

Part III - Administrative, Procedural and Miscellaneous

The Jobs and Growth Tax Relief Reconciliation Act of 2003—Information Reporting for Payments in Lieu of Dividends

Notice 2003-67

SECTION 1. PURPOSE

This notice provides guidance to brokers and individuals regarding provisions in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the JGTRRA), Pub. L. No. 108-27, 117 Stat. 752, that affect information reporting for payments in lieu of dividends (sometimes called “substitute payments”). This notice announces that:

1. The Internal Revenue Service will exercise its authority under section 6724(a) of the Internal Revenue Code to waive penalties under sections 6721 and 6722 for information returns with respect to calendar year 2003 payments if a broker makes a good faith effort to satisfy its information reporting obligations in a way that is consistent with the statutory changes effected by the JGTRRA.

2. The Service has revised the instructions to the 2003 Form 1099-MISC, “Miscellaneous Income,” to require brokers to report payments in lieu of dividends to individuals in Box 8 of Form 1099-MISC.

3. The Service expects to revise Rev. Proc. 2003-28, 2003-16 I.R.B. 759, to allow brokers to furnish composite substitute payee statements for Forms 1099-DIV, "Dividends and Distributions," and Forms 1099-MISC, reporting payments in lieu of dividends, as well as other information returns.

4. If a payment in lieu of dividends is reported as dividend income on a 2003 Form 1099-DIV, the taxpayer receiving the form may treat the payment for tax purposes as a dividend, and not as a payment in lieu of dividends, unless the taxpayer knows, or has reason to know, of the actual character of the payment.

5. The Service expects to amend section 1.6045-2 of the Income Tax Regulations to reflect the statutory changes effected by the JGTRRA regarding payments in lieu of dividends. The Service expects to amend the regulations to provide new rules for brokers to use to determine which shares are loanable and to permit brokers to use a new hierarchical method to allocate transferred shares to new pools of loanable shares. The amendments are expected to be applicable to dividends received on or after January 1, 2003.

SECTION 2. BACKGROUND

Effective for taxable years beginning after December 31, 2002, and beginning before January 1, 2009, section 302 of the JGTRRA reduces the tax rate for "qualified dividends" paid to an individual shareholder to the same tax rate as capital gains. The reduced tax rate does not apply to a dividend on stock that is held (within the meaning of section 246(c)) by the taxpayer for 60 days or less of the 120-day period that begins 60 days before the ex-dividend date. The favorable tax rate is also denied to the extent

that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

The legislative history states, however, that “Payments in lieu of dividends are not eligible for the lower rates.” H.R. REP. NO. 108–94, 108th Cong., 1st Sess. 31 n.36 (2003). (The distinction between payments made with respect to a financial instrument by its issuer and payments made by a third party who had borrowed the instrument was already relevant even before the JGTRRA for exempt interest dividends, capital gain dividends, distributions treated as a return of capital, foreign tax credit dividends, and dividends eligible for the dividends received deduction, but was generally not relevant for dividends or in-lieu-of-dividend payments received by an individual. See section 1.6045–2(a), (f)). In addition, the Conference Report states:

In the case of brokers and dealers who engage in securities lending transactions, short sales, or other similar transactions on behalf of their customers in the normal course of their trade or business, the conferees intend that the IRS will exercise its authority under section 6724(a) to waive penalties where dealers and brokers attempt in good faith to comply with the information reporting requirements under sections 6042 and 6045, but are unable to reasonably comply because of the period necessary to conform their information reporting systems to the retroactive rate reductions on qualified dividends provided by the conference agreement. In addition, the conferees expect that individual taxpayers who receive payments in lieu of dividends from these transactions may treat the payments as dividend income to the extent that the payments are reported to them as dividend income on their Forms 1099-DIV received for calendar year 2003, unless they know or have reason to know that the payments are in fact payments in lieu of dividends rather than actual dividends. The conferees expect that the Treasury Department will issue guidance as rapidly as possible on information reporting with respect to payments in lieu of dividends made to individuals.

H.R. CONF. REP. NO. 108-126, 108th Cong., 1st Sess. 42-43 (2003).

SECTION 3. WAIVER OF PENALTIES UNDER SECTION 6724(a)

Section 6721 imposes a penalty if a payor fails to file correct information returns with the Service, including returns required under section 6042 (relating to payment of dividends) and section 6045 (relating to returns of brokers). Section 6722 imposes a penalty if a payor fails to furnish correct information statements to payees, including statements required under sections 6042 and 6045. Section 6724(a) authorizes the Service to waive the section 6721 and 6722 penalties if the failure to comply is due to reasonable cause and not to willful neglect.

