarding implementation that we believe will make the program more effective. 1 ICI members include 8,719 open-end investment companies (mutual funds), 653 closed-end investment companies, 211 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $9.225 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households. Mr. W. Thomas Reeder Ms. Dianne Grant August 25, 2006 Page 2 of 6 Our survey was conducted with the understanding that, after implementation, direct deposit of refunds will continue to occur solely by transfer through the ACH system. The taxpayer will provide on his or her tax return a bank routing number and account number for each account to which the refund should be sent, and the Department's Financial Management Service (FMS) will transmit the refund through the ACH interbank clearing network. Because mutual funds are not themselves participants in the ACH system, their ability to accept ACH contributions requires a relationship with a bank or transfer agent that does participate. In addition, the mutual fund firm must be able to provide the taxpayer with a routing and account number that is unique to that individual and allows the firm or its transfer agent to know which particular fund or funds should be purchased when the direct deposit is received. Mutual Fund Industry Ability to Accept Direct

Deposit of Tax Refunds Our survey of Institute members included responses from firms holding 55% percent of the assets held in mutual funds, and 69% percent of the mutual fund assets held in IRAs.2 Ability to accept direct deposits. Fifty-nine percent of the members who responded (hereafter “members”) currently accept direct deposit of income tax refunds.3 About half reported no problems of consequence with receiving direct deposits although many indicated the number of these transactions currently is quite small.4 Of firms that reported problems in receiving direct deposits, the two most common problems were (1) contributions above the IRA contribution limit or (2) incorrect routing and account numbers. Most members allow a direct deposit to be the first share purchase, although the shareholder must first set up an account before a routing and account number can be given. Other firms require that the first share purchase must be by check, in part to ensure the purchase meets the fund’s minimum investment stated in the fund’s prospectus. Inability to accept direct deposits. Forty-one percent of members do not currently accept direct deposit of tax refunds. We asked these firms whether they contemplated accepting direct 2 Twenty-nine firms or fund complexes responded to the survey. The respondents included most of the largest mutual fund IRA providers, and included both firms that sell funds directly to investors and those that are distributed through networks of financial professionals. 3 On an asset weighted basis, i.e., weighting respondents by assets under management relative to other respondents, 69% indicated they currently accept direct deposit of income tax refunds. If the affirmative responses are weighted by fund assets held in IRAs, the number rises to 71% of assets. In other words, those with the capacity to accept direct deposit of refunds are weighted towards the larger mutual fund complexes and the larger IRA sponsors. 4 Some firms do not actively encourage or market direct deposit of tax refunds. Mr. W. Thomas Reeder Ms. Dianne Grant August 25, 2006 Page 3 of 6 deposits in the future. Slightly more than half have not decided whether to accept direct deposits. Most of the remainder indicated that they were not interested in accepting direct deposits of tax refunds. Those considering adding this capacity estimate it would take less than one year to do so. The most common reason members stated for not accepting direct deposits is that the mutual fund firm does not have separate ACH account numbers for each shareholder. These firms usually have one ACH account with a bank or transfer agent for incoming and outgoing transactions. Other firms assign ACH numbers by shareholder but, without more information, have no way to know to which mutual funds direct deposit money should be invested. Split Refund Implementation Issues How the Department and the IRS implement the split-refund program will help determine how successful the program will be in encouraging taxpayers to increase their savings and the extent to which financial firms invest in the necessary system changes, marketing expenses, and shareholder communications. This is particularly true with respect to IRAs, which present a number of unique issues. Reporting year of IRA contribution. Under current law, a traditional IRA contribution for a year can be made as late as the due date of the taxpayer’s return for that year. A taxpayer can take a deduction on his or her return for a prior year IRA contribution even if the contribution has not been made at the time the return is filed, so long as is it made by the filing deadline.5 A contribution is deemed made on the date it is received by the IRA custodian or trustee, although a contribution by mail is deemed made on the date of the postmark. (There is no equivalent postmark rule for contributions made electronically.) Accordingly, for a taxpayer to use his or her refund for a prior year IRA contribution, the taxpayer must file a return well in advance of April 15, and may need to monitor the account and the “Where’s my Refund” section of the IRS website to ensure the contribution is received timely. If the contribution is not received by the deadline, the taxpayer would lose the deduction and would be required to file an amended tax return. Possible Extension of Deadline. We understand that the Department has considered issuing guidance that would allow a prior year IRA contribution

