

MEMO# 7599

February 2, 1996

BACKUP WITHHOLDING REGULATIONS FINALIZED

1 See, e.g., Institute Memorandum to Tax Members No. 44-90, Operations Members No. 31-90, Closed- End Fund Members No. 41-90, Unit Investment Trust Members No. 67-90 and Transfer Agent Advisory Committee No. 38-90, dated October 12, 1990. 2 See, e.g., Institute Memorandum to Tax Committee No. 3-91, Operations Committee No. 4-91, Closed-End Fund Committee No. 3-91, Unit Investment Trust Committee No. 7-91 and Transfer Agent Advisory Committee No. 5-91, dated February 11, 1991. February 2, 1996 TO: TAX MEMBERS No. 5-96 OPERATIONS MEMBERS No. 5-96 CLOSED-END FUND MEMBERS No. 2-96 UNIT INVESTMENT TRUST MEMBERS No. 5-96 TRANSFER AGENT ADVISORY COMMITTEE No. 6-96 RE: BACKUP WITHHOLDING REGULATIONS FINALIZED

The "backup withholding" rules of Internal Revenue Code section 3406 require various payors, including payors of interest and/or dividends, to withhold from a payee and remit as tax 31 percent of certain "reportable payments" where: (1) the payee fails to furnish his taxpayer identification number ("TIN") to the payor in the manner required (e.g., certified on IRS Form W-9) -- known as "A" withholding, because the requirement is imposed under section 3406(a)(1)(A); (2) the Internal Revenue Service ("IRS") notifies the payor that the TIN furnished by the payee is incorrect -- "B" withholding; (3) the payor has been notified that the payee has underreported interest or dividend income -- "notified payee underreporting" or "C" withholding; or (4) the payee has failed to certify that he or she is not subject to withholding due to notified payee underreporting -- "payee certification failure" or "D" withholding. Over the years, IRS has issued and reissued backup withholding regulations in proposed and in temporary form¹, and the Institute has commented on these regulations packages,² many times. 3 See Institute Memorandum to Tax Members No. 24-92, Operations Members No. 16-92, Closed-End Fund Members No. 20-92, Unit Investment Trust Members No. 26-92 and Transfer Agent Advisory Committee No. 21-92, dated April 16, 1992. IRS began finalizing these regulations in 1992, when final "B" withholding regulations were issued.³ In the attached regulations -- effective for reportable payments made and transactions occurring after December 31, 1996 -- IRS has finalized the rules for "A", "C" and "D" withholding. Payors have the option to apply the final regulations as well to reportable payments made and transactions occurring after December 21, 1995. Previously-issued temporary regulations covering backup withholding and certain other issues (sections 35a.9999-1 through 35a.9999-5) will remain effective after December 31, 1996 to the extent they apply to the due diligence safe harbor and to international transactions, including transactions involving a foreign payee, a foreign payor or a payment from sources without the United States. This memorandum summarizes many of the backup withholding rule changes that have been made by the final regulations. As these regulations are quite long and detailed, they should be reviewed carefully. 1. Notified Payee

Underreporting -- "C" Withholding A. Identifying the Account Subject to "C" Withholding. Under the "C" withholding rules, a payor receiving IRS notification that one of its payees (e.g., shareholders) has underreported interest or dividend income (a "C Notice") must implement withholding on the payees accounts. The final regulations clarify the steps that a payor must undertake to locate accounts of the payee. Specifically, payors are required to identify and withhold on those accounts with the same TIN as the one provided on the IRS "C Notice." If a payor uses a "universal account number" for all accounts of each payee, the payor must use this number in identifying the payees accounts. The final regulations also clarify that a payor with multiple computer or other recordkeeping systems need not search a given system if it is highly unlikely that the system contains an account of the payee. B. Newly Opened Accounts. Another "C" withholding issue relates to the obligations of a payor who receives a "C Notice" for a payee and subsequently receives from the payee, in connection with a new account opening, a certification of his or her TIN on IRS Form W-9. Under the final regulations, a payor who has previously received a "C Notice" for a given payee is required to impose "C" withholding on a newly opened account only if: (i) the employee/agent of the payor receiving the Form W-9 knows at the time the account is opened that the payee has untruthfully certified that he/she is not subject to withholding, (ii) the payor subsequently discovers that the payee is subject to "C" withholding on a pre-existing account with the payor, (iii) the payor uses a single Form W-9 for multiple accounts of the payee or (iv) the payor uses a universal identifier to associate all of the payees accounts, and other accounts under that universal identifier have been identified as subject to "C" withholding. C. Inclusion of Dates in the Payor's Notice to the Payee. Under the final regulations, a payor's notice to the payee informing the payee of its receipt of the IRS' "C Notice" need not inform a payee of the date on which the "C Notice" was received. Instead, the payor need only inform the payee of the date the payor started (or plans to start) backup withholding on the account(s). D. Monitoring Dormant Accounts. Under the final regulations, "C Notice" withholding terminates no later than the close of the third calendar year after the later of (i) the date that the payor pays the last reportable payment to the account or (ii) the date that the payor received the "C Notice."

