SIFMA
Securities Industry and
Financial Markets Association

March 18, 2008

Internal Revenue Service
Attn: CC:PA:LPD:PR
Room 5203
P.O. Box 7604
Ben Franklin Station
1111 Constitution Avenue, N.W.
Washington, D.C. 20044

Re: Proposed Rules Providing Guidance on Section 529 Accounts for Qualified Tuition Programs

Dear Sir or Madam:

On behalf of the Securities Industry and Financial Markets Association[1] ("SIFMA"), thank you for the opportunity to share our comments on the Notice of Proposed Rulemaking under Internal Revenue Code ("Code") section 529 ("Proposal"). SIFMA appreciates the effort that the Internal Revenue Service ("IRS") has made to facilitate a dialogue on how best to coordinate the effects that Code section 529 has on both the income and the estate and gift tax provisions of the Code and the favorable treatment that section 529 plans enjoy. The Notice of Proposed Rulemaking ("NPRM") includes a number of proposals that would provide needed clarification in this area. However, SIFMA believes that some of the proposed rulemaking provisions might include account transactions that are not abusive and that use the tax benefits as they were intended. If we are correct, then the effect of the Proposal would be to discourage the use of section 529 plans and would run counter to Congress's efforts to encourage these plans, as evidenced by the inclusion in the Pension Protection Act of provisions making their beneficial tax consequences permanent.

[1]The Association, or "SIFMA," brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

I. Analysis and Commentary

Anti-abuse rule. As contemplated by the IRS, the anti-abuse rule will focus on those accounts in which the account owner ("AO") withdraws funds from a section 529 plan for purposes other than qualified higher education expenses ("QHEE"). An example used in the NPRM was a grandparent who contributed to numerous section 529 plans on behalf of his or her grandchildren and named his or her child as the AO. Under current rules there would be no adverse income tax effects to the AO if the funds are ultimately distributed to him or to her, if the AO is a member of the same family as the original

beneficiary. A beneficiary's "family" includes not only members of the same generation, but a beneficiary's parents, as well. As a result the NPRM notes the concern that an AO who is the parent of the beneficiaries of the section 529 plans could withdraw the funds with minimal income tax consequences while enabling the contributor to the section 529 plan to make a large gift to the AO with little or no gift tax consequences. The NPRM also suggests that a contributor could establish multiple section 529 plans, thereby leveraging the ability to make multiple gifts. The contributor could then change the beneficiary on the accounts to accomplish a large transfer to one beneficiary and avoid the use of the contributor's lifetime exemption.

While SIFMA agrees that these examples are contrary to the intent of section 529, we believe the proposed response should target any abuses in a precise manner. We urge the Service to consider that Code section 2503(e) permits the payment of educational expenses directly to the educational institution without imposition of gift taxes. Taken in that context the movement of funds both into and out of the 529 plan without gift tax consequences does not seem quite so onerous. Additionally, the extent of the "abuse" could be tempered if it is determined that the AO needed the funds due to disability, death or other financial hardship (as that term has come to be used in the retirement plan context).

The NPRM also states that the anti-abuse rule will focus "on the actual source of the funds for the contribution…" SIFMA has asked its members if they know the identity of the source of the contribution and the response has uniformly been "no". SIFMA would be opposed to a new requirement that would place a burden on financial services firms or program managers to identify the source of contributions. Even if we were to obtain this information for new accounts (and it is very unlikely that we could) it would be impossible to obtain this information for existing accounts.

When drafting the proposed regulations, the IRS should illustrate what types of transactions are considered abusive and what types are not. Three examples could be –

- The designated beneficiary ("DB") receives a birthday gift of cash from a grandparent and the AO, who is the DB's parent, deposits the gift in a 529 account for the DB. The IRS should state that this common transaction is not considered abusive.

- The parent who is AO, names child as DB of a 529 account. AO changes the DB and names him/herself as DB and withdraws funds to pay for QHEE for his/her education. The IRS should state that this transaction is not considered abusive. It is consistent with the rules that permit changes of DB to the same generation or higher.

- Grandparent funds 5 section 529 plans for his grandchildren with $60,000 in each account and names his son as AO. Three years later the AO withdraws the funds to use for personal needs unrelated to QHEE. This would potentially be an abusive use of the plans.

These examples are not exhaustive. SIFMA also remains concerned about an anti-abuse rule that would apply onerous consequences on a grandparent AO who may need to access funds in the 529 account because of hardship or medical issues. SIFMA believes that unless the AO uses the funds in the section 529 plan for himself or herself and for non-QHEE, the current rules accurately reflect the correct tax consequences, i.e., unless the new beneficiary is two or more generations below the current beneficiary and not a member of the original beneficiary's family, there should not be any gift or generation skipping tax consequences.

II. Rules Relating to the Tax Treatment of Contributions to and Participants in Section 529 Accounts.

This section also deals with a change of the beneficiary by the AO and again states that the adverse gift and generation skipping tax consequences should be imposed on the AO, rather than on the beneficiary. Again, we would respond that the transfer tax consequences should be applied precisely. SIFMA assumes that the IRS will address this issue by permitting changes in the AO under circumstances that occur due to uncontrollable events (death, disability, divorce, etc).

The IRS is also concerned with contributions to section 529 plans that are made by trusts or other "persons" (which would apparently include corporations). The concern over a trust making contributions to a section 529 plan seems to be misplaced because the actions of trustees are governed by the provisions of the trust document. Distributions from an irrevocable trust are also governed by the distributable net income rules (which impose income tax on distributions), so it is unlikely that trusts will be involved in abusive 529 arrangements. If the trust provides that contributions to or on behalf of the trust beneficiary can be made for higher education purposes, then it should follow that the trust could make distributions to a trust beneficiary's section 529 plan. Likewise, a corporation or non-profit may sponsor a 529 plan to provide scholarships, matching grants or other programs to facilitate attendance at institutions of higher education.

The NPRM applies this analysis to UGMA's and to UTMA's when it states that, "section 529 accounts provide an efficient method for UGMA and UTMA accounts to provide for the higher education expenses of their minor beneficiaries." We feel that there should be no substantive difference between a trust that is permitted to make distributions to beneficiaries for educational purposes and a UGMA or UTMA and that distributions from a trust could be used to fund a section 529 plan.[2]

Since the IRS acknowledges that an individual cannot make a gift to himself or to herself, if a contribution to a section 529 plan is made from a UGMA or UTMA (in which the beneficiary is

[2] If the reproposed regulations discuss the treatment of UGMA and UTMA accounts, it would be helpful to confirm that when the DB of the UGMA/UTMA529 reaches age of majority and takes control of the 529 asset as AO, the DB can name a new DB. At the point of majority, the UGMA/URMA 529 should be treated as a self-funded 529 account and subject to the same rules. Of course, it is considered a new gift to the new beneficiary and gifting rules will apply.

considered to be the beneficial owner) it will not be considered a gift. However, we agree that when the beneficiary is also the AO, then a withdrawal and transfer to another individual's section 529 plan will be considered a distribution and subsequent gift to the new section 529 plan, but will not be subject to income tax or to the 10% penalty tax if the new beneficiary is a member of the former beneficiary's family.

Estate tax inclusion. SIFMA feels that the NPRM takes a reasonable approach to the inclusion of the section 529 plan in the estate of the beneficiary, particularly in Rules 1, 2 and 3. However, if the AO is viewed as holding a limited power of appointment, then, except where the account is paid to the AO within a specified period of time following the beneficiary's death, e.g., six months, the balance remaining in the account at the time of the beneficiary's death should be included in the beneficiary's estate. While we acknowledge that the beneficiary does not have the type of control over the account that would normally cause its estate tax inclusion, if the contribution to the section 529 plan is considered to be a completed gift to the beneficiary, then the account should be included in the beneficiary's estate, except when the AO withdraws the funds remaining in the account shortly after the beneficiary's death and before an estate tax return (if applicable) was filed on behalf of the beneficiary's estate. The financial institution or program where the account was invested has no way of knowing if the beneficiary has died and cannot report any change to the account if this has occurred. Under these circumstances the financial institution will not know when to report a taxable distribution.

III. Rules Governing the Function and Operation of QTPs and Section 529 Accounts

SIFMA would urge that the position taken in the NPRM relating to the exclusion of income will be available for distributions used for QHEE that are made during the calendar year or by June 30 of the following year.

SIFMA believes that 15 months is the minimum grace period that would be needed to ensure operational compliance with any final regulations. Additional time may be needed if the final regulation would require changes to state rules, which may also require approval by a state legislature.

IV. Additional Issues

SIFMA would also recommend that the IRS address two issues relating to the investment of a Section 529 plan and the definition of qualified expenses. We have long supported additional flexibility to change investments. The need for additional flexibility is especially acute with the uncertainty in the market and shorter investment horizon of those who are saving for college.

We would also urge the IRS to expand the definition of "qualified higher education expenses" to include computers even if the selected educational institution does not expressly require the purchase of a computer. "Qualified higher education expenses" also should include expenses permitted by the rules governing Coverdell accounts, *e.g.*, computer technology, internet access and transportation.

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Please do not hesitate to contact me if you need additional information about SIFMA's comments. We look forward to working with the IRS on this important project.

Sincerely,

Liz Varley

Liz Varley
Managing Director, Government Affairs