Notice 97–61

The Internal Revenue Service has undertaken a large-scale effort to address the year 2000 issue. The Year 2000 Conversion Project's primary goal is to make all current and future IRS information systems year 2000 compliant. That is, ensure that all computer systems function correctly before and after January 1, 2000.

The Internal Revenue Service has adopted a standard for the year representation and date representation. This standard will be used in all data exchanges with external trading partners (ETPs), Federal, state and local governments as well as the private sector. The standard is:

— an 8-position year when using the Gregorian data format; the 8 characters (YYYYMMDD) must be contiguous and the 4-position year field must be at the beginning of the date field;

— a four-position year when using the Julian date format; the date field would be represented as YYYYDDD;

— a four-position year when using the Epock/Offset date format where the Epoch (year field) contains four characters and the Offset is a time element determined by the system owner; and,

— a four-position year will be used in conjunction with all other date formats and the other elements of the date field.

The IRS said it will be contacting its external trading partners to inform them of the date by which data exchanges will be converted. The trading partners will be expected to certify that they will be ready to receive the data and that they will provide any related exchanges to the IRS as specified in the standard.

External Trading Partners who provide data in accord with specifications generally issued in Revenue Procedures will continue to be informed of the date requirements through Revenue Procedures. Others, with whom IRS has agreements for specific exchanges, such as with state revenue departments involved in tax administration, will be contacted individually by the IRS.

Certain Payments Made Pursuant to a Securities Lending Transaction

Notice 97–66

SECTION 1. SUMMARY

On October 14, 1997, final regulations were published in the Federal Register [T.D. 8735], RIN 1545-AP71, (the "final regulations") which source substitute interest and substitute dividend payments that are made pursuant to a securities lending or sale-repurchase transaction by reference to the income that would be earned with respect to the underlying transferred debt security or stock. The final regulations also provide that substitute interest and dividend payments that are U.S. source under the regulations are also characterized as interest and dividends for purposes of determining the fixed or determinable annual or periodical income of foreign resident individuals and corporations subject to tax under sections 871, 881, 4948(a) and Chapter 3 of the Internal Revenue Code and for purposes of granting tax treaty benefits with respect to interest and dividends. As promulgated, the final regulations were made applicable in all respects for substitute interest (as defined in § 1.861–2(a)(7) of the income tax regulations) and substitute dividend payments (as defined in § 1.861–3(a)(6)) made after November 13, 1997.

This Notice provides guidance on complying with the statement requirement of section 871(h)(5) for substitute interest payments made after November 13, 1997, and before January 1, 1999. In addition, the Treasury and the Service intend to propose new regulations to provide specific guidance on how substitute dividend payments made by one foreign person to another foreign person ("foreign-to-foreign payments") are to be treated. Until the proposed regulations are promulgated, this Notice clarifies how the amount of the tax imposed under §§ 1.871–7(b)(2) and 1.881–2(b)(2) will be determined with respect to foreign-to-foreign payments. The Treasury and the Service request comments on the treatment of foreign-to-foreign payments provided in this Notice.

SECTION 2. SUBSTITUTE INTEREST PAYMENTS

Substitute interest payments made by a foreign person that are U.S. source interest under the final regulations must satisfy the statement requirement of section 871(h)(5) to qualify as portfolio interest. The final regulations refer taxpayers to § 1.871–14(c) for this purpose, but those regulations are not generally applicable until January 1, 1999. Under this Notice, the statement requirement of section 871(h)(5) will be satisfied with respect to substitute interest payments made after November 13, 1997 and before January 1, 1999, if any written, electronic, or oral statement that reasonably establishes that the payee is a foreign person is given or made to the payor prior to, or within a reasonable period of time after, the payment. The statement requirement of the preceding sentence is deemed to be satisfied if the payor is subject to, and satisfies with respect to the payee, the regulatory rules in the jurisdiction in which the payor is operating regarding establishing the identity of a customer (i.e., "know your customer" rules). Also, if a taxpayer makes an election under § 1.1441-1(f)(2)(ii), such election will be effective, pursuant to this Notice, to allow a withholding agent to apply retroactively the documentation requirements of § 1.871–14(c) with respect to one or more substitute interest payments made after November 13, 1997. Treas. Reg. § 1.871–14(c)(3) allows a withholding agent to collect a certificate or documentary evidence at any time until the expiration of the beneficial owner's period of limitation for claiming a refund of tax with respect to portfolio interest.

SECTION 3. SUBSTITUTE DIVIDEND PAYMENTS

The final regulations were adopted to eliminate unjustifiable differences between the taxation of similar economic investments. It has been brought to the attention of the Treasury and the Service, however, that, in certain circumstances, the total U.S. withholding tax paid with respect to a securities loan or sale-repurchase transaction, or series of such transactions, could be excessive due to the application of the final regulations. The Treasury and the Service believe that taxpayers can avoid such excessive withholding taxes in the vast majority of cases by structuring their transactions appropriately. In some circumstances, however, such structuring may be difficult or impossible.

