

**INTERNAL REVENUE SERVICE**

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**Department of the Treasury**

**Washington, DC 20224**

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**Date:** November 20, 1999

**Legend**

Corporation A =

X =

Commission =

Association =

Exchange =

Dear Sir or Madam:

This responds to your ruling request of May 18, 2000, and supplemental correspondence of September 14, 2000. You requested several rulings concerning the application of the backup withholding rules under section 3406 of the Internal Revenue Code (the Code) for payees acquiring readily tradable instruments through a broker. Specifically, you requested the following rulings:

1. That, with respect to bulk transfers of accounts from another broker to X:
  - (a) X may rely on notification from the Introducing Broker that a properly completed and executed Form W-9, "Request for Taxpayer Identification Number and Certification," has been provided by an account owner in determining X's obligations under the backup withholding provisions of section 3406 of the Code.
  - (b) X is not required to obtain a Form W-9 from such accounts if X receives notification from the Introducing Broker that the Introducing Broker has obtained a properly completed and executed Form W-9 from such accounts.

(c) X may rely on notification from the introducing Broker whether an account is a pre-1984 account, and thus subject to backup withholding only if a TIN is missing.

2. That X may rely on an Introducing Broker's representation as to an account owner's name, address, and TIN for purposes of filing information returns; and X's use of such TIN will satisfy the reasonable cause requirements under section 301.6724-1(f)(1)(i) of the Regulations on Procedure and Administration.

3. That X may rely on an Introducing Broker's notification to backup withhold under section 3406(a)(1)(A), (B), (C), and (D) of the Code. If the Introducing Broker provides a TIN to X and does not notify X that backup withholding is required, X is required to backup withhold only if it receives a notice from the Internal Revenue Service (the Service) that backup withholding is required under section 3406(a)(1)(B) or (C).

4. That X may rely on a Form W-9 that is FAXed or transmitted electronically from an Introducing Broker as if the form had been received directly from the account owner for purposes of filing information returns and for purposes of determining its backup withholding obligations under section 3406 of the Code.

#### I. Facts

Corporation A is securities broker dealer. X is a division of Corporation A and acts as a securities clearing broker. X provides clearing and execution services for broker dealers and other financial institutions (Introducing Brokers). An Introducing Broker is a broker-dealer that is regulated by Commission and Association. The Introducing Broker maintains a direct relationship with the investor and is responsible for opening new accounts and obtaining tax information (including the investor's TIN).

X and the Introducing Broker enter into a Clearing Agreement (Agreement). The Agreement defines the responsibilities of X and the Introducing Broker. The Agreement is regulated by the Exchange and must be approved by the Exchange to be effective. The Agreement provides that the Introducing Broker is the investor's agent for purposes of obtaining an investor's tax information. Under the Agreement, the Introducing Broker agrees to furnish X with investors' tax information (including TINs and backup withholding certifications). In addition, the Agreement provides that the Introducing Broker acknowledges that X will rely on such tax information in meeting X's backup withholding obligations under section 3406 of the Code.

X operates on a fully disclosed basis and carries accounts on an individual investor basis. The Introducing Broker discloses the identity of each investor to X. X is responsible for receipt, delivery, and safeguarding each investor's funds and securities. X holds securities in its own name (i.e., "in street name") and credits an investor's account with interest, dividends, and gross sales proceeds from the sales of securities.

With respect to sales of securities, the investor places his or her order with the Introducing Broker, and the Introducing Broker may request X to execute the trade, or the Introducing Broker or another broker may execute the trade. In all cases, the trade is reported to, and processed by X, and X credits the gross sales proceeds to the investor's account. If backup withholding is required, X withholds the required amounts.

X frequently receives bulk transfers of accounts from other brokers. With respect to accounts that are transferred in bulk, X relies on the Introducing Broker's notification that a properly completed and executed Form W-9 has been provided by the account owner. X does not obtain a separate Form W-9 for accounts that are transferred in bulk. X imposes backup withholding on accounts that are transferred in bulk only if the Introducing Broker has not received a TIN or if the Introducing Broker or IRS notifies X that backup withholding is required.

X prepares and files Forms 1099-INT, "Interest Income," and Forms 1099-DIV, "Dividends and Distributions," with respect to payments of interest and dividends credited to investors' accounts. X prepares and files Forms 1099-B, "Proceeds from Broker and Barter Exchange Transactions," with respect to gross proceeds credited to investors' accounts.

## II. Law and Analysis

### A. Backup Withholding under Section 3406

Section 3406(a)(1) of the Code requires a payor to withhold 31 percent of any reportable payment to a payee if:

- (A) the payee fails to furnish his or her TIN to the payor in the manner required;
- (B) the Service notifies the payor that the TIN furnished by the payee is incorrect;
- (C) the Service notifies the payor of payee underreporting; or
- (D) the payee fails to provide the certification described in section 3406(d).

