CMFI
Coalition of Mutual Fund Investors

March 20, 2014

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Subject: SEC Approval of Proposed Rule Change Relating to New MSRB Rule G-45, File Number SR-MSRB-2013-04

Dear Ms. Murphy:

The Coalition of Mutual Fund Investors ("CMFI")[1] appreciates the opportunity to comment on a rule change proposed by the Municipal Securities Rulemaking Board ("MSRB") to require underwriters of Section 529 college savings plans to report certain information to the MSRB regarding these plans.

This comment letter focuses on the issue of omnibus accounts, which was raised during the comment period for the proposed rule.[2] As the SEC is well aware, omnibus accounts permit broker-dealers and other financial intermediaries to assume recordkeeping responsibilities that have heretofore been the responsibility of mutual funds. Under this accounting structure, these 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 an omnibus account order as a single transaction, treating the intermediary—instead of the underlying investor—as the account holder and shareholder of record.

In their respective comment letters on proposed MSRB Rule G-45, two different associations stated the following about the omnibus accounts issue:

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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 (www.investorscoalition.com).
[2] See Letter from Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, July 16, 2013, available at http://www.sec.gov/comments/sr-msrb-2013-04/msrb201304-1.pdf (hereinafter "ICI Letter"); and Letter from David L. Cohen, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, July 18, 2013, available at http://www.sec.gov/comments/sr-msrb-2013-04/msrb201304-2.pdf (hereinafter "SIFMA Letter").

> [I]n practice, the mere fact that there is an omnibus relationship between a selling dealer and a plan's underwriter does not necessarily mean the underwriter has full transparency into all account information, including account owners, beneficiaries, contributions, and withdrawals, underlying the omnibus account. While *some* underwriters *may* have access to such information, this is not true of all underwriters and should not be presumed for purposes of Rule G-45.[3] (emphasis in original).

In a response letter to the SEC, the MSRB clarified that underwriters would be required to submit information they possess or have the legal right to obtain under Rule G-45, even if there has been a "voluntary relinquishment, by contract or otherwise, of such a right."[4] As a rationale for this requirement, the MSRB referenced an information-sharing service developed by the National Securities Clearing Corporation ("NSCC")—at the request of the industry—to share 529 plan activity and position changes on a daily basis with 529 plan sponsors and other parties.[5] This "full transparency" utility was developed, in part, to assist 529 plans in their Internal Revenue Service compliance obligations:

> [T]he MSRB believes that underwriters have possession or the legal right to the 529 aggregation files and, therefore, have information regarding all activity and positions in the 529 plans they underwrite. The MSRB further understands that DTCC/NSCC created the 529 aggregation files at the request of the program managers and state sponsors because they must have information regarding each customer subaccount in order to monitor the contributions and withdrawals so that no beneficiary accumulates more funds in an account than is permitted by the Internal Revenue Service under the Internal Revenue Code. Consequently, the MSRB understands that underwriters have information as to customer activity and positions, notwithstanding the omnibus accounting arrangements entered into by certain selling dealers.[6]

CMFI agrees with the MSRB's position regarding omnibus account transparency and acknowledges the IRS rules on aggregation of accounts for each 529 plan beneficiary. However, there are many other tax compliance reasons that require 529 program managers and state sponsors to have daily transparency into investor

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[3] SIFMA Letter at 4; ICI Letter at 6.
[4] Letter from Lawrence P. Sandor, Deputy General Counsel, Municipal Securities Rulemaking Board, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, at 9, January 14, 2014, available at http://www.sec.gov/comments/sr-msrb-2013-04/msrb201304-11.pdf (hereinafter "MSRB Response Letter").
[5] Municipal Securities Rulemaking Board, Notice of Filing of a Proposed Rule Change to a New MSRB Rule G-45, SEC Release No. 34-69,835, at 21-22, June 24, 2013, available at http://www.sec.gov/rules/sro/msrb/2013/34-69835.pdf.
[6] Id. at 22.

subaccounts. What follows is a discussion of these tax compliance issues for Section 529 plans and the problems created by non-transparent omnibus accounts.

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."[7] 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.[8]

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.[9] 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.[10] The state program also must provide a copy of the Form 1099-G to the distributee.[11]

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

[7] 26 U.S.C. § 529(b)(3).
[8] 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").
[9] Prop. Treas. Reg. § 1.529-4.
[10] 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 any distributions made during the year, together with other information such as the name, address and TIN of the distributee.").
[11] Prop. Treas. Reg. § 1.529-4(c).

> 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.[12]

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.

<u>Additional Tax Compliance Problems Caused by Omnibus Accounts in Section 529 Programs</u>

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 continue unabated, 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.

Several specific examples of the tax compliance problems created by non-transparent omnibus accounts include:

1. <u>Implementation of an IRS Anti-Abuse Rule for Section 529 Accounts</u>. In a 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

[12] Prop. Treas. Reg. § 1.529-3(d). <u>See also</u> <u>Notice 2001-81</u> at 619.

single, common beneficiary and distributing the entire amount to such beneficiary without further transfer tax consequences;[13]

- 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;[14] 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.[15]

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.[16] 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 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.[17]

It will be next to impossible for state agencies (and the IRS) to monitor transactions within individual accounts if non-transparent omnibus accounting is permitted to be utilized in 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 utilizing omnibus accounts, with multiple broker-dealer recordkeepers, will make it

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[13] 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").
[14] Id. at 3,442. See also JCT Technical Explanation at 369.
[15] Id.
[16] Id.
[17] Id.

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.[18] 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.[19]

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 impossible operationally 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.[20] 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 Section 529 plans, it will be very difficult to comply fully with this requirement across multiple recordkeepers each year.

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.[21]

[18] States that offer some type of matching incentive program for college savings include: Alaska, Colorado, Illinois, Kansas, Louisiana, Maine, Michigan, Minnesota, Missouri, and Oklahoma.
[19] 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.
[20] Prop. Treas. Reg. § 1.529-3(d).
[21] 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.").

4. Implementation of New IRS Recordkeeping and Administrative Requirements. According to several comment letters filed in response to the 2008 Advance Notice of Proposed Rulemaking, the IRS is also 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.[22]

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

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Thank you for the opportunity to comment on the omnibus account issues involved in new MSRB Rule G-45, requiring underwriters of Section 529 college savings plans to report certain information to the MSRB regarding these plans. If you have any questions, or need further information from CMFI, my telephone number is [redacted], and my email address is [redacted]

Sincerely,

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

[22] 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.