To address these concerns, under this Notice, the amount of U.S. withholding tax to be imposed under §§ 1.871–7(b)(2) and 1.881–2(b)(2) with respect to a foreign-to-foreign payment will be the amount of the underlying dividend multiplied by a rate equal to the excess of the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute payment over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment. This amount may be reduced or eliminated to the extent that the total U.S. tax actually withheld on the underlying dividend and any previous substitute payments is greater than the amount of U.S. withholding tax that would be imposed on U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment. The recipient of a substitute payment may not, however, disregard the form of its transaction in order to reduce the U.S. withholding tax. Therefore, a recipient of a foreign-to-foreign payment will not be entitled to a refund or tax credit against any other U.S. tax liability to reflect the fact that the rate of U.S. withholding tax that would be applicable to a U.S. source dividend paid by a U.S. person directly to such recipient is less than the rate of U.S. withholding tax that would be applicable to a U.S. source dividend paid by a U.S. person directly to the payor of the substitute payment (or any payor of a previous substitute payment or the underlying dividend).

As a result of this formula, substitute payments with respect to foreign-to-foreign securities loans and sale-repurchase transactions that do not reduce the overall U.S. withholding tax generally will not be subject to withholding tax. For example, no withholding tax is required in situations where transactions are entered into between residents of the same country. The Treasury and the Service believe that this Notice adequately addresses the concerns of those foreign persons who are required by their local regulators to enter into transactions only with residents of the same country. Conversely, to the extent a foreign-to-foreign securities loan or sale-repurchase transaction would reduce the overall U.S. withholding tax, an incremental amount of U.S. withholding tax is imposed on the substitute payment.

SECTION 4. LIABILITY OF WITHHOLDING AGENTS

Each person who makes a foreign-to-foreign payment shall be treated as a withholding agent under section 1.1441–7 with respect to such payment. If a U.S. withholding agent withholds the highest rate of tax which would be imposed on all foreign recipients of dividends and substitute payments in a chain of such payments, each foreign withholding agent will be treated as having satisfied its withholding obligation under §1.1441–7.

SECTION 5. EXAMPLES

The following examples illustrate the principles of this Notice:

Example 1. *Same Country Securities Loan.* FP, a pension fund resident in Country X, owns stock issued by USCo, a corporation resident in the United States. An income tax treaty between Country X and the United States limits the U.S. withholding tax on gross dividends to 15 percent. USBroker, a U.S. broker-dealer, needs to borrow the stock owned by FP. Under Country X rules intended to safeguard the interests of workers, however, FP is required to deal only with Country X residents in connection with its investment activities. Accordingly, FP enters into a securities loan with FBroker, a broker-dealer also resident in Country X. FBroker then enters into a securities loan with USBroker. USCo pays a dividend of $100 on March 15, 1998. USBroker is the shareholder of record with respect to the dividend. Since USBroker is a U.S. person, USCo does not withhold on the dividend. USBroker makes a substitute payment of $100 to FBroker from which USBroker withholds $15. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to FP is the same as the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to FBroker. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments made by FBroker to FP.

Example 2. *Non-Same Country Securities Loan.* A, a resident of Country X, owns shares of USCo, a U.S. resident corporation. Country X has a treaty with the United States which limits the United States tax on gross dividends to 15 percent. A enters into a securities loan with B, a resident of Country Y, whose treaty with the United States also limits the United States tax on gross dividends to 15 percent. USCo pays a dividend of $100 on March 15, 1998. B is the shareholder of record with respect to the dividend. USCo withholds $15 and pays B a net dividend of $85. B makes a substitute payment of $85 to A. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to A is the same as the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to B. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments made by B to A.

Example 3. *Increased Treaty Benefits.* The facts are the same as in example 2, except that Country X has no treaty with the United States. Since a dividend payment made by a U.S. person directly to A would have been subject to a 30-percent withholding tax, B must withhold an additional $15 ((30 percent - 15 percent) x $100) on the substitute payment it makes to A. Alternatively, USCo could have withheld 30 percent from the dividend payment made to B, thereby satisfying B’s withholding liability under § 1.1441–7.

Example 4. *Multiple Country Securities Loans.* A, a resident of Country W, owns shares of USCo, a U.S. resident corporation. Country W has an income tax treaty with the United States that limits the United States tax on gross dividends to 15 percent. B, a resident of Country X, enters into a securities loan with A. Country X does not have an income tax treaty with the United States. C, a resident of Country Y, enters into a securities loan with B. Country Y has an income tax treaty with the United States which limits the United States tax on gross dividends to 10 percent. D, a resident of country Z, enters into a securities loan with C. Country Z has an income tax treaty with the United States which limits the United States tax on gross dividends to 15 percent.