If they have not already done so, brokers as defined in section 6045 who engage in securities lending transactions, short sales, or other similar transactions on behalf of their customers in the normal course of the brokers' trade or business should immediately undertake action to conform their information reporting systems to the JGTRRA. The Service expects brokers to complete those efforts as soon as reasonably possible for the calendar year 2003 and, to the extent reasonably possible, to comply with their reporting responsibilities in a manner consistent with the JGTRRA for payments in lieu of dividends for the calendar year 2003.

The Service will exercise its authority under section 6724(a) to waive penalties if a broker shows that it made a good faith attempt to comply with the information reporting requirements under sections 6042 and 6045 in a manner consistent with the JGTRRA for dividend payments made during calendar year 2003 but could not reasonably do so because the broker had inadequate time within which to conform the broker's information reporting systems to the JGTRRA. The Service will consider all

relevant facts and circumstances in determining whether a broker acted in good faith in attempting to comply with the information reporting requirements for dividend payments made during calendar year 2003. For dividend payments made during calendar year 2004, however, except in extraordinary circumstances, the Service will consider brokers to have had adequate time to conform their information reporting systems to the new law for payments in lieu of dividends.

SECTION 4. INSTRUCTIONS TO FORM 1099-MISC AND REV. PROC. 2003-28

The Service has revised the Instructions to Form 1099-MISC for calendar year 2003 for payments in lieu of dividends. The revised instructions direct brokers to report payments in lieu of dividends in Box 8 of Form 1099-MISC whether the recipient is a corporation, an individual, or some other type of taxpayer. In addition, the Service expects to revise Rev. Proc. 2003-28 to allow brokers to furnish composite substitute payee statements for Forms 1099-DIV and Forms 1099-MISC, reporting payments in lieu of dividends, as well as other information returns.

SECTION 5. PAYMENTS REPORTED ON FORMS 1099-DIV FOR 2003

Some taxpayers may receive Forms 1099-DIV for calendar year 2003 that erroneously characterize payments in lieu of dividends as dividend income because the brokers issuing the forms have not yet modified their information reporting systems to comply with the JGTRRA. A taxpayer who receives payments in lieu of dividends may treat the payments as dividend income to the extent that the payments are reported to the taxpayer as dividend income on Form 1099-DIV for calendar year 2003, unless the

taxpayer knows, or has reason to know, that the payments are in fact payments in lieu of dividends rather than actual dividends.

SECTION 6. AMENDMENT OF REGULATION SECTION 1.6045-2

In general, section 1.6045-2 of the existing regulations, which was issued prior to enactment of the JGTRRA, excludes from the broker reporting requirements of section 6045 payments in lieu of dividends received by a broker on behalf of an individual. That is, these regulations generally require broker reporting only for payments in lieu of dividends received on behalf of corporations. The Service expects to amend section 1.6045-2 to reflect the differential tax treatment under JGTRRA for dividends and payments in lieu of dividends, effective for dividends received on or after January 1, 2003.

Under the existing regulations, brokers must allocate transferred shares (that is, shares giving rise to payments in lieu of dividends) among: (1) shares of stock that the broker has borrowed under a securities lending agreement with the customer (borrowed shares); and (2) shares of stock that are held by the broker on behalf of customers who have authorized the broker to loan their shares to third parties (loanable shares). Loanable shares also include shares of the same class and issue held for the broker's own account. Under the existing regulations, transferred shares may be allocated first to borrowed shares; then, to the extent that the number of transferred shares exceeds the number of borrowed shares (or if the broker does not allocate the transferred shares to the borrowed shares first), the broker must allocate the transferred shares between pools of loanable shares.

.01 Loanable Shares Defined

The amendments to section 1.6045-2 are expected to clarify the present rule that loanable shares do not include shares that the broker by law is prevented from lending. Thus, loanable shares do not include shares that the broker has not been given permission to borrow or lend, shares that the owner may not transfer (such as restricted stock), and shares that, although held in a margin account, may not be borrowed because of Securities and Exchange Commission restrictions on the value of the shares that may be borrowed from the account.

The Service also expects to amend the existing regulations to provide new rules regarding shares that are to be treated as loanable shares. When amended, the regulations are expected to permit brokers to exclude from loanable shares one or more of the following categories of shares:

1. All shares held for the broker's own account.
2. All shares that would not be loanable but for the fact that they are held in a margin account pursuant to account documentation authorizing the lending of shares.
3. Shares that the owner has requested the broker not to lend (even if the owner had executed a written authorization to lend), provided that, consistent with an established practice reflected in the broker's books and records, the broker complies with the request.
4. Shares which had been loaned, but, with respect to which the owner exercised a right under the lending agreement to call back the shares within a fixed period.

