

MEMO# 2554

February 25, 1991

TEMPORARY REGULATIONS ON INFORMATION REPORTING PENALTIES AND THE REASONABLE CAUSE WAIVER

February 25, 1991 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 TRANSFER AGENT ADVISORY COMMITTEE NO. 10-91 RE: TEMPORARY REGULATIONS ON INFORMATION REPORTING PENALTIES AND THE REASONABLE CAUSE WAIVER

As we previously informed you, the Omnibus Budget Reconciliation Act of 1989 ("OBRA 89") enacted four new Code sections (sections 6721 through 6724) to substantially revise the Internal Revenue Code's information reporting penalty system. (See Institute Memorandum to Closed-End Fund Members No. 68-89, Tax Members No. 48-89, Unit Investment Trust Members No. 70-89, Operations Committee No. 27-89, Accounting/Treasurers Committee No. 55-89 and Transfer Agent Advisory Committee No. 31-89, dated December 19, 1989.) One of the most significant changes made to the information reporting penalty rules was the change in the standard of care necessary to avoid the imposition of information reporting penalties. Specifically, the "higher waiver standard" of due diligence was replaced with the reasonable cause standard. As you may know, the Institute filed several comment letters with the IRS and the Treasury Department, and submitted statements to Congress, seeking relaxation of the old due diligence standard. (See, for example, Institute Memoranda to Tax Committee No. 7-88, Operations Committee No. 13-88, Closed-End Fund Committee No. 14-88 and Transfer Agent Shareholder Advisory Committee No. 8-88, dated April 21, 1988 (comment letter to IRS); and to Tax Committee No. 5-89, Operations Committee No. 7-89, Transfer Agent Shareholder Advisory Committee No. 10-89, Closed-End Fund Committee No. 11-89 and Unit Investment Trust Committee No. 9-89, dated April 21, 1989 (statement to House Ways and Means Committee)). In the attached set of temporary and proposed regulations, the IRS provides guidance on the new information reporting penalty provisions. These regulations are effective February 21, 1991 and are applicable to information returns and payee statements the due date for which (determined without regard to extensions) is after December 31, 1989. We are very pleased to inform you that the new reasonable cause standard, as provided in these regulations, generally reflects the suggestions made by the Institute. Specifically, payors will be permitted to open accounts without TINs or with incorrect TINs, and generally avoid penalties for failures to file correct information returns, so long as they make certain solicitations for a correct TIN. Of course, backup withholding will still apply to accounts with no TIN (under section 3406(a)(1)(A)) and to accounts for which a "B" Notice has been received (under section 3406(a)(1)(B)).

I. Reasonable Cause Standard

The information reporting penalties will be waived for reasonable cause if the payor establishes that (1) either (a) there are significant mitigating factors for the failure or

(b) the failure arose from events beyond the payor's control, and (2) the payor acted in a responsible manner both before and after the failure occurred.

A. Significant Mitigating Factors Significant mitigating factors for the failure include the fact that the payor has an established history of complying with the information reporting requirement with respect to which the failure occurred. In determining this history, significant consideration is given to whether the payor has incurred information reporting penalties in prior years and, if so, the extent of the payor's success in lessening its error rate from year to year.

B. Events Beyond Payor's Control Events which are generally considered beyond the payor's control include, but are not limited to: (1) the unavailability of the relevant business records, (2) an undue economic hardship relating to filing on magnetic media, (3) certain actions of the IRS, (4) certain actions of an agent and (5) certain actions of the payee or other person providing necessary information with respect to the return or payee statement. The regulations provide additional guidance relating to each of these events. To establish reasonable cause with respect to actions of the payee (or other person), the payor must show that the failure resulted either from the failure of the payee (or other person) to provide information to the payor or from incorrect information provided by the payee (or other person) which the payor relied on in good faith. To substantiate its reasonable cause defense, the payor must provide documentary evidence to the IRS upon request showing that the failure was attributable to the payee (or other person).

11/ As discussed above, backup withholding will apply under section 3406(a)(1)(A) on all accounts for which no TIN has been provided.

22/ The initial solicitation will be deemed made with respect to all accounts opened after December 31, 1989 and on or before April 22, 1991, which is 60 days after these regulations were published in the Federal Register.

C. Acting in a Responsible Manner Acting in a responsible manner means that the payor (1) exercised reasonable care (i.e., acted as a reasonably prudent person) and (2) undertook significant steps to avoid or mitigate the failure. Detailed rules are provided for determining whether these significant steps are taken. Special rules are also provided for determining whether a payor acted in a responsible manner when the payor is seeking a reasonable cause waiver based upon actions of the payee or other person which were considered beyond the payor's control.

D. Acting in a Responsible Manner When TIN Missing A payor will have acted in a responsible manner when a payee fails to provide a TIN only if the payor makes certain solicitations, or requests, for the TIN.

1/1 For these purposes, a number is treated as a "missing TIN" if the number does not contain nine digits or includes one or more alpha characters. An "initial solicitation" for a payee's correct TIN must be made at the time the account is opened.

2/2 If the account is opened in person, the initial solicitation may be made by either oral or written request. If the account is opened by mail, telephone or electronic means, the TIN may be requested through such communications. If a TIN is not received as a result of the initial solicitation, the payor must make no more than two additional solicitations. The "first annual solicitation" must be made on or before the later of December 31 of the year in which the account is opened or 30 days after the account is opened. If the TIN is not received as a result of the first annual solicitation, a "second annual solicitation" must be made after the period for making the first annual solicitation and on or before December 31 of the year following the year the account is opened. Annual solicitations may be made by mail or by telephone. Detailed rules are provided for the manner of making these solicitations. If a payor fails to make one of the required solicitations, the payor may satisfy the reasonable cause standard by making two consecutive annual solicitations in subsequent years ("make-up solicitations"). The penalty will apply, however, to failures

33/ The initial solicitation rules are the same for incorrect TINs as they are for missing TINs. for years during which the required solicitations were not made and for all subsequent years until the make-up solicitations are made. Special rules are also provided for circumstances under which solicitations need not be made. For example, financial institutions are not

required to make annual solicitations by mail on accounts with "stop-mail" or "hold-mail" instructions. Similarly, a payor is not required to make annual solicitations on accounts with respect to which the payor undertook two consecutive annual mailings by December 31, 1989 pursuant to the "fresh start" mailing requirements of regulation section 35a.9999-1 (A-56).

E. Acting in a Responsible Manner When TIN Incorrect A payor will have acted in a responsible manner when a payee fails to provide a correct TIN if the payor makes an initial solicitation for the TIN3/3 and any additional required solicitations for the correct TIN. Only the initial solicitation must be made unless the IRS or, in some cases, a broker notifies the payor that the TIN is incorrect. Payors may be notified of an incorrect TIN by receipt of either a "B" notice or a penalty notice issued by the IRS for failure to provide correct information pursuant to section 6721. An account contains an incorrect TIN at the time of notification by the IRS or broker if the name and number combination on the account matches the name and number combination set forth on the notice from the IRS or broker. A first annual solicitation must be made no later than December 31 of the year in which the payor is notified of the incorrect TIN. A second annual solicitation must be made by December 31 of the subsequent year if the payor is notified in the year following the year of notification that the TIN is incorrect. If a payor is notified of an incorrect TIN by a "B" Notice, the solicitation requirement will be satisfied only if the payor satisfies the solicitation requirements contained in the "B" Notice regulations (under section 35a.3406-1(c)(1)). (See Institute Memorandum to Tax Members No. 37-90, Operations Members No. 77-90, Closed-End Fund Members No. 36-90, Unit Investment Trust Members No. 61-90 and Transfer Agent Advisory Committee No. 34-90, dated September 21, 1990). If a payor is notified of an incorrect TIN by a penalty notice pursuant to section 6721 and has not received a "B" Notice, the solicitation requirement may be satisfied by mail or telephone (as provided by the missing TIN rules) or in person. Although, in general, no more than two annual solicitations are required, a payor who makes annual solicitations following receipt of a section 6721 penalty notice and who later receives a "B" Notice must make two additional mailings pursuant to the "B" Notice procedures. Special rules are also provided for "make-up solicitations" if a payor fails to make a required solicitation.

F. Due Diligence Safe Harbor A payor may establish reasonable cause if the payor satisfies the old due diligence standard provided under section 6776(b).

G. Transition Rules A payor will generally be deemed to have satisfied reasonable cause with respect to information returns required to be filed after December 31, 1989 and on or before April 22, 1991 ("the transition period") if the payor would have satisfied the section 6723 reasonable cause standard prior to its amendment by OBRA 89. In the case of missing or incorrect TINs on information returns required to be filed during the transition period, a payor will be deemed to have satisfied reasonable cause if, at the time the account was opened, the payor (1) exercised due diligence or satisfied the 1988 "fresh start" mailing requirements of regulation section 35a.9999-1 (A-56), (2) requested the TIN pursuant to the section 6109 regulations or (3) would have satisfied reasonable cause under section 6676(a) prior to its repeal by OBRA 89. No additional guidance is provided on these transition rules.

H. Procedure for Seeking Waiver To seek an administrative determination that a failure was due to reasonable cause, the payor must submit a written statement setting forth the specific basis for the waiver (such as the failure of a payee to provide the correct TIN), stating all the facts alleged as the basis for reasonable cause, containing the signature of the person required to file the return and containing a penalties of perjury declaration.

II. Failures to File Correct Information Returns The regulations under section 6721 apply to failures to timely file information returns to the IRS and failures to include correct information on these returns. An error on a magnetic media submission that prevents the IRS from processing the submission may constitute a failure to timely file. Special rules are also provided for computing the maximum penalty under the so-called sliding scale penalties where the \$50

per failure penalty is reduced to (1) \$15 with a \$75,000 cap if the failure is corrected within 30 days of the required filing date and (2) \$30 with a \$150,000 cap if the failure is corrected after 30 days but on or before August 1. Inconsequential errors and omissions which do not prevent or hinder the IRS from processing returns and utilizing the information will not be considered failures to include correct information. Errors and omissions relating to TINs, payee surnames and monetary amounts are never inconsequential. Special rules are also provided for applying the de minimis exception, which exempts from the penalty a small number of failures to include correct information, if the payor corrects such failures on or before August 1 of the year in which the required filing date occurs.

III. Failures to Furnish Correct Payee Statements The regulations under section 6722 apply to failures to timely furnish payee statements and failures to include correct information on these statements. Inconsequential errors or omissions will not be considered failures to include correct information if the failure cannot reasonably be expected to prevent or hinder the payee from timely receiving correct information and reporting it on his or her return or from otherwise putting the statement to its intended use. Errors and omissions relating to dollar amounts, the payee's address, the appropriate form for the information and the manner of furnishing a statement are never inconsequential. * * * The deadline for written comments and requests for a public hearing is April 22, 1991. We will keep you informed of developments.

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