

COMMENT LETTER

April 30, 2004

Letter Seeking Guidance on Fund, Education Savings, and Retirement Security Issues (pdf)

April 30, 2004 The Honorable Gregory F. Jenner The Honorable Donald L. Korb Acting Assistant Secretary for Tax Policy Chief Counsel U.S. Department of the Treasury Internal Revenue Service Room 3120 Room 3026 1500 Pennsylvania Avenue, N.W. 1111 Constitution Avenue, N.W. Washington, DC 20220 Washington, DC 20224 RE: Notice 2004-26-- Request for Inclusion on 2004-2005 Guidance Priority List Dear Assistant Secretary Jenner and Chief Counsel Korb: The Investment Company Institute¹ (the "Institute") requests that the following projects be included on the 2004-2005 IRS/Treasury Guidance Priority List (also known as the "business plan"). The requested guidance projects are divided into three categories: (1) issues for regulated investment companies ("RICs") and their shareholders; (2) education savings issues; and (3) retirement security issues. Within the categories, the projects are divided between (i) items requested by the Institute that were included in the 2003-2004 business plan but have not yet been issued or finalized and (ii) items that we submit should be included in the new business plan.

I. Issues for Regulated Investment Companies and Their Shareholders

A. 2004-2005 Business Plan Items

The Institute requests that the 2004-2005 business plan include a new project clarifying the application of the "business continuity" requirement to RICs under Code section 368 and Treas. Reg. § 1.368-1(d)(2).² This clarification is necessary because it is difficult to discern - - from the guidance most directly on point (Revenue Ruling 87-76)³ -- the intended scope of the

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,595 open-end investment companies ("mutual funds"), 612 closed-end investment companies, 124 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.554 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

2 See Institute letter to William D. Alexander and Lon B. Smith, dated January 15, 2003. See also Institute letter to William D. Alexander, dated April 30, 2004.

3 This ruling holds that a merger of a non-RIC (with a balanced portfolio of stocks and bonds) into a RIC (investing in tax-exempt bonds) failed to qualify under Code section 368(a)(1)(C) -- for lack of business continuity -- because the Investment Company Institute Letter April 30, 2004 Page 2 of 6 business continuity test as applied to RIC reorganizations. As a result, many RICs engaging in merger transactions are compelled to rely on the "asset continuity" test⁴ that (to the detriment of the RIC's shareholders) can place artificial limits on the ability of a portfolio manager to dispose of portfolio securities acquired from a target RIC and imposes significant compliance burdens on funds. Moreover,

the result in Rev. Rul. 87-76 appears to be inconsistent with the approach and result in Rev. Rul. 2003-18, which effectively ruled that a dealership selling and servicing one brand of automobile is in the same line of business as a dealership selling and servicing a different brand. This merger issue is the Institute's top priority for a new tax regulatory project.

Second, we request guidance amending the regulations applicable under Code sections 382 and 383 with respect to ownership tracking requirements that apply to participant directed retirement accounts holding RIC shares. Specifically, the regulations should permit the RIC to look through the participant directed retirement accounts and treat each participant who holds less than 5 percent of the RIC's shares as part of the RIC's direct public group. This change would effectively prevent a large collection of small investors making independent investment decisions from being treated as a single entity for ownership change purposes. Absent this change, a retirement plan administrator's decision as to what RICs to offer in a plan could significantly affect whether other shareholders in the RIC can use capital losses attributable to recent market conditions - even though the retirement plan administrator is neither a beneficial owner of RIC shares nor responsible for allocating investment assets among RICs. Third, we request clarification that redemption fees that are paid by a RIC's shareholders to the RIC (through a reduction in redemption proceeds) are not income to the RIC. Redemption fees designed to deter short-term trading in RIC shares have been in existence for many years, but are becoming more prevalent and may be required for most funds pursuant to a Securities and Exchange Commission proposal targeted at abusive short-term trading. Prompt clarifying guidance is thus important to the entire RIC industry. Fourth, the final PFIC mark-to-market regulations (TD 9123) published on April 29, 2004 note in three places that comments received relating to the impact of the PFIC rules on RICs were beyond the scope of the regulations project.⁵ We suggest that a regulations project be opened to address these issues. Fifth, we suggest that the business plan include guidance on the proper tax treatment of severely distressed, and speculative, debt. In some cases, it is unclear how the existing original issue discount and market discount rules should apply to these types of debt.⁶ In other cases, as balanced fund's historic business of investing in stocks and bonds was not the same line of business as investing in municipal bonds. ⁴ See Treas. Reg. § 1.368-1(d)(3). ⁵ See Institute comment letter, dated November 22, 2002, and Institute letter to Dale S. Collinson, dated April 24, 2003, for the Institute's comments that were determined to be beyond the scope of the regulations project. ⁶ For example, Technical Advice Memorandum 9538007 (June 13, 1995) concludes that "taxpayers must continue accruing OID [into income] for so long as they hold the debt instruments, regardless of the financial condition of the taxpayer." However, a subsequent Litigation Guidance Memorandum states that taxpayers "may not include Investment Company Institute Letter April 30, 2004 Page 3 of 6 noted in treatises and bar association submissions, application of these rules creates what many believe to be inappropriate results.⁷ Due to changing global economic conditions, the need for guidance in this area has increased significantly in recent years. Finally, we request guidance providing that a RIC (RIC 1) -- investing in another RIC⁸ (RIC 2), where RIC 2 either distributes exempt-interest dividends ⁹ or flows through foreign tax credits¹⁰ -- may look through to the underlying assets of RIC 2 to determine whether RIC 1 has met its statutory requirement to invest at least 50 percent of the value of its total assets in bonds exempt under section 103 (for exempt-interest dividend purposes) or in stock or securities in foreign corporations (for foreign tax credit purposes).