5. Any other category of shares described in guidance issued by the Service.

The regulations are expected to provide that, under the preceding paragraph, shares in any of these five categories may be treated as not loanable only if all of the following requirements are satisfied:

- a. At the time the broker designates the share as not loanable, the share has not, in fact, been loaned under an outstanding loan agreement;
- b. The designation of a category of shares as not being loanable is reflected in a written policy of the broker that was placed in its books and records on or before the time of the stock loans to be affected by the policy; and
- c. The policy is consistently applied for both tax and nontax purposes to all shares described in the category.

The Service invites comments on these categories of shares and on the requirements that must be satisfied to treat the shares as not loanable.

.02 Allocation and Selection of Transferred Shares

Pending issuance of amendments to section 1.6045-2, the rules of that section continue to apply for recordkeeping for payments in lieu of dividends and for identifying which customers had their shares transferred. A broker may continue to allocate transferred shares to borrowed shares. In addition, if a broker uses the method of allocation and selection of loanable shares specified in paragraph (f)(2)(ii) of section 1.6045-2, the amendments are expected to allow the broker, starting in 2003, to make the selection of the transferred shares within the individual pool described in

section 1.6045-2(f)(2)(ii)(C) using the methods of selection of transferred shares used within the nonindividual pool as prescribed in section 1.6045-2(f)(2)(ii)(B).

The Service expects to amend the existing regulations to permit brokers to use a new hierarchical method to allocate transferred shares. Under this new hierarchical method, a broker must allocate transferred shares first to shares that are borrowed under a securities lending agreement. Brokers must then allocate the remaining transferred shares to one or more pools of shares held by tax-indifferent customers to the extent of loanable shares in those pools. For this purpose, a tax-indifferent customer is a customer (for example, a tax-exempt entity) for whom the broker has reasonably determined that the tax treatment of qualifying dividends and payments in lieu of dividends are the same. These pools may also include shares held by customers for whom the tax treatment of dividends is more desirable than the tax treatment of payments in lieu of dividends, but who have specifically authorized that the shares be included in a tax-indifferent-customer pool. After the broker has exhausted all the loanable shares in the tax-indifferent-customer pools, the broker must allocate the transferred shares to a single residual pool of all other loanable shares. If only a portion of the loanable shares held in any pool are transferred, the broker must allocate the transferred shares among customers in the pool using the random lottery method provided in section 1.6045-2(f)(2)(ii)(B) of the existing regulations. A broker may use some other allocation method only with the consent of the Service. See Rev. Proc. 2003-1, 2003-1 I.R.B. 1, for the procedures to request a letter ruling. The Service invites comments on this hierarchical method as well as other methods of allocating

transferred shares (giving rise to payments in lieu of dividends) among customers holding loanable shares. The amendments are expected to allow brokers to use the allocation method described in this Section 6 for dividends received after January 1, 2003. The provisions applicable to foreign persons receiving substitute dividends payments continue to apply (e.g., character rules under section 1.871-7(b)(2)).

SECTION 7. EFFECTIVE DATE

This Notice is effective September 16, 2003.

SECTION 8. COMMENTS

The Service invites interested persons to comment on the issues raised in this notice. Interested persons should send comments to:

CC:PA:LPD:PR (NOT-139295-03)
Room 5207
Internal Revenue Service
1111 Constitution Avenue N.W.
Washington, D.C. 20224

Alternatively, comments may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to:

CC:PA:LPD:PR (NOT-139295-03)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue N.W.
Washington, D.C. 20224

Comments may also be transmitted electronically via the following e-mail address:

Notice.Comments@irs.counsel.treas.gov. Please include "Notice 2003-67" in the subject line of any electronic communications.

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1858.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The recordkeeping requirement in this notice is in Section 6. This information is required for brokers to use the rules for determining loanable shares and to use the rules for allocating transferred shares to loanable shares. The collection of information is voluntary to obtain a benefit. The likely respondents are businesses or other for profit institutions.

The estimated total annual recordkeeping burden is 60,000 hours.

The estimated annual burden per recordkeeper varies from 50 hours to 150 hours, depending on individual circumstances, with an estimated average of 100 hours.

The estimated number of recordkeepers is 600.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 10. CONTACT INFORMATION

The principal author of this notice is Michael Hara of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. Mr. Hara may be contacted at (202) 622-4910 (not a toll-free number).