Section 3406(d)(1) of the Code imposes backup withholding on payments of interest and dividends on new accounts and instruments unless the taxpayer certifies under penalty of perjury that the taxpayer is not subject to backup withholding (certification failure). Section 3406(d)(2) provides special rules for readily tradable instruments acquired through a broker. Under this special rule, the payee may furnish the required certifications to a broker instead of the payor. Section 3406(d)(2)(B) provides backup withholding is required for any reportable payment of interest or dividends on a readily tradable instrument acquired through a broker only if the broker notifies the payor that (broker notification requirements): (1) the payee failed to furnish his TIN to the broker in the manner required; (2) the Secretary notified the broker before

the acquisition that the TIN furnished by the payee is incorrect; (3) the Secretary notified the broker before the acquisition that the payee is subject to backup withholding because of underreporting; or (4) the payee has not provided the required certifications to the broker.

Section 3406(d)(4) of the Code also provides an exception from the broker notification requirements in section 3406(d)(2)(B) for readily tradable instruments acquired through a brokerage account established before January 1, 1984, if the broker acted as a nominee or bought or sold instruments for the payee during 1983. For these accounts, the broker is only required to provide the payee's TIN to the payor and notify the payor of backup withholding required under section 3406(a)(1)(C).

Section 3406(h)(4) of the Code provides that the term "payor" means, with respect to any reportable payment, a person required to file an information return described in section 3406(b)(2) or (3) (including interest payments reportable under section 6049, dividend payments reportable under section 6042, and gross proceeds from sales reportable under section 6045).

Section 3406(h)(5)(A) of the Code provides that, in general, the term "broker" has the same meaning as under section 6045(c)(1). Section 3406(h)(5)(B) provides that if, without this provision, there would be more than one broker, only the broker having the closest contact with the payee shall be treated as the broker. Section 3406(h)(5)(C) provides that, in the case of any instrument, the term "broker" does not include any person who is the payor with respect to such instrument.

Section 31.3406(a)-2(b) of the Employment Tax Regulations provides that a person who receives or collects payments on behalf of or for the account of a payee is a "middleman" and is treated as the payor of the payment. Section 31.3406(a)-2(b)(3) provides that a broker holding a security (including stock) for a customer in street name is treated as a payor.

Section 31.3406(d)-4 of the regulations describes the special rules for readily tradable instruments acquired through a broker. Section 31.3406(d)-4(a)(1) provides that if a readily tradable instrument is acquired through a post-1983 brokerage account and the broker is not the payor (as defined in section 31.3406(a)-2(b)(3)), the broker must: (1) obtain the required certifications relating to payee underreporting and TIN from the payee; (2) furnish the payee's TIN to the payor; and (3) notify the payor to impose backup withholding if the payee fails to make either of the required certifications to the broker or the IRS notified the broker before the acquisition of the instrument that the payer is subject to withholding under sections 3406(a)(1)(B) or (C) of the Code .

Section 31.3406(d)-4(a)(3) of the regulations provides that if a broker acquires readily tradable instruments for a payee through an account (with the broker) that is a pre-1984 account, and the broker is not the payor, the broker must furnish the payee's TIN to the payor. In addition, the broker must notify the payor to impose backup

withholding if the IRS has notified the broker that the payee is subject to withholding under section 3406(a)(1)(B) or (C) of the Code and transmit the information in the manner described in section 31.3406(d)-4(a).

Section 31.3406(d)-4(c) of the regulations provides that a payor of an instrument acquired by a payee through a broker may rely on the information that the payor receives from the broker under sections 31.3406(d)-4(a) and (b).

#### B. Information Reporting Penalties.

Under section 6721 of the Code, the Service may impose a penalty if a payor fails to timely file correct information returns. Under section 6722, the IRS may impose a penalty if a payor fails to timely furnish correct information statements. Section 6724 authorizes the IRS to waive the penalties under sections 6721 and 6722 if the payor can show that the failure was due to reasonable cause and was not due to willful neglect.

Section 301.6724-1(a) of the Regulations on Procedure and Administration provides that a penalty under section 6721 or section 6722 may be waived for reasonable cause only if the payor establishes: (1) that there were significant mitigating factors with respect to the failure as described in section 301.6724-1(b); or (2) that the failure arose from events beyond the payor's control as described in section 301.6724-1(c). In addition, the payor must establish that it acted in a responsible manner both before and after the failure occurred as described in section 301.6724-1(d).

Section 301.6724-1(c)(1) of the regulations provides that events that are generally considered beyond the payor's control include certain actions of the payee or any other person providing necessary information with respect to the return or payee statement. Section 301.6724-1(c)(6) provides that in order to establish reasonable cause due to the actions of another person, such as a broker defined in section 6045(c), the payor must show either: (1) that the failure resulted from the failure of the payee or any other person failing to provide the required information to the payor; or (2) that the failure resulted from incorrect information provided by the payee (or any other person) upon which the payor relied in good faith.

Section 301.6724-1(d) of the regulations describes the requirement that the payor acted in a responsible manner. Under section 301.6724-1(d)(2), the payor must satisfy specific rules in the case of missing or incorrect TINs.