to be deemed timely if the tax return is filed by the due date and the refund is being used as the contribution. You indicated it is unlikely the Department would issue guidance along these lines in time for the 2006 tax filing season. We agree this change should not be made for 2006 returns. 5 IRC § 219(f)(3); Revenue Ruling 84-18, 1984-1 CB 88. Mr. W. Thomas Reeder Ms. Dianne Grant August 25, 2006 Page 4 of 6 The ability of the split refund program to encourage saving likely would increase by facilitating prior year IRA contributions. Tax preparers could show taxpayers the financial advantage of making a deductible IRA contribution and some may have relationships with IRA providers that allow the opening of an account on the spot. However, implementing this liberalization of the timely filed rule in the first year of the split refund project would lead to significant operational problems: • IRA custodians and trustees must send Form 5498 by May 31. Tax refunds, especially where the taxpayer filed the return on paper with an April 15 postmark, would not arrive in time for the custodian or trustee to prepare Form 5498 accurately. • If the amount of the refund (or the portion being sent to the IRA) decreases because of offset by IRS or FMS, or if the deposit is rejected for some reason (incorrect account number, account closed for legal reasons, etc.), the taxpayer will not have time to make an additional contribution, which means the taxpayer will need to file an amended return. • The mutual fund IRA custodian or trustee receiving the direct deposit through its ACH relationship may not know the money was received through a direct deposit from the IRS and entitled to use the new filing rule. The custodian would not know, and could not verify, that the taxpayer filed the return on time. • Many IRA providers' procedure is to treat contributions made between January 1 and April 15 as current year contributions, unless the individual instructs otherwise. Because a direct deposit arrives without any additional information or instructions, there is a danger the Form 5498 might not reflect the intention of the taxpayer. We believe these and other issues can be overcome and would be happy to work with the Department and IRS on solutions. However, we believe a legal change to permit prior year contributions to be made through direct deposit where the tax return is filed by April 15 would be best addressed after the financial services industry and the IRS gain some experience with split refund deposits to IRAs. Guidance on Default Treatment. We recommend the Department issue additional guidance on the treatment of IRA contributions received between January 1 and April 15. Most members report an IRA contribution as attributable to the current year when the taxpayer has not indicated that the contribution should be reported for the prior year. Some providers, however, treat the contribution as attributable to the prior year if the contribution is received between January 1 and April 15 and no contribution was made during the prior year. (Firms generally attempt to contact a shareholder to confirm the treatment.) The split refund program could greatly increase the number of IRA contributions that are made without specific instructions as to which year the contribution relates. Mr. W. Thomas Reeder Ms. Dianne Grant August 25, 2006 Page 5 of 6 The Department's guidance on default treatment is not clear. Proposed Regulation § 1.219- 1(d)(2), which was proposed in 1981 but has not been adopted, states that in order for a IRA contribution to be made on behalf of the prior year, the individual must "irrevocably specif[y] in writing to the trustee, insurance company, or custodian that the amounts contributed are for" the prior year. Publication 590 states that if the taxpayer does not tell the IRA sponsor "which year [the contribution] is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it)."6 The Department should issue formal guidance stating that, in the absence of instructions otherwise, the IRA custodian or trustee should report the contribution on Form 5498 based on the default stated in the IRA agreement (or as otherwise disclosed to the IRA participant). Available accounts. We understand that the IRS will allow a direct deposit to be made to any type of account, including traditional and Roth IRAs, SIMPLE IRAs, Health Savings Accounts, and qualified tuition programs. The only

requirement is that the individual be able to provide IRS with a working routing and account number. We agree that the IRS should not limit the types of accounts that can accept direct deposits. Instructions to Form 8888. Because problems associated with direct deposit usually result from the taxpayer either not contacting the financial firm, or not following the firm's procedures, we suggest that instructions to Form 8888 remind taxpayers to contact their financial institutions to obtain the correct routing and account number and any other requirements for direct deposit. In particular, if the tax refund will be contributed to an IRA, the taxpayer should be sure the IRA trustee or custodian knows whether the contribution should be counted towards the current or prior year. In addition, the instructions should explain that if the refund is being used to fund an IRA contribution for the prior year (the year of the return being filed), the tax return must be filed early enough to ensure that the refund is received by the financial institution by the due date for the return (generally April 15). The instructions could refer the taxpayer to Publication 590 for more information. In addition, the instructions should provide some guidance on how long it typically takes for a refund to be processed. Current Form 1040 asks the taxpayer to check whether the account is a savings or checking account. In creating Form 8888 and its instructions, the IRS should make clear that the deposit need not be restricted to bank checking or savings accounts. 7 We suggest that these boxes be deleted. 6 The instructions to the 2005 Form 5498 state that for "contributions made between January 1 and April 17, 2006, trustees and issuers should obtain the participant's designation of the year for which the contributions are made." 7 Section 830 of the Pension Protection Act of 2006 specifically refers to individual retirement plans as defined in section 7701(a)(37) of the Code. Mr. W. Thomas Reeder Ms. Dianne Grant August 25, 2006 Page 6 of 6 Rejection of direct deposit. In some cases, a mutual fund firm may need to reject a direct deposit, either because the account does not accept direct deposits or for other operational or legal reasons. If a direct deposit is rejected and sent back to the U.S. government's account, we understand IRS will issue the taxpayer a paper refund check. Not all taxpayer errors in providing routing and account numbers will result in a rejection. It is possible that a taxpayer could provide an incorrect routing and account number that is legitimate and belongs to someone at the same or a different financial institution. The IRS should establish some corrective process that can be used to trace a direct deposit for affected taxpayers whose direct deposits do not end up in the right place. Changes in refund amounts. We believe the IRS should clearly state the manner in which it will handle a taxpayer's split refund instructions when the refund amount changes because of math errors, tax debt, or other offsets. It is important that tax filers and their advisors have this information to be able to fill out the tax forms in a manner that allows them to effectuate their plans. For example, if part of the refund is to be used for a prior year traditional IRA contribution, the taxpayer most likely would wish that amount to be the last altered, to avoid having to file an amended return. We understand the IRS intends to proceed by first modifying the last account listed on Form 8888, and then moving upward. We think this is the correct approach. However, we understand that the Financial Management Service may not use the same approach when making deductions for non-tax offsets such as child support and student loans. We strongly recommend that IRS and FMS coordinate and use the same method. * * * Thank you again for the opportunity to meet with you. Please let us know if we can be of any further assistance in helping you implement this program for the 2006 filing season. We also look forward to working with you to address the additional issues associated with prior year contributions that we recommend be deferred until the program is up and running. Sincerely, /s/ Mary S. Podesta Mary S. Podesta Senior Counsel – Pension Regulation