Part III. Administrative, Procedural, and Miscellaneous

Section 529—Programs

Notice 2001–55

This notice provides guidance to qualified tuition programs described in § 529 of the Internal Revenue Code and participants in § 529 programs regarding the restriction on investment direction described in § 529(b)(5). This notice sets forth a special rule under which a program may permit investments in a § 529 account to be changed annually, and upon a change in the designated beneficiary of the account.

Section 529(b)(5) states that a program shall not be treated as a § 529 program unless it provides that any contributor to, or designated beneficiary under, such program may not directly or indirectly direct the investment of any contributions to the program (or any earnings thereon). The proposed regulations under § 529, which were published in the Federal Register on August 24, 1998 (63 F.R. 45019), provide that a program does not violate this requirement if it permits a person who establishes a § 529 account to select among different investment strategies designed exclusively by the program, only at the time when the initial contribution is made establishing the account. Prop. Treas. Reg. § 1.529–2(g).

Several commenters on the proposed regulations suggested that permitting a participant in a § 529 program to select among various broad-based investment strategies offered by a program, both at the time that contributions are made, and at certain other times, would be consistent with § 529(b)(5). For example, these commenters suggested that it would be appropriate to allow a change in the investment strategy selected for an account where there has been a significant change in market circumstances since the account was initially established, where there is a change in the designated beneficiary of an account (as permitted under § 529(c)(3)(C)) and the new beneficiary has a different expected matriculation date, or where the program establishes new investment options.

The Internal Revenue Service and the Treasury Department recognize that there are a number of situations that might warrant a change in the investment strategy with respect to a § 529 account. Accordingly, the Internal Revenue Service and the Treasury Department expect that the final regulations under § 529 will provide that a program does not violate § 529(b)(5) if it permits a change in the investment strategy selected for a § 529 account once per calendar year, and upon a change in the designated beneficiary of the account. It is expected that the final regulations will also provide that, to qualify under this special rule, a program must (1) allow participants to select only from among broad-based investment strategies designed exclusively by the program; and (2) establish procedures and maintain appropriate records to prevent a change in investment options from occurring more frequently than once per calendar year or upon a change in the designated beneficiary of the account. The Internal Revenue Service and the Treasury Department believe that permitting a change in investment options once per calendar year, and upon a change in designated beneficiary should provide sufficient flexibility to address concerns raised by commenters.

Section 529 programs and their participants may rely on this notice pending the issuance of final regulations under § 529.

The Internal Revenue Service invites comments on the matter described in this notice and any other comments relating to § 529, including the amendments made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107–16, 115 Stat. 38). Please send written comments by December 24, 2001, to: CC:ITA:RU (Notice 2001–55), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submission may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (Notice 2001–55), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at *http://www.irs.gov/prod/tax_regs/regslist.html*. Comments will be available for public inspection.

DRAFTING INFORMATION

The principal author of this notice is Monice Rosenbaum of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Rosenbaum at (202) 622-6070 (not a toll-free number).

Weighted Average Interest Rate Update

Notice 2001–58

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for August 2001 is 5.48 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
September	2001	5.77	5.20 to 6.06	5.20 to 6.35

(2) Automatic change to section 1.162–3. A qualifying taxpayer that does not want to account for inventories under § 471 of an eligible trade or business must make any necessary change from the taxpayer's current method of accounting for inventoriable items in that trade or business to treat such inventoriable items in the same manner as materials and supplies that are not incidental under section 1.162–3. For purposes of such a change, the rules of section 6.02(1) of this revenue procedure apply. Taxpayers may file a single Form 3115 for both changes described in sections 7.02(1) and 7.02(2).

.03 Section 481(a) adjustment. The net amount of the § 481(a) adjustment computed under this revenue procedure must take into account both increases and decreases in the applicable account balances such as accounts receivable, accounts payable, and inventory. For example, the § 481(a) adjustment may include the difference resulting from changing from taking inventory accounts under § 471 to treating the goods as materials and supplies that are not incidental under § 1.162–3.

.04 Taxpayers not within the scope of this revenue procedure. A taxpayer that ceases to qualify for the qualifying small business taxpayer exception described in section 4 of this revenue procedure for any trade or business and otherwise is required to use an accrual method for that trade or business must change to an accrual method (and, if applicable an inventory method that complies with § 471) for that trade or business using either the automatic change in accounting method provisions of section 5.01 of the APPENDIX to Rev. Proc. 99–49, if applicable, or the advance consent provisions of Rev. Proc. 97–27 (1997–1 C.B. 680) (or its successor).

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99–49 (1999–2 C.B. 725) is modified and amplified to include this automatic change in section 10 of the APPENDIX.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2001. However, the Service will not challenge a taxpayer's use of the cash method under § 446, or a taxpayer's failure to account for inventories under § 471, for a trade or business in an earlier year if the taxpayer, for that year, was a qualifying small business taxpayer as described in section 3 of this revenue procedure and the taxpayer was eligible to use the cash method for such trade or business under section 4.01 of this revenue procedure.

CONTACT INFORMATION

For further information regarding this revenue procedure, contact Cheryl Lynn Oseekey of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4970 (not a toll-free call).

Weighted Average Interest Rate Update

Notice 2001–80

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act. Pub. L. 103–465 (GATT).

The average yield on the 30–year Treasury Constant Maturities for November 2001 is 5.12 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
December	2001	5.72	5.15 to 6.01	5.15 to 6.29

DRAFTING INFORMATION

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please call Mr. Newman at (202) 283–9888 (not a toll-free number).

Section 529 Programs

Notice 2001–81

This notice provides guidance regarding certain recordkeeping, reporting, and other requirements applicable to qualified tuition programs described in § 529 of the Internal Revenue Code, in light of certain amendments made to § 529 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107–16, 115 Stat. 38) (EGTRRA).

Among other changes to § 529, EGTRRA: (1) expands the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions; (2) provides an exclusion from gross income for distributions from a State § 529 program (and, beginning in 2004, a prepaid tuition program established and maintained by one or more eligible educational institutions) which are used to pay for qualified

higher education expenses of the designated beneficiary; (3) repeals the requirement that a § 529 program impose a more than *de minimis* penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary; and (4) replaces that penalty with an additional 10–percent tax on the amount of a distribution from a § 529 program that is includible in gross income (with certain exceptions). In general, these amendments are effective for taxable years beginning after December 31, 2001.[1]

In light of these changes, and to give § 529 programs adequate time to implement appropriate recordkeeping and reporting procedures, the Internal Revenue Service and the Treasury Department are issuing this guidance, which they intend to incorporate in final regulations under § 529. Section 529 programs and their participants may rely on this notice pending the issuance of final regulations under § 529.

a. Imposition of a penalty and verification of purpose of a distribution.

As currently in effect (prior to the effective date of EGTRRA), § 529(b)(3) provides that a program is not treated as a qualified § 529 program unless it imposes a more than *de minimis* penalty on any refund of earnings that is not: (a) used for qualified higher education expenses of the designated beneficiary; (b) made on account of the death or disability of the designated beneficiary; or (c) made on account of certain scholarships or other educational assistance received by the beneficiary. Prop. Treas. Reg. § 1.529–2(e) provides rules on *de minimis* penalties and procedures for verifying the use of distributions and imposing and collecting penalties.

EGTRRA repeals § 529(b)(3), effective for taxable years beginning after December 31, 2001. Therefore, the final regulations under § 529 will provide that, with respect to any distributions made after December 31, 2001, a § 529 program will no longer be required to verify how distributions are used or to collect any penalty. However, with respect to any distributions made on or before December 31, 2001, a § 529 program must continue to verify whether the distribution is used for qualified higher education expenses of the beneficiary and to collect a more than *de minimis* penalty on nonqualified distributions.

b. Reporting of distributions.

Section 529(d) provides that a § 529 program shall make reports regarding the program to the Internal Revenue Service and to designated beneficiaries regarding contributions, distributions, and such other matters as the Internal Revenue Service may require. 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 distribution made during the year, together with other information such as the name, address and TIN of the distributee. A § 529 program must furnish a statement to the distributee on or before January 31st of the year following the calendar year in which the distribution is made. In addition, a § 529 program must file Form 1099–G on or before February 28th of the year following the calendar year in which the distribution is made.

These reporting requirements continue in effect for distributions made in 2001. Thus, with respect to any distributions made in 2001, a § 529 program must furnish statements to the distributees on or before January 31, 2002, and file returns on Form 1099–G on or before February 28, 2002.

In light of the expansion of § 529 to include prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions), the Internal Revenue Service will issue a new form, Form 1099–Q, for taxable years beginning after December 31, 2001. A copy of Form 1099–Q is available on the IRS website at *www.irs.gov*.

c. Calculation of earnings.

1. In general.

Section 529(c)(3)(A) provides that a distribution from a § 529 program is includible in the gross income of the distributee in the manner as provided under § 72, to the extent not excluded from gross income under any other provision of Chapter 1 of the Code. Section 529(c)(3)(D)(iii) provides that, except to the extent provided by the Secretary, the value of the contract, income on the contract, and the investment in the contract are to be computed as of the close of the calendar year.

2. Recordkeeping requirements with respect to rollover contributions.

Section 529(b)(3)[2] states that a program must provide a separate accounting for each designated beneficiary. 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.

In the case of a contribution to a § 529 account that represents a transfer from a Coverdell education savings account described in § 530(b)(2)(B), a transfer of proceeds of a qualified U.S. Savings Bond described in § 135(c)(2)(C), or a "rollover" of amounts from another § 529 program account (each, a "rollover contribution"), the recipient § 529 program must determine the basis and earnings portions of the amounts contributed. (See Prop. Treas. Reg. § 1.529–3(a)(2), which provides that the earnings portion of the rollover amount must be added to the earnings of the account that received the contribution.)

Although this requirement was not changed by EGTRRA, § 529 programs have indicated that there is some confusion about the requirement that a § 529 program determine and maintain records that reflect the basis and earnings portions of any rollover contribution. Accordingly, it is expected that final regulations will clarify that, when accepting a contribution, a § 529 program must ask whether the contribution is a rollover contribution from a Coverdell education savings account, a qualified U.S. Savings Bond, or another § 529 program. If the contribution is a rollover contribution, the § 529 program must determine the earnings portion of the contribution, and add that amount to the earnings recorded in the account to which the rollover contribution

[1] Unless otherwise indicated, references herein are to § 529 of the Internal Revenue Code, as amended by EGTRRA.

[2] Section 529(b)(4) was renumbered as § 529(b)(3) by EGTRRA.

is made. 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: (1) in the case of a rollover contribution from a Coverdell education savings account, an account statement issued by the financial institution that acted as trustee or custodian of the education savings account that shows basis and earnings in the account; (2) in the case of a rollover contribution from the redemption of qualified U.S. Savings Bonds, an account statement or Form 1099-INT issued by the financial institution that redeemed the bonds showing interest from the redemption of the bonds; and (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.

3. Rollover statement between § 529 programs.

In the case of any direct transfer (*i.e.*, trustee-to-trustee rollover) between § 529 programs, the distributing program must provide to the receiving program a statement setting forth the earnings portion of the rollover distribution within 30 days after the distribution or by January 10th of the year following the calendar year in which the rollover occurred, whichever is earlier. This rule is effective for direct transfers between § 529 programs that occur on or after January 1, 2002.

4. Timing of earnings calculation.

Consistent with § 529(c)(3)(D), the proposed regulations provide that the earnings portion of any distribution is determined by applying an earnings ratio, generally the earnings allocable to an account as of the close of the year divided by the total account balance as of the close of the calendar year, determined by adding back the amount of all distributions made during the year. See Prop. Treas. Reg. § 1.529–1(c).

In response to comments received on the proposed regulations, and consistent with the Secretary's authority under § 529(c)(3)(D)(iii) to adopt a different rule, the Treasury Department and the Internal Revenue Service expect that final regulations will revise the time for determining the earnings portion of any distribution from a § 529 account. It is expected that final regulations will provide that, effective for distributions made after December 31, 2002, programs will be required to determine the earnings portion of each distribution as of the date of distribution. In the case of direct transfers between § 529 programs, this requirement is effective for distributions made after December 31, 2001. In the case of any State program for which this change would require legislation and whose State legislature has a biennial legislative session, the program will have until January 1, 2004, to conform to this method of calculating earnings.

5. Aggregation of Accounts.

Section 529(c)(3)(D)(i) provides that to the extent provided by the Secretary, all § 529 programs of which an individual is a designated beneficiary shall be treated as one program. Prop. Treas. Reg. § 1.529–3(d) provides that all accounts maintained by a § 529 program for the benefit of a designated beneficiary shall be treated as a single account for purposes of calculating the earnings portion of any distribution. Based on comments received on the proposed regulations, it is expected that the final regulations will provide that only accounts maintained by a § 529 program and having the same account owner and the same designated beneficiary must be aggregated for purposes of computing the earnings portion of any distribution. For this purpose, a State that has both a prepaid § 529 program and a § 529 savings program should consider each program separately for purposes of calculating the earnings portion of any distribution from either the prepaid or the savings program. These changes will apply for purposes of the earnings calculation only, and will not affect the application of § 529(b)(6) (prohibition on excess contributions)[3]. The § 529(b)(6) limit will continue to be applied based upon all accounts, both savings and prepaid, in programs established and maintained by the State for the benefit of the same designated beneficiary.

Comments on Future Guidance Invited

The Internal Revenue Service invites comments on the matters described in this notice and any other matters relating to § 529 and the regulations thereunder. Please send written comments by March 25, 2002, to: CC:ITA:RU (Notice 2001–81), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submission may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (Notice 2001–81), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at *http://www.irs.gov/prod/tax_regs/regslist.html*. Comments will be available for public inspection.

DRAFTING INFORMATION

The principal author of this notice is Monice Rosenbaum of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Rosenbaum at (202) 622–6070 (not a toll-free number).

Expansion of Safe Harbor Provisions Under Notice 88–129

Notice 2001–82

PURPOSE

This notice amplifies and modifies Notice 88–129 (1988–2 C.B. 541) as modified and amplified by Notice 90–60 (1990–2 C.B. 345). Notice 88–129 provides that a regulated public utility (utility) will not realize income upon transfers of interties from qualifying small power

[3] Section 529(b)(7) was renumbered as § 529(b)(6) by EGTRRA.