USCo pays a dividend of $100 on March 15, 1998. D is the shareholder of record with respect to the dividend. USCo withholds $15 and pays D a net dividend of $85. D makes a substitute payment of $85 to C. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to C is less than the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to D. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments received by C. However, C is not entitled to a refund or tax credit against any other U.S. tax liability for the additional 5-percent tax reflected in its substitute payment from D over the amount to which C would have been subject had C received a dividend directly from USCo.

C makes a substitute payment of $85 to B from which C withholds $15. Since a dividend payment made by a U.S. person directly to B would have been subject to a 30-percent withholding tax, C generally would be required to withhold an additional $20 ((30 percent - 10 percent) x $100) on the substitute payment it makes to B. However, because $15 actually was withheld with respect to a $100 gross dividend paid to D, C may reduce by $5 ((15 percent - 10 percent) x $100) the $20 withholding obligation on its substitute payment to B.

B makes a substitute payment of $70 to A. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to A is less than the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to B. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payment received by A. However, A is not entitled to a refund or tax credit against any other U.S. tax liability for the additional 15-percent tax reflected in its substitute payment from B over the amount to which A would have been subject had A received a dividend directly from USCo.

Alternatively, USCo could have withheld 30 percent from the dividend payment made to D, thereby satisfying C's withholding obligation under § 1.1441–7.

SECTION 6. EFFECTIVE DATE OF REGULATIONS

The provisions of this Notice are effective for purposes of applying the final regulations as of November 14, 1997, the effective date of those regulations. Because some withholding agents may require additional time to adjust their business practices to implement the provisions of the final regulations and this Notice, a withholding agent can elect to defer the application of the final regulations, other than Treas. Reg. § 1.864–5(b)(2)(ii), and this Notice until January 1, 1998. A withholding agent makes such an election by attaching a statement to such effect to a timely filed tax return (Form 1042) for the period that includes November 14, 1997, or if no such return is otherwise required for the period including that date, on a timely filed return (Form 1042) for the period that includes January 1, 1998. Withholding agents making this election must apply the provisions of the final regulations and this Notice for substitute payments made after December 31, 1997.

SECTION 7. REQUEST FOR COMMENTS

Treasury and the Service invite comments on the guidance provided by this Notice. Written comments should be submitted by January 12, 1998, to the Internal Revenue Service, P.O. Box 7604 Ben Franklin Station, Attention: CC:CORP:T:R: (Notice 97-66) Room 5228, Washington, DC 20044. Alternatively, comments may be submitted via the internet at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The comments submitted will be available for public inspection and copying.

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information contained in this Notice have 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 1545–1566.

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 control number.

The collections of information contained in this Notice are in Sections 2 and 6. The information is required to qualify substitute interest payments as portfolio interest and to defer, on election by the taxpayer, the effective date of this Notice and the final securities lending regulations (T.D. 8735, 62 FR 53498) for substitute payments made after December 31, 1997. The information will be used for the same purpose described in the preceding sentence. The collections of information are required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 61,750 hours.

The estimated annual burden per respondent/recordkeeper varies from 1 minute to 15 minutes, depending on individual circumstances, with an estimated average of 10 minutes. The estimated number of respondents and/or recordkeepers is 377,500.

The estimated frequency of responses (used for reporting requirements only) is once.

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 9. CONTACT INFORMATION

The principal author of this Notice is Paul Epstein of the Office of the Associate Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. For further information regarding this Notice contact Milton Cahn or Paul Epstein at 202-622-3870 (not a toll-free call).

Grace Period Interest

Notice 97–67

Many credit card agreements provide for a grace period during which the credit card issuer does not charge interest for a billing cycle if the credit card holder pays off its account balance by a specified date. Under section 1004 of the Taxpayer Relief Act of 1997 (the "Act"), Pub. L. No. 105–34, 111 Stat. 788, 911, if a taxpayer holds a pool of credit card receivables, the taxpayer must accrue interest and original issue discount on the receivables based on a reasonable assumption regarding the timing of the payments by the obligors of the receivables in the pool. Thus, the taxpayer is not permitted to assume that all of its credit card holders will pay their balances by the date specified in the grace period provision of the credit card agreement and, based on this assumption, defer the inclusion of grace period interest. Section 1004 of the Act is effective for taxable years beginning after August 5, 1997. The Internal Revenue Service will issue guidance that provides the procedures for a taxpayer to automatically change its method of accounting to comply with section 1004 for the taxpayer's first taxable year beginning after August 5, 1997.

The Service will process requests by taxpayers to change their methods of accounting for grace period interest that were pending with the Service on August 4, 1997. For any requests filed on or after August 5, 1997 (the date of enactment of the Act), the Service will exercise its discretion to deny requests to change to a method of accounting for grace period interest other than the method required by section 1004 of the Act. *See* § 446(e) of the Internal Revenue Code. *See also* H.R. Conf. Rep. No.