B. 2003-2004 Business Plan Items We also request that the 2003-2004 business plan items relating to RICs be issued expeditiously. Specifically, these items relate to guidance: (1) necessary to implement the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"), including guidance regarding the application of Section 1(h) to RIC capital gain dividends¹¹ and guidance to enhance a RIC's ability to determine and report distributions attributable to income that is eligible for treatment as

qualified dividend income;¹² interest, including original issue discount, in income after the issuer has filed a petition in bankruptcy.” See 1996 IRS LGM Lexis 7. 7 See, e.g., Letter of May 15, 1991 from Jere D. McCaffey to the Honorable Fred T. Goldberg, Jr. (transmitting comments prepared by members of the American Bar Association’s Section of Taxation on the application of market discount rules to speculative bonds). 8 This investment may take place in a fund-of-funds structure, where one RIC (the upper-tier RIC) invests in two or more other RICs (the lower-tier RICs) and thereby provides investors with a broader range of asset class exposure and an asset allocation service. 9 Pursuant to Section 852(b)(5), where at least 50 percent of the value of the total assets of a RIC consists of tax- exempt obligations, a RIC may designate the portion of its distribution attributable to interest earned on bonds exempt from tax under Section 103) as an exempt-interest dividend (which, likewise, is treated as interest excludable under Section 103). 10 Pursuant to Section 853, where more than 50 percent of the value of the total assets of a RIC consist of foreign stock or securities, a RIC may elect to treat its shareholders as having paid directly any foreign taxes paid on the foreign- source income (by grossing up the dividend for the amount of such taxes and flowing through the foreign tax credit). 11 See Institute letter to Michael S. Novey, dated September 25, 2003. Among other things, this letter recommended certain modifications to the “bifurcation adjustment” contained in Notice 97-64 in order to reflect the statutory changes since 1997 and industry experience with the adjustment. RICs should be required to bifurcate their taxable years only to the extent necessary to protect the character of amounts distributed to shareholders from being affected by post-October gains and losses. Specifically, the “triggers” for applying the bifurcation adjustment should be modified (i) to require bifurcation only if there is a post October-loss in some category and (ii) to permit bifurcation in cases where a RIC has a net short-term capital gain for the pre-November period. 12 See, e.g., Institute letter to Barbara M. Angus, dated July 31, 2003. Investment Company Institute Letter April 30, 2004 Page 4 of 6 (2) clarifying that the RIC diversification rules should be applied with respect to a repurchase agreement (consistent with Rule 5b-3 under the Investment Company Act of 1940) by “looking through” to the underlying U.S. Government obligations;¹³ (3) clarifying that RICs flowing through foreign tax credits to their shareholders under Section 853 need not report foreign tax credit information on a country-by-country basis (as the statutory requirement for such reporting was repealed in 1976); and (4) under Circular 230 providing a targeted exception from the definition of tax shelter opinion for unqualified tax opinions that interest on a municipal bond is tax-exempt under section 103 and for opinions with respect to those synthetic municipal investments meeting the requirements of Revenue Procedure 2003-84 (or the grandfathering provisions of the Revenue Procedure).¹⁴ Education Savings Issues The 2003-2004 business plan included a guidance project under Section 529 regarding qualified tuition programs (“Section 529 plans”). It remains important, for those saving for education through Section 529 plans, that the tax treatment of investments in such plans be clear.¹⁵ If a determination is made that legislation is necessary to resolve some issues, we urge that work on the guidance project continue with respect to the remaining issues. The 2003-2004 business plan also included a guidance project to clarify the requirements for reporting Coverdell ESA (“ESA”) contributions and distributions. The temporary reporting procedures set forth in the guidance issued pursuant to the 2003-2004 business plan (Notice 2003-53) should be incorporated as final reporting procedures in any subsequent ESA reporting guidance. Alternatively, guidance should be issued that addresses concerns raised regarding 2003 changes to Forms 5498-ESA and 1099-Q.¹⁶ 13 See Institute letter to Robert P. Hanson and Lon B. Smith, dated July 12, 2002. 14 See Institute comment letter, dated March 4, 2004. 15 As stated in the Institute’s 2002 submission on these issues, it would be useful for guidance to: (1) clarify permissible time lags between the date that the amounts are withdrawn from 529 plan accounts and the date that qualified educational

