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May 31, 2007

Eric Solomon
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
Room 3104
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Donald L. Korb
Chief Counsel
Internal Revenue Service
Room 3026
1111 Constitution Avenue, NW
Washington, DC 20224

RE: 2007-2008 Business Plan Suggestions

Dear Assistant Secretary Solomon and Chief Counsel Korb:

The Investment Company Institute (the "Institute")¹ is pleased to submit recommendations for projects to be included on the 2007-2008 Guidance Priority List. Our recommendations cover three categories: (1) issues for regulated investment companies ("RICs") and their shareholders; (2) education savings issues; and (3) retirement security issues. Within each category, we describe (i) items requested by the Institute that were included in the 2006-2007 Guidance Priority List but have not yet been issued or finalized, and (ii) items that we request be included in the new guidance priority list.

I. Issues for Regulated Investment Companies and their Shareholders

A. 2006-2007 Guidance Priority List Items

The Institute requests that the remaining items on the 2006-2007 Guidance Priority List relating to RICs be issued as promptly as possible. Most importantly, we request guidance clarifying the application of section 1(h) to RIC capital gain dividends² and addressing similar bifurcation-related issues arising under section 871(k)(2), which permits flow-through of short-term capital gain dividends.³

¹ ICI members include 8,826 open-end investment companies (mutual funds), 666 closed-end investment companies, 398 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$10.634 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

² See Institute letter to Alice Bennett dated May 24, 2006.

³ Specifically, this rule provides that the amount of distributions that a RIC may designate as short-term capital gain dividends to its foreign shareholders is not reduced by short-term capital losses or net capital losses arising after October 31

We note that other items on the 2006-2007 Guidance Priority List continue to be of interest to our members. These items include (i) finalizing the regulations that will clarify that RICs flowing through foreign tax credits to their shareholders under section 853 need not report foreign tax credit information on a country-by-country basis, and (ii) issuing final regulations on notional principal contracts.⁴

B. 2007-2008 Guidance Priority List Items

The Institute also requests that the IRS and Treasury include the following items on the 2007-2008 Guidance Priority List.

First, we request guidance providing a *de minimis* rule for preferential dividends paid by publicly-offered RICs. Section 562(c) provides that a RIC dividend distribution is treated as a preferential distribution unless (1) the distribution is pro rata, (2) the distribution is made with no preference to any share as compared with other shares of the same class, and (3) the distribution is made with no preference to one class of stock as compared with another class except to the extent that the former is entitled to such preference. There are cases, however, in which mathematical, computer, or other processing errors may cause a RIC to unintentionally pay a dividend to shareholders in one or more classes that is more or less than they are entitled to receive. For example, a mathematical error may cause a shareholder class to pay more in expenses than it should, reducing the shareholders' distributions. Alternatively, a processing error may result in the distribution amounts for two or more shareholder classes being allocated to the wrong classes. Even though these distribution errors are generally very small (*e.g.*, a few cents per share or less), they create a preferential dividend issue and thus may affect the RIC's dividends paid deduction. Further, it is not clear that RICs are able to correct those mistakes by making an additional distribution to the affected taxpayers, because the correcting distribution itself arguably would be a preferential dividend. A *de minimis* rule would allow RICs to easily resolve these minor and unintentional mistakes.

Second, we request additional guidance regarding issues relating to excess inclusion income of a real estate investment trust ("REIT") that is a taxable mortgage pool ("TMP") or that has a qualified REIT subsidiary that is a TMP. Notice 2006-97 sets forth a number of tax and reporting requirements for REITs, RICs, nominees, and other pass-through entities that receive excess inclusion income from a

of the RIC's taxable year. To the extent provided in regulations, this rule also applies for purposes of determining the RIC's taxable income.

⁴ See Institute letter to Greg F. Jenner and Donald L. Korb dated September 25, 2003. Our letter recommended that marks under the elective mark-to-market method, as well as value payments under the noncontingent swap method, be treated as resulting in capital gain or loss. We also suggested that credit default swaps and certain short-term swaps should be excluded from the modified noncontingent swap method and the mark-to-market election. We requested additional guidance on determining whether a payment is "significant." We also commented on several technical issues, most importantly on the need for RICs to treat adjustments to income attributable to a redetermination or a mark-to-market arising after October 31 of a taxable year as arising on the first day of the following taxable year. Finally, we suggested that the proposed regulations should be made entirely prospective upon promulgation of final regulations.

real estate mortgage investment conduit (“REMIC”) residual interest or a REIT TMP. Additional guidance and clarification of the reporting and withholding requirements in the Notice are needed, however, to prevent shareholder confusion and reduce administrative burdens on shareholders, RICs, and the government.⁵

