



Securities Industry Association

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To everyone on the Tax Policy Dividends Exclusion Team:

This paper supplements our letter of January 31, 2003, concerning the Administration's proposal to eliminate the double taxation of corporate earnings. It outlines a number of issues to be considered relating to the reporting of dividend and basis adjustment information to shareholders and the Internal Revenue Service. We appreciate the opportunity you have provided to work with you on these issues.

As an initial matter, we would like to emphasize that members of the Securities Industry Association (SIA)¹ are committed to providing clients with the information that

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of (continued ...)

they will need to benefit from the proposal as quickly as possible. As we discussed when we met recently, however, implementation of the proposal will require substantial modifications to our dividend processing, monthly statement, record keeping, and information reporting systems. Therefore, it is critical that a transition phase be incorporated in the implementing legislation. In addition, the proposal should incorporate certain technical and procedural requirements in order to ensure that information flows smoothly and accurately to shareholders. We have set out our specific recommendations below.

I. Treatment of "in lieu of dividend" payments.

First, as we indicated in our letter of January 31, 2003, we have not yet identified a practical way to allow taxpayers to exclude in lieu of dividend payments from income without allowing any double exclusion (given that the person to whom borrowed stock is sold short will receive actual excludable dividends). However, we are continuing to devote resources to considering this question.

In the meantime, as we discussed when we met in January, it would be very difficult, if not impossible, operationally for securities firms to retroactively distinguish actual dividend payments from in lieu of dividend payments made to securities lenders who are individuals. This will also be true for a significant period following the date of enactment, before systems changes can be made and business practices modified to accommodate the new laws. Under current Treasury Regulations, securities firms are not required to distinguish between actual dividends and payments in lieu of dividends made to lenders who are individuals (except in the case of exempt-interest, capital gain and foreign tax credit dividends). Both actual dividends and in lieu of dividend payments are permitted to be reported on Form 1099-DIV, because the tax consequences to an individual generally are the same irrespective of the character of the payment. As a result, securities firms generally do not maintain records that would enable them to determine retroactively which individuals received in lieu of payments rather than actual dividend payments.

In the case of securities borrowed from margin accounts, in lieu of payments generally are allocated to individuals as a pool, but the specific individuals whose securities were loaned are not identified. In fact, most individual customers holding stock in margined accounts are unaware of the fact that they may not be receiving actual dividends when they receive payments in lieu of dividends. Thus, it generally would not be possible for securities firms to determine retroactively which individual customers with margined securities received taxable in lieu of dividend payments.

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nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated \$280 billion in U.S. revenue and \$383 billion in global revenues.

Securities firms would need time to implement systems modifications that would enable them to allocate payments in lieu of dividends to specific individuals and report them on Form 1099-MISC. They would also need time to inform customers of the change in law and offer them the opportunity to withdraw their stock from the short market. The markets would need time to develop new ways to deal with, and price, stock borrowing, in light of the change in law. Otherwise, there could be an unnecessary "freeze" in the liquidity of the markets as stock lenders focused on the differing treatment of actual dividends and payments in lieu of dividends. Therefore, we recommend the following:

- In lieu of dividend payments made to individual taxpayers in respect of excludable dividends should be eligible for the dividends exclusion until at least the end of 2003, and for a period beyond that to the extent necessary to provide firms with sufficient time to adopt the systems changes required to track the recipients of in lieu of dividend payments (as opposed to actual excludable dividends).
- Going forward, securities firms will need additional guidance on how to implement a nondiscriminatory system for allocating in lieu of dividend payments among margin accounts whose owners have authorized loans of their shares. Once guidance has been promulgated, firms will need sufficient time to implement such a new system.
- Securities firms should be given the option to hold all "loanable" shares owned by individual and non-individual customers in a single pool and determine which of the shares in the pool were loaned on a random basis. This option would be in addition to the methods presently permitted under the applicable regulations. SIA will continue to consider whether additional options also should be provided.

II. Transition relief for reporting of 2003 dividends.

Following enactment of the proposal, the Internal Revenue Service, corporations, securities firms and other financial market participants all must accomplish certain tasks, in some cases sequentially, before the proposal can be fully implemented. The Internal Revenue Service first will need to publish some basic guidance concerning the mechanics of the new rules, amend the Form 1099-DIV to accommodate the reporting of excludable dividend amounts, and publish the new paper form and new filing specifications for magnetic and electronic media submissions. Corporations, stock exchanges, depositories and other institutional shareholders of record, financial data services and securities firms will need to develop new processes for communicating tax-related dividend and basis adjustment information. Finally, securities firms will need to modify their information reporting systems and databases to collect and process the required information, to accommodate the new Form 1099-DIV and to provide for the reporting of basis adjustments.

These required modifications to securities firms' systems and databases will be particularly significant in the case of basis adjustments. Most securities firms have an integrated processing, record keeping and reporting system that identifies shareholders on the dividend record date, coordinates with internal cash payment systems to direct dividend payments to the appropriate accounts, and then feeds payment information into the record keeping and information reporting systems that generate monthly statements and Forms 1099-DIV. These systems cannot readily be used to track and report basis adjustments, because there is no associated entry or activity (*i.e.*, cash payment).

We estimate that securities firms will require a minimum of six months from the date on which the IRS publishes all final essential guidance and specifications for the new form(s) to fully implement the proposal. Therefore, unless the proposal is enacted very soon, it is very unlikely that securities firms will be able to report accurate dividend exclusion information to customers on Forms 1099-DIV issued in early 2004. (We note that error rates for Forms 1099-DIV tripled or quadrupled for many firms in 1997, when capital gains rate reductions were enacted in July and were effective from May 7, 1997.) Therefore, we recommend the following:

- Securities firms should not be required to report dividend exclusion and basis adjustment information for 2003 dividends.
- Regardless of enactment date, information reporting penalties should be waived for firms that attempt to report excludable amounts and basis adjustments for 2003.
- In January 2004, the Internal Revenue Service should publish per share excludable dividend amounts and basis adjustments for 2003 for stocks in U.S. and foreign corporations. This publication would be similar to Publication 1212, "List of OID Instruments." We suggest that Treasury and IRS consider a requirement that corporations furnish this information directly to the IRS by a certain deadline, and consider conditioning the availability of an exclusion for a corporation's 2003 dividends upon the corporation having provided this information to the IRS in a timely manner. At least in the case of widely-held corporations, it may be difficult otherwise to ensure that shareholders receive consistent, timely information.
- The due date for nominees to furnish customers with information concerning their excludable dividends and basis adjustments should be extended from January 31 to February 28 of the calendar year following the year of payment, both for 2003 and all future years. Even under current law, it is very difficult for securities firms to meet the January 31 deadline for providing customers with Forms 1099 with low error rates, primarily because securities firms must rely on others to provide them with the necessary information on a timely basis. Accordingly, for a

number of years securities firms have been actively seeking a short extension of the due date.² Under the proposal, the need for an extension of the due date will increase substantially, as securities firms will be even more highly dependent upon third parties than they are now in order to report accurate exclusion and basis adjustment amounts. While we understand the desire to ensure that taxpayers receive tax reporting information as early as possible, we would expect error rates to increase significantly in future years if the current January 31 deadline is maintained. We strongly believe that taxpayers would be better served by receiving accurate information during February than by the receipt of potentially inaccurate information one month earlier. Although the proposal affects only the Form 1099-DIV directly, a due date extension is needed for all Forms 1099 because of the difficulties firms currently face in meeting the January 31 deadline and because the multiple mailings that would result from different due dates for different types of Form 1099 would only confuse taxpayers – particularly those who currently receive Form 1099-DIV as part of a consolidated Form 1099 payee statement.

III. Announcement of excludable dividend and basis adjustment information in advance of payment.

Under the proposal, it will be critical that information on excludable dividends and basis adjustments be provided in advance of the payment or adjustment date, so that this information can be reflected *currently* in dividend processing, monthly statement and reporting systems. Taxable lenders of securities that want to claim the dividend exclusion also should have the opportunity, where feasible, to recall loaned stock prior to the record date for the dividend payment. Therefore, we recommend:

- Corporations should be required to announce a dividend at least two weeks prior to the record date, and the announcement should state both the record date and the payment date.
- Dividend announcements should include the amounts that will be excludable and non-excludable (in dollar amounts per share), calculated using the aggregate expected dividends for the year. Corporations should not be permitted to determine excludable and non-excludable amounts retroactively for dividends previously paid (other than as necessary to correct errors).
- Any errors in prior announcements of excludable and non-excludable amounts should be required to be announced within two weeks of discovery of the error.

