CMFI
Coalition of Mutual Fund Investors

June 17, 2011

Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Room 3000
Washington, D.C. 20224

Subject: Tax Compliance Issues Involving Section 529 College Savings Accounts

Dear Commissioner Shulman:

On behalf of the Coalition of Mutual Fund Investors ("CMFI"),[1] my purpose for writing is to request Internal Revenue Service ("IRS") scrutiny of a new broker-dealer recordkeeping practice that will create a significant lack of transparency within Section 529 college saving plan accounts. This lack of transparency will increase the risk of abusive transactions occurring within these accounts.

This recordkeeping practice is also being implemented without any type of competitive bidding process and for the sole purpose of generating fee income for large brokerage firms. While broker-dealers promote this recordkeeping process as being more efficient than current practices, the reality is that the extra later of intermediation between Section 529 Plan administrators and individual investors will only increase costs for all participants, without discernable benefits to anyone but the broker-dealers themselves.

The IRS has proposed regulations to address abusive transactions occurring within Section 529 accounts. However, this broker-dealer recordkeeping initiative—called omnibus accounting—should cause the IRS to refine further its Section 529 regulatory rules, in order to avoid a threat to the proper administration of the Internal Revenue Code.

Omnibus accounting permits broker-dealers and financial advisers to assume recordkeeping responsibilities that have heretofore been the responsibility of mutual funds. Under this accounting structure, financial intermediaries collect and aggregate mutual fund transaction requests from their customers into one consolidated order for each mutual fund on a daily basis. A fund handles this order as a single transaction,

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[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors on public policy issues. You can learn more about the Coalition and its advocacy efforts at www.investorscoalition.com.

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treating the broker-dealer or financial advisor—instead of the underlying investor—as the account holder and shareholder of record.[2] The lack of transparency at the individual account level that is caused by omnibus accounting will—if implemented on a widespread basis—result in significant tax compliance problems for Section 529 accounts.

As a result, the IRS should consider prohibiting any type of non-transparent recordkeeping practice by broker-dealers administering Section 529 accounts, as it makes it more difficult for state agencies overseeing college savings plans to collect, retain, and report required information on individual accounts to the IRS.

## The Use of Omnibus Accounting in Section 529 Accounts

Omnibus accounting is increasing in its usage within the mutual fund industry, as large broker-dealers seek to convert investor accounts controlled by mutual funds—including Section 529 accounts—onto their own brokerage account platforms. A conversion process is currently taking place within the Virginia College Savings Plan, and other states may be considering a similar approach for 529 accounts sold through financial intermediaries.[3]

The primary motivation behind omnibus accounting is the opportunity to extract additional fees for overseeing mutual fund accounts that are converted onto a brokerage account platform and are placed under the complete control of the broker-dealer. Mutual funds are quite reliant on brokerage firms—and especially the largest broker-dealers—to sell and distribute their shares to individual investors. As a result of the market power of these large firms, the fees paid by mutual funds and their investment advisers for services provided are typically set without any competitive bidding process and are often fees that are higher than those set by normal market forces.[4]

As noted earlier, the most significant problem created by the use of omnibus accounting is a lack of transparency at the investor account level. Each omnibus account can involve thousands of investors in a particular mutual fund and, in most circumstances, the identity of the underlying investors and their specific transactions are

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[2] Within the financial services industry, this consolidated account is referred to as an "omnibus account." It is an operational structure very similar to purchasing stocks and bonds in "street name."

[3] See PowerPoint Presentation for Panel Discussion, "Leverage the Professional Community," National Association of State Treasurers, 2010 Treasury Management Conference, May 16-19, 2010, available at http://www.nast.org/2010TreasuryMgmt/College/TUE_LeveragingthePlannigCommunity.pdf.