Third, to the extent not covered by the existing guidance project under section 382, we request that a project be opened to amend the regulations under sections 382 and 383 with respect to ownership tracking requirements that apply to participant-directed retirement accounts holding RIC shares and to variable insurance products.⁶ These rules were created to limit tax-motivated acquisitions of corporations with favorable tax attributes, such as loss carryforwards. These concerns are not implicated when a RIC’s new shareholders are retirement accounts or variable insurance product accounts that cannot benefit from such tax attributes. Specifically, the regulations should permit a RIC to look through participant-directed retirement accounts and variable insurance product account owners and treat each participant/investor who holds less than five percent of the RIC’s shares as part of the RIC’s direct public group. This change would effectively prevent a large collection of small investors making independent investment decisions from being treated as a single entity for ownership change purposes. Absent this change, a retirement plan administrator’s decision as to what RICs to offer in a plan could significantly affect whether other shareholders in the RIC can benefit from the RIC’s capital losses even though the retirement plan administrator is neither a beneficial owner of RIC shares nor responsible for allocating investment assets among RICs. Likewise, absent this change, an ownership change could occur if the insurance company holding the variable insurance product shares is bought by another company.

Fourth, we request guidance regarding RIC investments in a partnership in which the RICs and the partnership have different tax years. In general, partners must take partnership items into account at the end of the partnership’s tax year. If a RIC invests in a partnership with a different tax year, however, this can cause mismatches between the RIC’s distributions and the amount of earnings and profits associated with the partnership’s income. Guidance allowing RICs to take partnership items into income at the end of each month, rather than at year-end, would resolve these issues.

⁵ See Institute letter to Lon B. Smith dated December 29, 2006. Our letter asked that Notice 2006-97 be applied prospectively only, and that it not be effective until some reasonable period after a workable reporting regime is implemented.

⁶ This item and the following items regarding distressed debt and passive foreign investment companies involve issues or sections of the Code that are generally described in the current guidance priority list. It is unclear whether the general descriptions from last year’s list envisioned the specific issues described above. We have included these issues as items for the 2007-2008 Guidance Priority List to clarify our request that last year’s items be broadened, if necessary, to cover these specific issues.

Fifth, we request guidance regarding a RIC (“RIC 1”) that invests in another RIC (“RIC 2”) that either distributes exempt-interest dividends⁷ or flows through foreign tax credits.⁸ Specifically, we ask that RIC 1 be permitted to look through to the underlying assets of RIC 2 to determine whether RIC 1 has met its statutory requirement to invest at least 50 percent of the value of its total assets in bonds exempt under section 103 (for exempt-interest dividend purposes) or in stock or securities in foreign corporations (for foreign tax credit purposes).

Sixth, we request that the upcoming business plan include a project that specifically addresses the tax treatment of distressed debt to the extent these issues are not addressed under the current business plan item relating to interest accruals on non-performing loans. In some cases, it is unclear how the existing original issue discount and market discount rules should apply to severely distressed, and speculative, debt. In other cases, as noted in treatises and bar association submissions, application of these rules creates what many believe to be inappropriate results.⁹

Finally, we request additional guidance regarding passive foreign investment companies (“PFICs”). The preamble to the final PFIC mark-to-market regulations (TD 9123) published on April 29, 2004, notes in three places that comments received relating to the impact of the PFIC rules on RICs were beyond the scope of that regulations project.¹⁰ We request that a regulations project be opened to address these and other PFIC-related issues to the extent they are not encompassed by the current guidance project on PFICs.

II. Education Savings Issues

The 2006-2007 business plan included a guidance project regarding section 529 qualified tuition programs (“section 529 plans”). It remains important, for those saving for education through section 529 plans, that the tax treatment of investments in such plans be clear.¹¹ If the Service determines that legislation is necessary to resolve some issues, we urge the Service to continue work on the guidance project with respect to the remaining issues.

⁷ Pursuant to section 852(b)(5), where at least 50 percent of the value of the total assets of a RIC consists of tax-exempt obligations, a RIC may designate its distributions attributable to interest earned on bonds exempt from tax under section 103 as exempt-interest dividends.

⁸ Pursuant to section 853, where more than 50 percent of the value of the total assets of a RIC consist of foreign stock or securities, a RIC may elect to treat its shareholders as having paid directly any foreign taxes paid on the foreign-source income (by grossing up the dividend for the amount of such taxes and flowing through the foreign tax credit).

⁹ See, e.g., Letter of May 15, 1991, from Jere D. McCaffey to Fred T. Goldberg, Jr. (transmitting comments prepared by members of the American Bar Association’s Section of Taxation on the application of market discount rules to speculative bonds).

¹⁰ See Institute comment letter, dated November 22, 2002, and Institute letter to Dale S. Collinson, dated April 24, 2003, for the Institute’s comments that were determined to be beyond the scope of the regulations project.

¹¹ See Institute comment letter, dated March 22, 2002.

III. Retirement Security Issues

A. 2006-2007 Guidance Priority List Items

The Service should promptly finalize the proposed regulations under section 403(b), including the proposed regulation for designated Roth accounts in section 403(b) plans.¹² This matter remains from the 2006-2007 Guidance Priority List. If these regulations are not finalized by the end of the 2006-2007 business plan year, we urge the Service to postpone the general effective date of the final regulations (currently set for January 1, 2008) so that employers and providers have sufficient time to implement changes to their arrangements and systems.

B. 2007-2008 Guidance Priority List Items

The Institute requests that the Service add the following retirement security matters to the 2007-2008 Guidance Priority List. First, we request that the Service update the safe harbor language under section 402(f) to reflect changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). EGTRRA implemented a new automatic rollover provision and requires that 402(f) notices explain the effect of the automatic rollover rules. Although Notice 2005-5 provides guidance on automatic rollovers, the Service has not yet updated Notice 2002-3's model 402(f) safe harbor language. The revised 402(f) notice should include an explanation of rollover options available with respect to designated Roth contribution accounts. Because the automatic rollover rules and designated Roth contribution rules are already in effect, updated 402(f) language is needed now to allow for the proper administration of rollover distributions, especially for plans with mandatory distribution provisions and designated Roth accounts.

Second, we request guidance under section 402(c)(11) confirming that a non-spouse beneficiary of a designated Roth account may roll over the distribution into an inherited Roth IRA. Section 829 of the Pension Protection Act of 2006 (PPA) amended section 402(c) to permit non-spouse beneficiary rollovers into inherited IRAs. Because section 402(c)(11) (as amended) does not specifically mention Roth IRAs and section 829 of the PPA did not amend the designated Roth account rules in section 402A, confusion exists as to whether Roth balances are eligible for rollover by non-spouse beneficiaries. Confirmation from the Service that non-spouse beneficiaries may roll over designated Roth account balances into inherited Roth IRAs is important to eliminate potentially inconsistent practices within the pension community. Without such confirmation, some plan sponsors and service providers may determine not to allow rollovers from a plan to an inherited Roth IRA.

Third, we request amended regulations under section 411(a)(11) (and guidance revising Notice 2007-7), regarding the description of a participant's right to defer a distribution. Section 1102(b) of the PPA directs the Secretary to modify Treasury Regulation section 1.411(a)-11 to provide that the description of a participant's right to defer a distribution must also include a description of the

¹² See Institute comment letter, dated February 14, 2005; and Institute comment letter, dated April 26, 2006.

consequences of failing to defer receipt of a distribution. Although section 1102 is effective for years beginning after 2006, the PPA provides that a plan will not be treated as failing to meet the new requirements if the plan administrator makes a reasonable attempt to comply during the period ending 90 days after the issuance of revised regulations under section 411. In Notice 2007-7, the Service provided a safe harbor method for making a reasonable attempt to comply with the new rules under PPA section 1102(b). Under the safe harbor, the description must indicate the investment options available under the plan (including fees) that will be available if distributions are deferred (in the case of a defined contribution plan) and include the portion of the summary plan description that contains any special rules that might materially affect a participant's decision to defer. This formulation requires much greater plan-specific detail than was previously provided in the notice under section 411(a)(11). Consequently, significant changes to the systems that generate these notices will be necessary. The information required under this formulation also is duplicative of information already provided to participants. We urge the Service to retract the safe harbor interpretation expressed in Notice 2007-7 and issue a notice of proposed rulemaking with opportunity for comment.

Fourth, the Institute requests guidance on various issues relating to automatic enrollment arrangements, as described in section 902 of the PPA. These issues are as follows:

Model Notice

The safe harbor for qualified automatic contribution arrangements in section 401(k)(13) requires written notice to each employee eligible to participate in the arrangement, within a reasonable period before each plan year. The notice must describe the employee's rights and obligations under the arrangement, including the right not to have elective contributions made on the employee's behalf and how contributions will be invested absent instructions from the employee. Section 414(w), as added by the PPA, requires a similar notice for purposes of meeting the requirements for a permissible withdrawal from an eligible automatic contribution arrangement. We request that the Service provide a model notice for purposes of satisfying these requirements.

Permissible Withdrawals

Section 414(w) allows an employee to withdraw amounts contributed under an eligible automatic contribution arrangement no later than 90 days after the date the first elective contribution is made on behalf of the employee. The distribution must equal the amount of elective deferrals made before the election to withdraw, plus any earnings attributable to those contributions. We request guidance on when the 90-day period begins to run; *e.g.*, the date money is withheld from an employee's paycheck, the date money is contributed to the plan, or some other date. We also request guidance on the tax reporting requirements for permissible withdrawals.

Fifth, we request guidance on the proper tax treatment of escheated amounts from qualified plans. In 2004, the Department of Labor ("DOL") issued guidance regarding missing participants in

terminating defined contribution plans.¹³ The DOL guidance requires that a plan administrator use certain search methods to locate a missing participant. If all efforts to locate the missing participant fail, the DOL provides, then the fiduciary should consider distributing the amounts to a federally insured bank account or escheating them to a state unclaimed property fund. The requested 2006-2007 business plan guidance should address certain federal tax implications of escheatment, including (1) whether Form 1099-R reporting is required, (2) whether payors should designate amounts as escheated and, if so, how payors should make such a designation, and (3) whether withholding is required.

Sixth, we request guidance complementing the DOL's recent final regulations on the termination of abandoned plans.¹⁴ This guidance should implement language in the preamble to the DOL's regulations that the Service will not challenge the qualified status of any plan termination under the DOL's regulations or take any adverse action against a "qualified termination administrator" (the party that assumes responsibility for plan distributions and termination), the plan, or any participant or beneficiary of the plan as a result of the termination, provided that several conditions are met.¹⁵ The guidance also should clarify how parties other than a participant can establish IRAs for abandoned plan accounts;¹⁶ under the DOL's regulations, IRAs for abandoned plan participants could be established by default — without the participant's involvement — in a manner similar to IRAs established under the automatic rollover rules of EGTRRA.

Finally, the Institute requests guidance adopting a more uniform approach for providing future disaster relief. In response to Hurricanes Katrina, Rita and Wilma, the Service issued an extensive array of tax relief in the form of various notices, announcements and news releases explaining the relief provided to hurricane victims, the applicable time-periods and the covered areas. As the scope and severity of the devastation unfolded, additional rounds of guidance were issued to expand the types of acts for which relief is provided and to further extend deadlines announced in earlier guidance.

The authority for postponing tax-related deadlines in the event of a Presidentially declared disaster is set forth in Code section 7508A. That provision permits a postponement of up to one year for the performance of certain time-sensitive taxpayer and governmental acts. Revenue Procedure 2005-27 lists some of the acts that may be postponed under section 7508A. In the case of a disaster (or terrorist or military action), relief is not automatically provided under Rev. Proc. 2005-27. Instead,

¹³ U.S. Department of Labor, Employee Benefits Security Administration, Field Assistance Bulletin No. 2004-02, dated September 30, 2004.

¹⁴ 71 Fed. Reg. 20820 (April 21, 2006).

¹⁵ These conditions are as follows: (1) the qualified termination administrator reasonably determines whether, and to what extent, the survivor annuity requirements of sections 401(a)(11) and 417 apply to any benefit payable under the plan; (2) each participant and beneficiary must have a non-forfeitable right to the benefit as of the deemed termination date, subject to income, expenses, gains, and losses between that date and the distribution date; and (3) participants and beneficiaries must receive notification of their rights under section 402(f).

¹⁶ See Notice 2005-5; Institute Letter to the U.S. Department of Labor, dated March 10, 2003.

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relief is provided only if the Service issues additional guidance that provides specific relief for that particular disaster (or terrorist or military action). With respect to military service in a combat zone or contingency operation, however, all of the taxpayers acts listed in Rev. Proc. 2005-27 are automatically extended even if the Service does not issue any additional guidance.

To adopt a more uniform approach for disaster relief like that used for combat zone service, Rev. Proc. 2005-27 could be modified to provide automatic postponement of all listed acts for a specified period of time (such as 1 year) for all taxpayers in a Presidentially-declared disaster area. This would eliminate the need for additional guidance specifying the particular acts postponed, the postponement period and the covered area.

In addition, the Service should consider compiling all of the acts that may be postponed following a disaster into a single pronouncement (such as Rev. Proc. 2005-27). Listing all of the acts that may be postponed in a single place will reduce confusion and help clarify which acts are postponed following a disaster. Moreover, if the complete list of acts is contained in guidance outside of the Code or regulations, the Service could easily modify the list in the future to add or remove specific acts.

* * *

If we can provide you with any additional information regarding these issues, please do not hesitate to contact the undersigned at 202/326-5800.

Sincerely,

/s/ Mary Podesta

/s/ Keith Lawson

Mary Podesta
Senior Counsel – Pension Regulation

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