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Securities Law Developments

NEWSLETTER

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Information Reporting for Payments in Lieu of Dividends

Time is fast running out for broker-dealers to upgrade their back office systems for providing accurate tax reports to individual investors on payments in lieu of dividends. The Treasury Department has recently issued Notice 2003-67 (the "Notice") to provide guidance on information reporting and other issues with respect to payments in lieu of dividends made to individuals. Previous reporting methods were made obsolete by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "Act").¹

Since payments in lieu of dividends are not eligible for the Act's reduced tax rate for certain qualified dividends, broker-dealers must change their information reporting systems to report such payments separately. Before the changes made by the Act, broker-dealers were required to report payments in lieu of dividends of at least \$10 on IRS Form 1099-MISC, but were generally not required to report such payments on Form 1099-MISC if they were made to an individual. Such payments instead were reported together with actual divi-

dends on Form 1099-DIV. The need to identify payments not eligible for the reduced tax rate now requires that payments in lieu of dividends made to individuals be reported separately on Form 1099-MISC. The IRS also plans to allow broker-dealers to furnish composite statements that include both kinds of 1099 forms.

Since the reduced tax rate for qualified dividends is effective retroactive to January 1, 2003, the IRS expects broker-dealers to conform their information reporting systems with respect to payments in lieu of dividends for the calendar year 2003. However, as the Conference Report accompanying the Act indicated, the IRS will waive any related penalties for payments made during 2003 upon a showing that the broker-dealer made a good faith attempt to comply with the information reporting requirements but could not reasonably do so because the broker-dealer had inadequate time to conform its systems. This waiver does not extend to payments made during 2004.

¹ Under the Act, qualified dividends (generally dividends received from domestic corporations or certain qualified foreign corporations) will generally be taxed at a maximum rate of 15%, retroactive to January 1, 2003. This reduced rate, however, is applicable only to actual dividends, and not to payments in lieu of dividends (which typically arise in securities lending, short sales, or other similar transactions).

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Additionally, due to the expected problems in conforming the broker-dealers' reporting systems, for 2003 individual taxpayers may treat payments as dividend income if such payments are reported to the taxpayer as dividend income on Form 1099-DIV, unless the taxpayer knows or has reason to know that such amounts are in fact payments in lieu of dividends.

Shares give rise to payments in lieu of dividends when they are loaned or otherwise hypothecated by a customer's broker-dealer. A broker-dealer may lend shares of stock that the customer has authorized its broker-dealer to loan to third parties ("loanable shares"), or shares that a broker-dealer, itself, has been authorized to borrow from a customer under a securities lending agreement with its customer ("borrowable shares"). The IRS "expects to amend the regulations to provide new rules for broker-dealers to use to determine which shares are loanable." The Notice specifies new categories of shares that the IRS expects to exclude from being loanable shares. Broker-dealers should expect individual customers to request modifications of existing agreements, in order to prevent the customer's tax-favored dividends from being converted into fully-taxed payments in lieu of dividends.

In order to determine which customers are receiving payments in lieu of dividends and which ones are receiving actual dividends, a broker-dealer must allocate the shares that are in fact borrowed/loaned among the pools of borrowable shares and loanable shares. The IRS expects to amend the regulations to permit broker-dealers to use a new hierarchical method for this allocation, in addition to other methods available under the current regulations. Under the new permitted method, shares that have been borrowed/loaned out would first be allocated to the pool of borrowable shares, and then to the pool of loanable shares owned by tax-indifferent customers (such as tax-exempt entities), and finally to the pool of all remaining loanable shares. To the extent that only a portion of the loanable shares held in a pool are actually loaned out, the broker-dealer would use a random lottery method to determine which customers' shares were loaned out and thus which customers received payments in lieu of dividends.

The IRS has requested comments from the private sector regarding these regulatory amendments.

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