² See SIA's letter to Treasury dated June 27, 2002, requesting Treasury's support for legislation extending the due date for nominee reporting to customers. See *also* the IRPAC comment letter dated February 23, 1999, "Proposal to Extend the Due Date for Payee Copy of Form 1099."

- Corporations should be required to announce basis adjustments in the same manner that dividends are announced.
- These advance notification requirements would not apply to dividends paid prior to the date that is 30 days after enactment of the proposal.

Since the Securities and Exchange Commission, the New York Stock Exchange and other stock exchanges have rules governing the announcement of dividends, it may be necessary to coordinate with these organizations to implement some of these recommendations.

IV. Reporting basis adjustments.

We do not believe that basis adjustment information would be useful to the Internal Revenue Service, especially in the absence of any other information regarding a taxpayer's stock holdings. Since taxpayers will not be required to report basis adjustments on their income tax returns, the principal function that information reporting serves of permitting the IRS to confirm that taxpayers have reflected income items on their returns is not relevant here. Therefore, we recommend:

- Securities firms should not be required to report basis adjustments to the Internal Revenue Service.
- Securities firms should not be required to use a Form 1099 to report basis adjustments to customers, although they should be permitted to do so.
- Securities firms should have the flexibility to determine the timing and format for communicating basis adjustments to customers (e.g., on a monthly statement, year-end statement or separate communication).
- To the extent that the reporting of basis adjustments to customers is to be accomplished by use of a Form 1099 (e.g., a broker prefers this means of furnishing the information), we would suggest the use of Form 1099-B, rather than Form 1099-DIV or on an entirely new Form 1099. Creating a new form would impose substantial additional burdens on the Internal Revenue Service in terms of form design and processing and on securities firms by requiring more significant investments in systems, resources and new procedures. Form 1099-DIV is not suitable for this type of reporting, because it is designed to reflect the aggregate amount of dividends received by the taxpayer on all securities in his account. The Form 1099-B is designed for transactional reporting, and thus could more easily be modified to reflect individual basis adjustments for each security in the taxpayer's account.

V. Reporting to corporate shareholders.

Under current law, securities firms generally are not required to provide Forms 1099 to corporate payees (other than Forms 1099-MISC with respect to in lieu of dividend payments), primarily because corporations would receive no benefit from them. This is because corporations often adopt non-calendar taxable years, while Form 1099 is prepared on a calendar year basis, and Form 1099 reflects cash payments, while most corporations are accrual basis taxpayers. In addition, corporations ordinarily must account for their taxable income (*i.e.*, in computing estimated tax payments) well in advance of the due date for Forms 1099. The proposal will not alter these basic facts. Thus, we do not believe that Forms 1099 showing dividend exclusion information would be useful for corporate payees. In addition, adding new reporting requirements for a large class of payees who are currently exempt from reporting would require securities firms to undertake additional costly systems modifications and procedural changes. Therefore, we recommend:

- Securities firms should not be required to report dividend (or basis adjustment) information to corporate shareholders (or to the Internal Revenue Service with respect to corporate shareholders).
- Securities firms should have the flexibility to report this information to their corporate customers upon request (*e.g.*, in monthly statements or annual statements). Alternatively, corporate shareholders should be able to obtain the relevant information from public data sources or directly from the issuing corporation.

VI. Backup withholding should apply to excludable dividends.

Backup withholding currently does not apply to items that are not gross income, *e.g.*, tax-exempt interest. Extending this exemption, however, to excludable dividends would give rise to over- and underwithholding issues with respect to payment reclassifications. More importantly, extension of the exemption would create a tax avoidance opportunity for non-U.S. shareholders who could escape any U.S. tax withholding on such dividends simply by failing to furnish a withholding agent with documentation of their nonresident status. More specifically, an undocumented nonresident recipient of an excludable dividend would, under current Treasury Regulations, be presumed to be a U.S. resident recipient who is generally subject to backup withholding. However, if backup withholding does not apply to the excludable dividend, the nonresident recipient would escape both backup and nonresident withholding. Therefore, we recommend:

- Treasury should clarify that backup withholding will continue to apply with respect to all dividend payments, notwithstanding that a dividend may be potentially excludable in whole or in part.

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Once again, thank you for your consideration of our views. Please do not hesitate to contact me (202-326-5324) if you would like additional information concerning any of the implementation or other aspects of your proposal.

Sincerely,

Patti McClanahan
Vice President and Director for Tax Policy
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