[4] CMFI has developed an extensive body of research on both the fee structure and the regulatory problems of omnibus accounts. In August 2010, CMFI issued a White Paper analyzing the fee practices being employed by the largest broker-dealers using the omnibus account structure. CMFI's analysis concluded that these broker-dealers are imposing unnecessary costs on individual investors each year of as much as $1 billion in account maintenance charges and more than $6 billion in various shareholder servicing payments. See Coalition of Mutual Fund Investors, CMFI White Paper: The Costs of Providing Shareholder Services to Hidden Mutual Fund Accounts, August 18, 2010, available at http://www.investorscoalition.com/CMFIWhitePaperAug18.pdf.

not disclosed outside of the broker-dealer accounting platform. For Section 529 accounts, this lack of transparency will cause significant oversight and compliance problems for the state agencies operating Section 529 programs.

## The Operational Structure of 529 College Savings Plans

Section 529 college savings plans are typically administered by state agencies and are generally of two types: prepaid tuition plans and college savings plans. A prepaid tuition plan permits the pre-purchase of tuition credits to entitle a beneficiary to future attendance at a designated educational institution. A college savings plan permits contributions to be paid into an investment account in which: (1) investment earnings accumulate free of federal and/or state tax; and (2) account distributions are free of federal and/or state tax, if used for qualified higher education expenses.

State college savings plans are of two general types: (1) direct-sold plans in which individuals establish an account and select investment options without the use of a broker-dealer, financial advisor, or other intermediary; and (2) advisor-sold plans offered through financial intermediaries. The fees are typically higher for advisor-sold plans, as these plans charge additional fees to compensate the financial advisors involved.[5] For advisor-sold plans, the fees charged typically include: (1) sales loads levied either as a percentage of asset purchases ("front-end load") or asset sales ("back-end load"); (2) periodic charges levied as a percentage of account balances; and (3) fixed-dollar annual account maintenance fees.[6]

Even though Section 529 plans are overseen by state agencies, the substantial majority of states contract out recordkeeping and investment management services to financial service companies using a competitive bidding process.[7] The state agencies that oversee these accounts are still responsible for collecting, retaining, and reporting certain information to the IRS.

Section 529 plans have been authorized by Federal statute since 1996.[8] However, for some reason, the IRS has not finalized regulations regarding these plans. On August 24, 1998, the IRS issued a Notice of Proposed Rulemaking, outlining proposed

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[5] See U.S. Department of the Treasury, An Analysis of Section 529 College Savings and Prepaid Tuition Plans, at 2 (Executive Summary), Sep. 9, 2009, available at http://www.treasury.gov/resource-center/economic-policy/Documents/09092009TreasuryReportSection529.pdf ("Advisor sold plan fees include compensation for the advisors, which contributes to fees being higher for advisor sold plans that [sic] for direct sold plans."). See also Id. at 32 (Table 10) (percent of real returns absorbed by fees in advisor-sold funds average 47.7% for moderate risk investments) (hereinafter "Treasury Report on Section 529 Plans").

[6] See Id. at 2 (Executive Summary).

[7] See Id. at 2 (Report).

[8] Small Business Job Protection Act of 1996, Public Law 104-188, Aug. 20, 1996, codified at 26 U.S.C. § 529.

regulations for state agencies with qualified tuition programs.[9] Additional guidance was published in Notice 2001-55 and Notice 2001-81.[10] On January 18, 2008, the IRS issued an Advance Notice of Proposed Rulemaking, re-affirming its earlier guidance and inviting public comments.[11]

## The Current IRS Recordkeeping Rules for Section 529 Accounts

Section 529(b)(3) of the Internal Revenue Code states that "[a] program is not to be treated as a qualified tuition program unless it provides separate accounting for each designated beneficiary."[12] The IRS regulations proposed in 1998 to implement this recordkeeping rule require state programs to maintain account-level records for each account owner and designated beneficiary:

> (f) *Separate accounting.* A program shall not be treated as a [Qualified State Tuition Program] unless it provides separate accounting for each designated beneficiary. Separate accounting requires that contributions for the benefit of a designated beneficiary and any earnings attributable thereto must be allocated to the appropriate account. If a program does not ordinarily provide each account owner an annual account statement showing the total account balance, the investment in the account, earnings, and distributions from the account, the program must give this information to the account owner or designated beneficiary upon request.[13]

The proposed regulations issued in 1998 also require state programs to file a Form 1099-G with the IRS, for each account owner and beneficiary who receives a taxable distribution.[14] A state program must include account-level information in any Form 1099-G filed, including: (1) the name, address, and taxpayer identification number of the distributee; and (2) the amount of earnings distributed to the distributee in the calendar year.[15] The state program also must provide a copy of the Form 1099-G to the distributee.[16]

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[9] Qualified State Tuition Programs, Notice of Proposed Rulemaking and Notice of Hearing, 63 Fed. Reg. 45,019 (Aug. 24, 1998).
[10] Notice 2001-55, 2001-39 I.R.B. 299 (Sept. 24, 2001); and Notice 2001-81, 2001-52 I.R.B. 617 (Dec. 26, 2001).
[11] Guidance on Qualified Tuition Programs Under Section 529, Advance Notice of Proposed Rulemaking, 73 Fed. Reg. 3,441 (Jan. 18, 2008) (hereinafter "Advance Notice of Proposed Rulemaking").
[12] 26 U.S.C. § 529(b)(3).
[13] Prop. Treas. Reg. § 1.529-2(f). See also Section 529 Programs, Notice 2001-81, Internal Revenue Bulletin No. 2001-52, at 618, Dec. 26, 2001 ("Prop. Treas. Reg. § 1.529-2(f) requires a § 529 program to maintain records with respect to the designated beneficiary of each account showing the total investment in the account and any earnings attributable thereto.") (hereinafter "Notice 2001-81").
[14] Prop. Treas. Reg. § 1.529-4.
[15] Prop. Treas. Reg. § 1.529-4(b)(3). See also Notice 2001-81 at 618 ("Prop. Treas. Reg. § 1.529-4 requires a State tuition program to report on Form 1099-G, Certain Government Payments, the earnings portion of

Additionally, the proposed regulations require that all accounts maintained by a state 529 program for the benefit of a designated beneficiary are to be treated as a single account for the purpose of calculating the earnings portion of any distribution:

> (d) *Aggregation of accounts.* If an individual is a designated beneficiary of more than one account under a [Qualified State Tuition Program], the [Qualified State Tuition Program] shall treat all contributions and earnings as allocable to a single account for purposes of calculating the earnings portion of any distribution from that [Qualified State Tuition Program]. For purposes of determining the effect of the distribution on each account, the earnings portion and return of investment in the account portion of the distribution shall be allocated pro rata among the accounts based on total account value as of the close of the current calendar year.[17]

In summary, the current IRS recordkeeping rules require that state agencies maintain oversight of individual Section 529 accounts, including all contributions, earnings, distributions, and other transactions. State college savings plans must report certain account-level information to the IRS—including the preparation of Form 1099-G for all distributions—and must track earnings and contributions for each account in a state program.

## The Problems Caused by Omnibus Accounts in Section 529 Programs

By definition, the use of omnibus accounting in mutual funds permits broker-dealers to become the primary recordkeepers for their customers, instead of leaving recordkeeping responsibilities with a mutual fund and its compliance personnel. In Section 529 accounts, this will cause a significant diffusion of recordkeeping responsibilities, replacing a framework that relies on a small number of recordkeepers—directly overseen by the state agencies with qualified tuition programs—in favor of a new system with hundreds of broker-dealers and other financial intermediaries assuming primary recordkeeping responsibilities for these mutual fund accounts.

If allowed to occur, a very transparent system for tracking the activities and transactions of individual Section 529 accounts will be converted into a non-transparent system, with multiple recordkeepers and an unnecessary layer of intermediaries in between individual investment accounts and those charged with overseeing account-level activities and transactions.

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any distributions made during the year, together with other information such as the name, address and TIN of the distributee.").

[16] Prop. Treas. Reg. § 1.529-4(c).

[17] Prop. Treas. Reg. § 1.529-3(d). See also Notice 2001-81 at 619.

Several specific examples include:

1. Implementation of an IRS Anti-Abuse Rule for Section 529 Accounts. In its 2008 Advance Notice of Proposed Rulemaking, the IRS expressed concern about certain situations in which present law raises the potential for abusive transaction in individual Section 529 accounts. In its Advance Notice, the IRS provided three examples:

- Abuse may arise because of the ability to change designated beneficiaries ("DBs") in certain circumstances without triggering a transfer tax. For example, taxpayers may seek to establish and contribute to multiple accounts with different DBs, with the intention of subsequently changing the DBs of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary without further transfer tax consequences;[18]

- Abuse may arise because taxpayers seek to use section 529 accounts as retirement accounts, with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts;[19] and

- Abuse may arise if a person contributes a large sum to an account for himself or herself and then changes the DB to a member of his or her family who is in the same or higher generation as the contributor. The contributor may claim that the subsequent change of DB to a member of the contributor's family avoids the gift tax under the special transfer tax rules of section 529.[20]

The Advance Notice of Proposed Rulemaking goes on to note that the IRS intends to propose a general anti-abuse rule that will apply when Section 529 accounts are established or used for purposes of avoiding or evading transfer tax, or for other purposes inconsistent with Section 529.[21] The IRS intends to implement this anti-abuse rule as follows:

> The IRS and the Treasury Department anticipate that the anti-abuse rule will generally follow the steps in the overall transaction by focusing on the actual source of the funds for the contribution, the person who actually contributes the cash to the section 529 account. and the person who ultimately receives any distribution from the account. If it is determined that the transaction, in whole or in part, is inconsistent with the intent of section 529 and the regulations, taxpayers will not be able to rely on the favorable tax treatment

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[18] Advance Notice of Proposed Rulemaking at 3,441. See also Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006 and as Considered by the Senate on August 3, 2006, JCX-38-06 (Aug. 3, 2006), at 369 (hereinafter "JCT Technical Explanation").
[19] Id. at 3,442. See also JCT Technical Explanation at 369.
[20] Id.
[21] Id.

> provided in section 529. The anti-abuse rule will include examples such as those set forth above that provide clear guidance to taxpayers about the types of transactions considered abusive.[22]

It will be next to impossible for state agencies (and the IRS) to monitor transactions within individual accounts if omnibus accounting is permitted to be used in advisor-sold Section 529 plans. The proposed IRS anti-abuse rule depends, in part, on complete transparency down to the account level, in order to ensure a process in which abusive transactions can be identified and sanctioned. A move to a system of multiple broker-dealer recordkeepers will make it difficult, if not impossible, for state agencies to retain the type of transparency required to properly oversee these accounts.

2. Use of Incentive Matching Programs in Section 529 Accounts. A number of states have established matching incentive programs to encourage low-income residents to make contributions to Section 529 savings plans.[23] In addition, there are several non-profit entities with matching contribution programs that facilitate and encourage college savings by the residents of a particular state.[24]

While the IRS has not taken a final position on the legality of these matching programs, the use of omnibus accounting adds unnecessary complexity to the oversight of these worthwhile programs, as it will be extremely challenging on an operational basis to oversee matching contributions and their uses without full transparency into the individual accounts maintained by each of these state tuition programs.

3. Implementation of IRS Section 529 Account Aggregation Rules. As noted above, the IRS currently requires state college savings programs to aggregate the earnings on all such accounts within a state's program for tax reporting purposes on Form 1099-Q.[25] Since most states have several different college savings plans (e.g., direct-sold and advisor-sold), it will become more difficult to comply with this aggregation requirement for account owners and designated beneficiaries, when accounts are held with many different recordkeepers.

Under the current system, state agencies work with a limited number of service providers and it is relatively easy to aggregate the earnings portion of each distribution across individual accounts. If omnibus accounting is permitted to be used in a widespread manner for advisor-sold plans, it will be very difficult to comply fully with this requirement across multiple recordkeepers each year.

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[22] Id.
[23] States that offer some type of matching incentive program for college savings include: Alaska, Colorado, Illinois, Kansas, Louisiana, Maine, Michigan, Minnesota, Missouri, and Oklahoma.
[24] The most prominent non-profit matching contribution program is operated by the Harold Alfond Foundation, which offers a $500 matching gift to every child born in Maine who opens a Section 529 account starting in 2009. Another program operated by The Center for Social Development makes matching contributions to Section 529 accounts in Oklahoma. See Letter from David G. Lemoine, Treasurer, State of Maine, to Internal Revenue Service, March 19, 2008.
[25] Prop. Treas. Reg. § 1.529-3(d).

As a related issue, it will also be difficult operationally to enforce the statutory prohibition on excess contributions for each designated beneficiary within a state program—a rule that requires coordination among both prepaid and college savings programs—under a system in which there are multiple broker-dealer recordkeepers using omnibus accounting.[26]

4. Implementation of New IRS Recordkeeping and Administrative Requirements. According to several comment letters filed in the 2008 Advance Notice of Proposed Rulemaking, the IRS is considering a requirement that state agencies report annually to the IRS the total year-end balance for each Section 529 account, by account owner and designated beneficiary.[27]

Again, this type of requirement will be a challenge to implement within an omnibus accounting framework, as it will require coordination among multiple recordkeepers, with unnecessary added complexity, compared to the existing structure of Section 529 accounts.

5. Other Regulatory Problems with Omnibus Accounts. As a separate concern, the lack of transparency within omnibus accounts has created a number of regulatory problems for mutual funds. As you may know, omnibus accounts were implicated in the 2003-2004 market timing and late trading scandals within the mutual fund industry. In response, the U.S. Securities and Exchange Commission promulgated a regulation that requires a minimum level of transparency for these otherwise non-transparent accounts.[28] However, this information-sharing tool is not being used regularly by mutual funds and the lack of transparency within these accounts continues to raise regulatory concerns.[29] For example:

- Mutual funds are not able to monitor, on a real-time basis, excessive short term trading activities at the investor account level;

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[26] See 26 U.S.C. § 529(b)(6) ("*Prohibition on excess contributions.* A program shall not be treated as a qualified tuition program unless it provides adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary.").

[27] See Letter from Lisa Robinson, Associate Counsel – Tax Law, Investment Company Institute, to Richard Hurst, Mary Berman, and Monice Rosenbaum, Internal Revenue Service, at 6, May 12, 2008; See also Letter from Lisa Robinson, Associate Counsel, Investment Company Institute and Liz Varley, Vice President for Retirement Policy, Securities Industry and Financial Markets Association, to Michael J. Desmond, Tax Legislative Counsel, U.S. Department of the Treasury, at 5, June 12, 2007.

[28] See 17 C.F.R. § 270.22c-2(c)(5).

[29] See Coalition of Mutual Fund Investors, Excerpts from SEC Prospectus Filings Regarding Enforcement of Mutual Fund Market Timing and Other Short-Term Trading Policies within Third-Party Hidden Accounts, Updated as of May 1, 2011, available at http://www.investorscoalition.com/Analysis_of_Omnibus_Surveillance_Procedures_6-10-11.pdf.

