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Submitted Electronically

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Re: Guidance Requested under Code Section 529

Dear Ms. Judson and Ms. Cook:

As you know, the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”), enacted on December 18, 2015, included a number of enhancements to section 529 plans. The Investment Company Institute¹ appreciates the timely guidance already issued by the Internal Revenue Service (“IRS”) and Treasury, which provides transition relief for section 529 college savings plans with respect to 2015 tax reporting that may have been impacted by the PATH Act’s changes.² We write today to request guidance on additional issues that our member companies are contemplating as they have implemented the PATH Act changes to section 529 – specifically issues relating to the ability to recontribute refunded amounts.

Prior to the PATH Act, an account owner who withdrew money from a 529 plan, paid for a qualified higher education expense, and then received a refund for that expense (for example, if a

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² IRS Notice 2016-13.

student was forced to withdraw from school due to illness) would have had to treat the withdrawal as nonqualified, which would have resulted in income inclusion and penalties. The PATH Act added a new subsection, Code section 529(c)(3)(D), which allows a beneficiary to recontribute a withdrawn amount to a 529 plan, up to the refunded amount, without incurring income inclusion or penalties, provided the amount is recontributed within 60 days of the date of the refund. The Code uses the term “recontribution,” but it does not address the characterization of the contribution. Questions have been raised regarding how the recontributed amount will be treated.

We understand that the College Savings Plan Network (“CSPN”) recently submitted a letter to you seeking clarification that when an amount is recontributed under Code section 529(c)(3)(D), the entire amount recontributed will be treated as a new contribution.³ The alternative to this interpretation would be that the recontributed amount must be divided into an earnings portion and a return of investment portion, based on the earnings ratio applied to the amount originally distributed (*i.e.*, the amount that represented earnings when distributed must continue to be treated as earnings upon the recontribution).⁴ This would allow earnings previously distributed as non-taxable (used for qualified expenses) to be placed back into a 529 plan for future taxable (non-qualified) or nontaxable (qualified) purposes. Although the Institute does not take a position on which is the correct interpretation, the industry is currently approaching recontributions inconsistently and this has potential to cause confusion for investors as they encounter these differences. In the event that you do not agree with treating the refund as a new contribution (CSPN’s position), then we request guidance on three questions related to the treatment of recontributed amounts, as described in detail below.

(A) Application of Limit on Investment Changes

Under Code section 529(b)(4), an account owner may not exchange amounts (any contributions and any earnings thereon) from his current investment option(s) to a different option(s) more than twice in any calendar year.⁵ The result of exceeding this limit is disqualification of the program as a 529 plan.

³ See Letter from Hon. Young Boozer, CSPN Chair, to the IRS, dated January 20, 2017.

⁴ See Proposed Treasury Regulation § 1.529-1(c) for definition of “contribution,” distinguishing between treatment of new contribution and a tax-free rollover. “Contribution means any payment directly allocated to an account for the benefit of a designated beneficiary or used to pay late fees or administrative fees associated with the account. In the case of a tax-free rollover, within the meaning of this paragraph (c), into a QSTP account, only the portion of the rollover amount that constituted investment in the account, within the meaning of this paragraph (c), is treated as a contribution to the account as required by § 1.529-3(a)(2).”

⁵ A change in investment strategy is also permitted upon a change in the designated beneficiary of the account. See IRS Notice 2009-01.

In the case of a recontribution of a refunded amount, if the recontribution is directed into a different investment option than when it was distributed, then the IRS could view this transaction as counting as one investment change for purposes of applying this limit. This potential treatment may be viewed as appropriate if the purpose of the recontribution is essentially to “unwind” the various transactions and put the account owner in the same position as he would be in had the distribution of the refunded amount not been taken. It is not clear, however, if the IRS would require the application of the rules in this manner. For example, if the account owner had previously made two investment changes in the year of the distribution, must he be required to select the investment options used prior to the distribution? This question would not arise if the recontribution is treated as a new contribution, because the limitation on investment changes does not apply to investment changes made to future contributions.

(B) Treatment as Earnings in Absence of Documentation

If a student receives a refund of qualified education expenses that were paid by a distribution from a 529 plan, the student can recontribute this amount into any 529 plan for which he or she is the beneficiary.⁶ If an amount is recontributed to a 529 plan with a different plan administrator from the plan from which the distribution was taken, the plan administrator must rely on the account owner to provide a statement issued by the distributing 529 program, showing the earnings portion of the distribution, so that the principal and earnings may be properly recorded. Absent such records, the plan administrator would not have the ability to determine the amount that is required to be treated as earnings. Please confirm that until a 529 plan administrator (other than the administrator of the 529 plan from which the distribution was made) receives such documentation from the account owner with respect to a recontribution, it may treat the entire recontribution as earnings. Note that this mirrors the treatment in the case of a “60-Day rollover.”⁷ This question would not arise if the recontribution is treated as a new contribution, because no portion of the recontributed amount would be characterized as earnings.

⁶ See IRS Publication 970 at p. 60.

⁷ See IRS Notice 2001-81. “Until the § 529 program receives appropriate documentation showing the earnings portion of the contribution, the program must treat the entire amount of the contribution as earnings in the § 529 account receiving the distribution. For this purpose, “appropriate documentation” means: ... (3) in the case of a rollover contribution from another § 529 program, a statement issued by the distributing § 529 program that shows the earnings portion of the distribution). See also Proposed Treasury Regulation § 1.529-3(a)(2). [Rollover distributions. No part of a rollover distribution is included in the income of the distributee. Following the rollover distribution, that portion of the rollover amount that constituted investment in the account, defined in § 1.529-1(c), of the account from which the distribution was made is added to the investment in the account of the account that received the distribution. That portion of the rollover amount that constituted earnings of the account that made the distribution is added to the earnings of the account that received the distribution.”

(C) Recontribution of Amounts Distributed from Multiple Plans or Accounts

A beneficiary may have multiple 529 plan accounts. When a beneficiary receives distributions from more than one 529 plan and then receives a refund of qualified education expenses relating to those distributions, processing the recontribution will be more complex. It would be helpful for IRS and Treasury to establish a default rule to apply in this situation and to permit the plan administrator to override the default rule by relying on specific instructions from the account owner. Our preferred default approach would be that the plan administrator is to start with the most recent distribution and work backwards, until the entire recontribution amount is accounted for. Establishing this default would provide helpful guidance while preserving flexibility. Like the two previous questions, this question would not arise if the recontribution is treated as a new contribution, because there would not be a need to tie the recontribution to the previous distributions.

Transition Period

Given that programming for 529 plan systems is based on states' and providers' current interpretations on how the PATH Act should be implemented, we request that any guidance issued by IRS and Treasury would only be required to apply prospectively, applicable for the next reporting season.

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The Institute appreciates your consideration of our comments. If you have any questions or wish to discuss these issues further, please do not hesitate to contact me at (202) 326-5809 or shannon.salinas@ici.org.

Sincerely,

/s/ Shannon N. Salinas

Shannon N. Salinas
Assistant General Counsel – Retirement Policy

cc: Catherine V. Hughes, Attorney-Advisor
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