Section 301.6724-1(f)(1) of the regulations provides special rules for acting in a responsible manner in the case of incorrect TINs. In general, in the case of a failure resulting from the inclusion of an incorrect TIN, the payor must make the required initial and annual TIN solicitations. Section 301.6724-1(f)(1)(i) provides that a payor must make an initial solicitation for a payee's correct TIN at the time the account is opened; however, the payor is not required to make an initial solicitation if the payor has the

payee's TIN and uses the TIN for all accounts of the payee. Under this regulation, no additional solicitation is required unless the Service or a broker notifies the payor that the TIN is incorrect.

### C. FAXed or Electronic Form W-9

Announcement 98-27, 1998-15 I.R.B. 30, and the Instructions to Form W-9 provide that a payor may establish a system to receive Form W-9 from a payee electronically (including by FAX) if certain requirements described in the announcement are met.

Section 31.3406(h)-3(d) of the regulations provides that a broker may act as the payee's agent for purposes of furnishing a TIN or certification to a payor with respect to any readily tradable instrument provided the payee provides a TIN on Form W-9 or other acceptable substitute form to the broker. The regulations further provide that the payor may rely on a TIN provided by the broker unless certification is required and the broker notifies the payor that the TIN was not certified.

### III. Conclusions

#### Ruling Request 1

The information reporting requirements and backup withholding obligations in the present case depend on whether the readily tradable instrument is held in the name of the X (i.e., "in street name") and whether the brokerage account is a pre-1984 or post-1983 account. Under section 3406(d)(2) of the Code and the regulations, if a payee acquires a readily tradable instruments through a broker who is not treated as the payor, and the account is a post-1983 account, the broker must: (1) obtain the required certifications, (2) furnish the payee's TIN to the payor in the manner required; (3) notify the payor to impose backup withholding if the payee fails to make the required certifications, and notify the payor that payee is subject to backup withholding under section 3406(a)(1)(B) or (C). For readily tradable instruments acquired through a broker who is not treated as the payor, if the account is a pre-1984, the broker must furnish the payee's TIN to the payor. In addition, if the broker has been notified by the IRS that the payee is subject to backup withholding under section 3406(a)(1)(B) or (C), the broker must notify the payor to backup withhold. The bulk transfers of accounts from Introducing Brokers to X will not affect an account's status as a pre-1984 account.

In the present case under section 3406 of the Code and the regulations, X is treated as the payor for backup withholding purposes. X holds the securities in street name and credits interest, dividends, and sales proceeds to the investors' accounts. In addition, the Introducing Broker is the broker that has the closest contact with the investors. Accordingly, under section 3406(d)(2)(B) and the regulations, with respect to the transfers of accounts from another broker to X, X need not obtain a signed W-9 and may rely on notification from the Introducing Broker that the taxpayer has properly completed and signed a Form W-9. In addition, X may rely on a notification from the

Introducing Broker of whether the account is a pre-1984 account.

#### Ruling Request 2

If the information provided on an information return is incorrect, a payor may request a waiver under section 6724 of the Code based on reasonable cause of the penalties imposed under sections 6721 and 6722. If the payor relies in good faith on incorrect information provided by another person such as a broker, the failure to file correct information returns or to furnish correct information statements may be treated as an event beyond the payor's control under section 301.6724-1(c)(6) of the regulations. Under section 301.6724-1(f)(i), certain solicitation requirements apply for determining if a payor acted in a responsible manner. However, an initial solicitation is not required if the payor has the TIN and uses it for all accounts of the payee, unless a broker or the Service notifies the payor that an investor's TIN is incorrect. Accordingly, in meeting its information reporting obligations, X may rely on the Introducing Broker's representation as to an account owner's name, address, and TIN for purposes of filing information returns.

#### Ruling Request 3

Under section 31.3406(d)-4(c) of the regulations, a payor of an instrument acquired by a payee through a broker may rely on the information that the payor receives from the broker under sections 31.3406(d)-4(a) and (b) of the regulations. Accordingly, X may rely on an Introducing Broker's notification to backup withhold under sections 3406(a)(1)(A), (B), (C), and (D). In addition, if the Introducing Broker provides a TIN to X and does not notify X that backup withholding is required, X is required to backup withhold only if it receives a notice from the Service that the payee is subject to backup withholding under section 3406(a)(1)(B) or (C).

#### Ruling Request 4

Section 31.3406(h)-3(d) of the regulations provides that a broker may act as the payee's agent for purposes of furnishing a TIN or certification to a payor with respect to any readily tradable instrument provided the payee provides a TIN on Form W-9 or other acceptable substitute form to the broker. In the present case, the Introducing Broker is the investor's agent for purposes of furnishing the investor's TIN and required certifications to X, the payor. If the requirements of Announcement 98-27 and the Instructions to Form W-9 are satisfied, an Introducing Broker may furnish X an investor's Form W-9 electronically or by FAX. Accordingly, X may rely on a Form W-9 that is FAXed or transmitted electronically from an Introducing Broker as if the form had been received directly from the account owner for purposes of filing information returns and for purposes of determining its backup withholding obligations under section 3406 of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

John J. McGreevy  
Acting Senior Technician Reviewer  
Branch 3  
Administrative Provisions & Judicial Practice

Enclosures (2)  
Copy of this letter  
Copy for section 6110 purposes

cc: