



Securities Industry Association

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May 19, 2003

Ms. Monice L. Rosenbaum
Internal Revenue Service
Exempt Organizations 1
(CC:TEGE:EOEG:EO1)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Coverdell ESA Reporting

Dear Ms. Rosenbaum:

The Retirement & Savings Committee of the Securities Industry Association (SIA), appreciates the opportunity to comment on recently issued Forms 1099-Q and 5498-ESA. SIA has been a frequent contributor to employee benefit plan issues as identified by the Internal Revenue Service. SIA brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans.

As sponsors of Coverdell ESAs, we share your goal of accurate and timely reporting of distributions from these accounts and securing the information needed for proper tax reporting. Yet, as we have reviewed and discussed the recently issued 1099-Q and 5498-ESA, we have concluded that some of the information requested on these revised forms, specifically the cost basis of distributions, may be impossible to obtain. Further, supplying cost basis would not, except in occasional cases, yield information that a taxpayer would need to file his or her tax return. Finally, in most cases the taxpayer is the best or only source of cost basis information.

Form 1099-Q

It is our understanding that the Service's intent of adding Coverdell ESAs to this new form was to distinguish the reporting of Coverdell ESAs from that of IRAs so that there would be less confusion to taxpayers concerning the use of Coverdell ESAs. To further this objective, the new form requires that payers report both the basis and the earnings portions of any gross distribution amount and to provide a statement to any receiving qualified education program (as defined under both Code sections 529 and 530) identifying the earnings portion of

the distribution by the earlier of January 10th or thirty days following a trustee-to-trustee transfer. However, separate reporting for Coverdell ESAs may be all that is needed to reduce confusion as taxpayers come to understand that under most circumstances Coverdell ESAs are fully distributed by the beneficiary's 30th birthday, rather than at retirement, and as the Coverdell ESA is no longer referred to as an "Education IRA."

The requirement to report the basis of a distribution is puzzling but more importantly, can be confusing for taxpayers and difficult, if not impossible, for payers to meet. Until the issuance of proposed 2003 Form 1099-Q, taxpayers kept track of their Coverdell ESA basis on Form 8606 or, for 2002, on Worksheet 5-3 from Publication 970. On both of these, a taxpayer annually determines his or her Coverdell ESA basis in a calculation that uses (1) the total amount of distributions for the year from all Coverdell ESAs and (2) a determination of qualified education expenses with adjustments for other education related tax credits or deductions that a taxpayer may claim. Clearly, Coverdell ESA custodians have no access to these two pieces of information or the data needed to determine them. Also, taxpayers will be confused because the simplified determination of basis required on the new Form 1099-Q does not correspond to the more detailed calculation from prior years. Further, a taxpayer's actual Coverdell ESA basis cannot be known until the taxpayer actually claims that a portion of a Coverdell ESA distribution is taxable when the taxpayer files his or her return.

Additionally, until the issuance of proposed 2003 Form 1099-Q, custodians had not tracked and had never been asked to track the basis of Coverdell ESAs. This presents an insurmountable problem because this information was not "captured" on record keeping systems and the only practical method of recreating this information is to ask customers to provide the data. In the past, custodians have found that customers do not respond to this type of request, regardless of repeated attempts and we would expect our experience for Coverdell ESAs to be the same (even more so because of the modest size of most of these accounts). Furthermore, there is no guarantee that the information provided by customers will be accurate. The anticipated difficulty in obtaining information is only compounded when an ESA has been transferred or rolled over to a new custodian from a custodian that, in all likelihood, has not tracked the basis of the account. Obtaining basis information prior to the acceptance of the account presents obstacles not only to the accepting custodian but to the beneficiary, as well, and the accuracy of the information becomes increasingly unreliable when a Responsible Individual, who might have several Coverdell ESAs for the same beneficiary, is asked to calculate this information.

Coverdell ESAs share some structural similarities with IRAs, e.g., acceptance of cash contributions, rollover and transfers of accounts, contribution timing and the use of custodial accounts, etc. It was due to these similarities with IRAs that allowed most custodians to use their IRA record keeping systems to handle the reporting for Coverdell ESAs. However, any earnings on Coverdell ESA distributions will **not** be subject to income tax, if used to pay for the Qualified Education Expenses of the designated beneficiary and the distribution is issued prior to the beneficiary's attainment of age 30 (unless a special needs beneficiary). Most distributions will fall into this category. This bifurcation of taxable-nontaxable distributions

most closely resembles a Roth IRA where there is a distinction between qualified and non-qualified distributions.

A custodian's ability to utilize its IRA record keeping system enabled financial institutions to offer Coverdell ESAs, even when the annual contribution limit was only \$500. Had it not been for this, many financial institutions would not have been able to offer these accounts and even with contributions having been made since 1998, most of these accounts are quite small and have been offered as an accommodation to existing customers. As an example, an informal survey of our members indicated that the ratio of assets held in Coverdell-ESA's to assets held in Roth IRAs is less than 2%. If a comparison were made to traditional IRAs the ratio would be infinitesimally small. If custodians are required to set up a separate record keeping system to track basis it is likely that many custodians will withdraw their sponsorship of Coverdell-ESA accounts.

Because of the difficulty in obtaining basis information, suggestions have been made to require the reporting of basis only for new accounts. We do not think that is advisable because most record keeping systems cannot be programmed to report different information for similar type accounts. Customers will be dissatisfied if they receive account statements containing different information for one Coverdell ESA than for another, determined solely by the date on which the accounts were opened. Ultimately, since this Committee believes that basis information will only be needed for the occasional distribution that is not used to pay Qualified Education Expenses and not for the more typical distribution that is used to pay for these expenses, it is not a practical item to include on Form 1099-Q, either for existing accounts or for new accounts.

As an aside, the instruction concerning the date on which basis is calculated is ambiguous. The instructions for the form refer to Regulations section 1.529-3. That section refers to Regulations section 1.529-1(c) which in turn refers to the last day of the calendar year as the date for determining the account balance and for calculating the earnings ratio. Yet, it would be reasonable to interpret the 1099-Q as requiring the calculation of basis on the date of distribution. This ambiguity should be cleared up.

The instructions for 1099-Q, Box 4, state that the custodian must send an "earnings statement" to the receiving custodian with respect to any trustee-to-trustee transfers or distribution by the earlier of 30 days of the transfer or distribution or January 10th. For trustee-to-trustee transfers that have already taken place in 2003, the statement/report should have already been issued, but numerous ESA custodians have informed us that earnings and basis information was not available and that no earnings statements have been issued as required within the allotted time periods. Aside from the unmanageable reporting deadline imposed for trustee-to-trustee transfers on the 1099-Q, we also noted that a similar reporting requirement does not exist for the 5498-ESA. We think that, regardless of the reporting deadline, the obligation to report a trustee-to-trustee transfer should be equally borne by the distributing as well as by the receiving trustee. We question the usefulness of this report for the same reason that one is not required for IRA's, since there is no taxable event when the transfer is from one trustee to another.

Form 1099-R, which had been used to report distributions from Coverdell ESAs for taxable years prior to 2003, contains the following statement in the Instructions for Recipient, "For distributions from a Roth IRA, generally the payer is not required to compute the taxable amount. You must compute any taxable amount on Form 8606..." We strongly urge the Service to continue to place the responsibility for reporting the taxable amount of a distribution on the taxpayer, who is the only party with the requisite information to compile and report this information. If the taxpayer can be relied on to accurately report this information for a Roth IRA (a much more widely used account) and was also asked to report similar information for Coverdell ESAs on Form 8606 prior to 2003, then surely the Service can continue to rely on the taxpayer to report this information for a Coverdell ESA. Moreover, the methodology for calculating basis and earnings can be found in IRS Publication 970.

Form 5498-ESA

Form 5498-ESA has also been issued for 2003 and the new reporting requirements present problems. Contributions received as late as April 15th and that are made for the preceding year must be reported to the "beneficiary (participant) by April 30". This reporting schedule would be extremely difficult, if not impossible, to meet. If the custodian was required to issue the 5498-ESA by April 30th, and a contribution was made slightly before April 15th for the preceding year, there would not be enough time to process the transaction and issue a regulatory report. An April 30th notification date also would have to report "excess" contribution corrections. Unlike an IRA, in a Coverdell-ESA this can be done through June 1st. Normally, the deadline for providing a copy of form 5498 to a taxpayer is May 30th. At the very least, we suggest that this deadline also apply to 5498-ESA, although it makes more sense to make the filing deadline June 30th, or some date after "excess" contributions can be corrected.

In closing, SIA supports the Service's issuance of Forms 1099-Q and 5498-ESA and its effort to distinguish Coverdell ESAs from "traditional" retirement plans. However, we urge reconsideration of the requirement to report the basis of distributions on Form 1099-Q and the establishment of more reasonable filing deadlines for the 5498-ESA.

Thank you for your consideration. If you would like, we would be pleased to meet with you to discuss this further.

Sincerely,

Liz Varley
Vice President and Director
Retirement Policy