- Investors being charged sales loads by broker-dealers are not receiving the proper volume or "breakpoint" discounts, as outlined in mutual fund prospectus filings;

- Money market funds are not able to evaluate accurately the liquidity needs of both retail and institutional investors, by being unable to "look through" the omnibus accounting structure to the investor account level; and

- Restitution payments and other distributions from SEC enforcement proceedings and private class action cases are not being made in as precise and timely a manner because of an inability to obtain investor-level information.

## Conclusion

Since their inception, Section 529 accounts have generally resided directly with each mutual fund, using an operational structure that permits state agencies (and the funds themselves) to enjoy full transparency of all investor identity and transaction information at the account level. Under this structure, a state agency overseeing the Section 529 accounts within its programs is able to comply with the information collection and reporting requirements imposed by the IRS.

The practice of omnibus accounting is being used by broker-dealers to improve the internal operating efficiencies of their brokerage platforms. This practice, however, does not increase efficiencies or reduce costs for Section 529 Plan participants. Instead, omnibus accounting only benefits broker-dealers through the payment of new (and more expensive) recordkeeping fees than those which were previously paid to mutual funds. A conversion of investor accounts to omnibus accounting platforms also will result in a more complex and complicated recordkeeping structure for Section 529 Plans, with the only beneficiary of this conversion being the broker-dealers.

For these reasons, CMFI believes that it is not in the best interests of these educational savings programs to permit large broker-dealers to convert Section 529 accounts into omnibus accounts. There is no benefit to anyone in reducing transparency regarding the activities and transaction of Section 529 plan investors. Similarly, there are no additional benefits being received by investors being asked to pay higher broker-dealer fees. And, as noted earlier, state agencies (and mutual funds) will be forced to develop duplicative and expensive tax compliance processes.

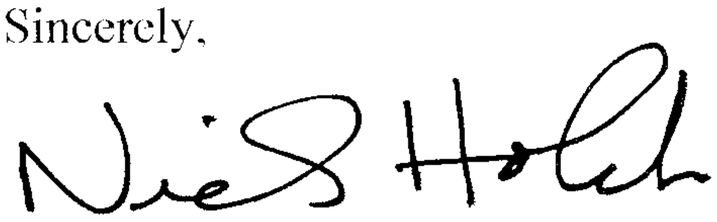
The proposed conversion of these accounts onto broker-dealer accounting platforms is clearly a step in the wrong direction. Any type of new accounting platform for Section 529 Plans should not create tax compliance and regulatory problems, increase investor costs, and operate only for the convenience of large broker-dealers. There is simply no credible reason to replace the current operational structure of full transparency recordkeeping with a structure that will involve a myriad of different recordkeepers, all of

which will be receiving higher fees without delivering any tangible benefit to investors, the mutual funds, or the state agencies charged with overseeing these accounts.

As recommended by the recent U.S. Treasury Department Report on Section 529 Plans, additional measures need to be implemented to strengthen the compliance and monitoring of Section 529 accounts and the transactions within these accounts.[30] Non-transparent omnibus accounting will detract from this objective and should be prohibited for these accounts before it becomes a widespread practice within advisor-sold college savings plans. If omnibus accounting is permitted to occur, then the IRS should require full transparency at the investor level for all Section 529 accounts, on a real-time or same-day basis.[31]

Thank you for considering our views. Please contact me if I can be of further assistance on regulatory issues involving Section 529 accounts.

Sincerely,



Niels Holch
Executive Director
Coalition of Mutual Fund Investors

cc: Michael F. Mundaca, Assistant Treasury Secretary (Tax Policy)

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[30] See Treasury Report on Section 529 Plans at 22 ("*Recommendation No. 5: Improved Monitoring and Compliance*. Section 529 accounts are relatively new. To reduce the potential for abuse, Congress and the states should work together to strengthen compliance and monitoring of Section 529 accounts and their disbursements.").

[31] This can be accomplished through the use of the Networking service offered through the National Securities Clearing Corporation, a financial services industry utility that is used by the substantial majority of broker-dealers and mutual funds to share account-level information on a real-time and same-day basis.