expenses are paid; (2) coordinate the rules for 529 plans with the rules for Hope and Lifetime Learning credits; and (3) address issues relating to rollovers between Coverdell Education Savings Accounts ("ESAs") and 529 plans, e.g., beneficiary designations, identity of account owner and contribution limitations. See Institute comment letter, dated March 22, 2002. 16 See Institute letter to Sarah Hall Ingram, dated April 29, 2003. As discussed in this letter, the mechanism provided by the revised forms for reporting ESA contributions and distributions cannot be implemented fully. Thus, guidance should: (1) provide that ESA record keepers should not be required to track earnings and basis in ESA accounts; (2) alternatively, provide that any obligation imposed on ESA record keepers to calculate earnings and basis should be imposed only prospectively, for new accounts opened after a transition period sufficient to permit record keepers to comply with the new requirements; (3) clarify the requirements of Notice 2001-81 with respect to ESA reporting, including the requirement to aggregate accounts; and (4) clarify or resolve several technical issues regarding reporting on Forms 5498-ESA and 1099-Q.

Investment Company Institute Letter April 30, 2004 Page 5 of 6 Retirement Security Issues

The 2003-2004 business plan includes several retirement security projects of interest to Institute members. While many of these projects have been completed, guidance on two matters -- regulations under section 401(a)(9) and guidance under section 403(b) -- have not yet been issued. We urge that these projects be completed expeditiously and incorporate the recommendations previously made by the Institute. The Institute also requests that guidance on the following retirement security matters be included in the 2004-2005 business plan. First, we request guidance on the implementation of the automatic rollover provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). While EGTRRA directs the Department of Labor to issue safe harbor regulations on the selection of investments and IRA providers under these rules, the provision raises numerous issues that require regulatory clarification from Treasury and the IRS. These issues, many of which were raised in the Institute's March 2003 letter,¹⁸ include the following: (1) establishment procedures for automatic rollover IRAs where, for example, the employer (rather than the employee) opens the account; (2) the ability of financial institutions in this situation to rely upon the terms of the IRA document and related materials; (3) the applicability of certain regulatory requirements, such as the seven-day revocation period, to automatic rollover IRAs; (4) the need for model amendment language for plans subject to the automatic rollover rules; and (5) the need for safe harbor language under section 402(f), as EGTRRA requires the 402(f) notice to explain the effect of the automatic rollover rules. Guidance addressing these and other tax-related matters arising from the automatic rollover provision should be issued expeditiously to give plan sponsors and IRA providers sufficient time to implement changes.¹⁹

Second, the business plan should include guidance on the EGTRRA provision permitting qualified plans and 403(b) annuity arrangements to include a "qualified Roth contribution program." This provision is effective for taxable years beginning after December 31, 2005. It is therefore imperative that this guidance project be placed on the 2004-2005 business plan and that the guidance be issued promptly so that plans and their service providers have sufficient opportunity to make systems changes before this EGTRRA change becomes effective. 17 Specifically, the Institute requested guidance addressing the treatment of "separate accounts" established following an IRA owner's death. See Institute letter to W. Thomas Reeder, dated April 24, 2003. 18 See Institute letter in response to the Department of Labor's request for information regarding EGTRRA's automatic rollover provision, dated March 10, 2003. 19 EGTRRA provides that the automatic rollover rules become effective after the Department of Labor issues final implementing regulations. The Department has proposed that EGTRRA's automatic rollover provision become effective 6 months following the Department's issuance of final regulations. See 69 Fed. Reg. 9903 (March 2, 2004). Although it is anticipated that guidance under the Internal Revenue Code

will be issued in advance of or simultaneously with the Department's issuance of its final regulations, we are concerned that efforts to comply with such guidance (while, at the same time, implementing the Department's final regulations) may require a significant transition period — far in excess of 6 months. Investment Company Institute Letter April 30, 2004 Page 6 of 6 Finally, we request that the IRS issue guidance on "orphan" or "abandoned" plans. These plans, for which there is no longer an employer to administer the plan or authorize distributions, often have qualification and other defects. While the Department of Labor has jurisdiction over various aspects of such plans, IRS guidance on deficiencies under the Code and the resulting tax consequences would give much needed direction to plan participants and service providers. * * * * * If we can provide you with any additional information regarding these issues, please do not hesitate to contact me at 202/326-5832. Sincerely, Keith Lawson Senior Counsel cc: CC:PA:LPD:PR (Notice 2004-26) William D. Alexander Barbara M. Angus Susan Brown Nicholas J. DeNovio Carol D. Gold Helen M. Hubbard Nancy J. Marks Michael S. Novey W. Thomas Reeder Paul T. Shultz Lon B. Smith Eric Solomon William F. Sweetnam, Jr.

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