2. Special Rules For Acquiring/Disposing of Readily Tradable Instruments The final regulations clarify the withholding rules for acquisitions/dispositions of "readily tradable instruments" (such as mutual fund shares) by electronic submission or mail. Under the regulations, if a payee acquiring readily tradable instruments by electronic transmission or by mail provides the payor with a TIN, but does not certify the TIN on Form W-9, a payor is required to impose backup withholding on withdrawals during the first 30 days following the accounts creation only if the payee withdraws more than 69 percent of the reportable interest or dividends paid to the payee during the relevant 30-day period and, at the time of withdrawal, the payor has not received the payees Form W-9 certifications.

3. Confidentiality Issues Another issue addressed by the final regulations relates to permissible uses by payors of tax information obtained pursuant to the TIN certification and backup withholding procedures. The final regulations clarify that a payor who closes an account at or before the end of the calendar year in which the payee opens the account, where the payee failed to provide a certified TIN, will not be deemed (in the absence of evidence to the contrary) to have impermissibly used confidential taxpayer information. The confidentiality rules will be violated, however, if a payor refuses to allow a payee to withdraw funds from the payees account solely because the payee has not furnished a TIN.

4. Exemptions From Backup Withholding A. Interaction Between Reporting and Withholding Exemptions. The final regulations clarify that the regulatory list of payees specifically exempt from backup withholding is not exclusive and that any payee exempt from information reporting is also exempt from backup withholding. B. Awaiting-TIN Certificate. Another clarification made by the final regulations relates to situations under which a payor is not required to impose

backup withholding on withdrawals made during the 60-day period following receipt by a payor of certification from a payee that he or she has requested and is awaiting a TIN (an "awaiting-TIN certificate"). So long as the payee has certified that he or she is not subject to withholding, a payor may elect to defer backup withholding during this 60-day period unless the payee makes a withdrawal of more than \$500 in one transaction. If a withdrawal of more than \$500 is made, payors must impose backup withholding to the extent of any reportable dividend and interest payments made to the account during the 60 days, unless the payee reserves 31 percent of all reportable payments made to the account during that period. The final regulations also clarify that "day" for this purpose means calendar day and not business day.

5. Other Changes

A. Joint Accounts. The final regulations clarify the application of the backup withholding rules to joint accounts by providing that the relevant payee for backup withholding purposes is the payee whose name and TIN are used by the payor for information reporting purposes, whether or not the account registration lists that payee's name first.

B. Refund of Amount Erroneously Subject to Backup Withholding. Because of certain enhancements in the IRS "C Notice" withholding program, IRS will no longer send notices to payors instructing them to refund amounts "erroneously" subject to "C" withholding. Consequently, the final regulations eliminate a requirement, contained in the proposed regulations, that a payor refund amounts previously withheld pursuant to a "C Notice" if the IRS instructs the payor to do so.

C. Correct Identifying Number for Estates. The final regulations clarify that the TIN to be used to identify estates of decedents is the employer identification number rather than a social security number. * * * * *

We will keep you informed of developments.

Keith D. Lawson Associate Counsel - Tax Attachment

Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute's Information Resource Center at (202)326-8305 or (202)326-5903, and ask for this memo's attachment number: 7599.