

MEMO# 3413

January 10, 1992

FINAL REGULATIONS ON INFORMATION REPORTING PENALTIES AND THE REASONABLE CAUSE WAIVER

January 10, 1992 TO: TAX MEMBERS NO. 2-92 OPERATIONS MEMBERS NO. 1-92 CLOSED-END FUND MEMBERS NO. 1-92 UNIT INVESTMENT TRUST MEMBERS NO. 1-92 TRANSFER AGENT ADVISORY COMMITTEE NO. 1-92 RE: FINAL REGULATIONS ON INFORMATION REPORTING PENALTIES AND THE REASONABLE CAUSE WAIVER

As we previously informed you, in February 1991, the Internal Revenue Service ("IRS") issued temporary and proposed regulations providing guidance on the information reporting penalty provisions of Internal Revenue Code sections 6721 through 6724 that were enacted in 1989. (See Institute Memorandum to Tax Members No. 6-91, Operations Members No. 7-91, Closed-End Fund Members No. 9-91, Unit Investment Trust Members No. 9-91 and Transfer Agent Advisory Committee No. 10-91, dated February 25, 1991.) Among other things, these regulations provided a very detailed definition of the new reasonable cause standard, which is the standard of care necessary to avoid the imposition of penalties for failures to file correct information returns and payee statements, the due date for which (determined without regard to extensions) is after December 31, 1989. In general, the reasonable cause standard included in the temporary and proposed regulations resolved the most significant problems that investment companies had with the due diligence standard that applied under prior law. Following issuance of the temporary and proposed regulations, the Institute filed written suggestions for improving the regulations and testified in support of these suggested changes at a public hearing. (See Institute Memoranda to Tax Committee No. 25-91, Operations Committee No. 21-91, and Transfer Agent Advisory Committee No. 36-91, dated July 31, 1991; and to Tax Committee No. 29-91, Operations Committee No. 27-91 and Transfer Agent Advisory Committee No. 41-91, dated September 12, 1991.) In general, the Institute's requested changes involved relatively technical clarifications to the reasonable cause standard. - 2 - Recently, the IRS issued the attached final regulations, effective January 1, 1990, which generally adopt the Institute's suggested changes. The following summarizes many of the changes made by the final regulations. The section of the attachment entitled "Response to Public Comments" discusses the changes made in greater detail. I. Reasonable Cause Standard As we previously informed you, the reasonable cause standard will be satisfied if the filer establishes that (1) either (a) there are significant mitigating factors for the failure, or (b) the failure arose from events beyond the filer's control, and (2) the filer acted in a responsible manner both before and after the failure occurred. Detailed rules have been provided to determine whether each of these requirements has been met. Three changes to the reasonable cause standard that were requested by the Institute have been generally adopted by the final regulations. First, the

regulations clarify that the initial solicitation requirement for a taxpayer identification number ("TIN") will be met if the account is opened by the payee's completing and mailing an application furnished by the filer that requests the payee's TIN. Second, the final regulations provide that the first annual solicitation required following notification of an incorrect TIN must be made by January 31, rather than December 31, if the filer is notified of the incorrect TIN in December. Third, annual solicitations for a TIN need not be made for any account on which two consecutive annual mailings were made by December 31, 1989, under the temporary regulations defining due diligence for accounts established prior to January 1, 1984. The final regulations make several other changes to various parts of the reasonable cause standard. First, in determining whether a filer has an established history of complying with information reporting requirements, a filer may treat various self-assessed penalties as having not been incurred, which will prevent these penalties from having a negative impact on the filer's compliance history. The regulations also modify the unavailability of relevant business records standard to provide that the filer's business records must ordinarily (but not in all cases) be unavailable for at least two weeks prior to the due date for the returns. Third, the regulations delete from the exception for actions of agents the requirement that the filer monitor the agent and require instead that the filer exercise reasonable business judgement in selecting the agent. In addition, the actions of other persons exception is clarified to include upstream payors (such as funds providing tax information to brokers) as "other persons." Fifth, with respect to the requirement that, to act in a "responsible manner", a filer must rectify a failure as promptly as possible by providing or - 3 - correcting the information return or payee statement, the final 11/ The Response to Public Comments emphasizes, however, that filers continue to be subject to penalties imposed by section 6721 with respect to these fiduciary and nominee accounts. 22/ The section 6722 regulations for failures to provide correct information statements to payees still provide, however, that "significant items in the address of a payee" are never inconsequential. 33/ The temporary regulations had limited the middle-tier \$30 penalty to information returns due on February 28. - 4 - regulations provide that a rectification is considered prompt if it is made within 30 days after the date the failure is discovered or on the earliest date thereafter on which a regular submission of corrections is made. The final regulations provide that submissions will be considered regular only if made at intervals of 30 days or less. Other changes are made by the final regulations in applying the reasonable cause standard to failures to provide correct TINs. First, the final regulations provide that if a filer receives a so-called "B" Notice on a fiduciary or nominee account, indicating that the TIN is incorrect, and the B Notice withholding rules are not being applied at that time to fiduciary and nominee accounts (as is the case currently pursuant to Treas. Reg. section 35a.3406-1(a)(3)(x)), annual solicitations to these fiduciary and nominee accounts may be made under the less burdensome solicitation requirements applicable when the filer receives a section 6721 penalty notice. 1/1 Second, the solicitation requirements are modified to delete the requirement that filers are required to send corrected information returns and statements following receipt from a payee of a TIN or a corrected TIN. II. Failures to File Correct Information Returns The final regulations make several changes to the section 6721 penalty requirements for failures to file correct information returns. First, they delete the example that appeared in the temporary regulations which suggested that an error in the payee address is never inconsequential. 2/2 Second, the final regulations modify the three-tier penalty structure contained in the temporary regulations to permit corrections of returns due on March 15, such as Form 1042S (Foreign Person's U.S. Source Income Subject to Withholding), to be eligible for the middle-tier \$30 penalty when a correction is made after 30 days after the applicable due date and before August 1. 3/3 Third, - 5 - the final regulations clarify that all information returns required to be filed during a calendar year are taken into account in calculating the number of returns subject to the

de minimis exception for penalties, regardless of whether the returns themselves are subject to relief under the rule. Fourth, - 6 - pursuant to requests to clarify whether transfer agents might be considered "filers", the regulations clarify that the filer of an information return is the person who is required to file under the applicable information reporting rules. Finally, the regulations clarify that a filer's economic decision to incur a penalty rather than bear the cost of complying with the applicable information reporting requirements is a basis for finding intentional disregard of the information reporting requirements. III. Failures to Furnish Correct Payee Statements A request by another commentator that special guidance be provided for brokers holding shares of a regulated investment company ("RIC") in street name has not been adopted, however, by the final regulations. Specifically, the commentator suggested that brokers should have no obligation to file corrected IRS Form 1099 payee statements to reflect any information received by them after January 16 regarding the character of a fund's distributions (in order to be eligible for the reasonable cause waiver), so long as the broker forwarded to the payee a copy of any written notice or explanation that the broker received from the fund. In rejecting these suggestions, the Treasury observed that penalties for failure to file correct information returns and statements may be waived if the filer demonstrates that the requirements of the reasonable cause standard have been met. As discussed above, to act in a responsible manner under this standard, payee statements must be corrected within 30 days after the date the failure is discovered or on the earliest date thereafter on which a regular submission of corrections is made. * * * * * We will keep you informed of developments

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