



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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The Honorable Bob Goodlatte  
Member, U.S. House of Representatives  
10 Franklin Road, S.E.  
Suite 540  
Roanoke, VA 24011-2121

Dear Congressman Goodlatte:

This letter responds to your inquiry dated January 31, 2000, on behalf of your constituent, [REDACTED]. [REDACTED] questions why his broker withheld a "TEFRA tax" of \$ [REDACTED] on a cash dividend of \$ [REDACTED]. [REDACTED] stated that this tax has been withheld since last Fall.

From the information provided, it appears that [REDACTED]'s broker has withheld 31 percent of dividend payments as backup withholding. Under § 3406(a)(1) of the Internal Revenue Code (the Code), backup withholding is required on dividends in four situations, briefly described below:

- The payee does not furnish his taxpayer identification number (TIN) to the payor and certify under penalties of perjury that the TIN furnished is correct. Certification is not required if the account was opened prior to 1984. See §§ 3406(a)(1)(A) and 3406(e)(1) of the Code and § 31.3406(d)-1 of the Employment Tax Regulations.
- The Internal Revenue Service (IRS) notifies the payor that the TIN furnished by the payee is incorrect. The payor sends "B" notices to the payee after notices of incorrect TIN are received from the IRS. After the first IRS notice, the payor sends the first "B" notice, and the payee has 30 days to provide a Form W-9 certifying to his correct TIN. The payor must begin backup withholding if the Form W-9 is not returned within the 30-day period. If the payor receives a second IRS notice of incorrect TIN within a three year period, the payor must send a second "B" notice to the payee. The payor must begin backup withholding after 30 days and continue until the payor receives notice of the payee's correct TIN from the Social Security Administration or the IRS. See §§ 3406(a)(1)(B) and 3406(h) of the Code and § 31.3406(d)-5(d) of the Regulations.

- There is notified payee underreporting. Notified payee underreporting occurs when (1) the IRS has determined that a payee failed to report reportable interest or dividends on his income tax return, or failed to file a return on which interest or dividends should have been reported; (2) the IRS has sent at least four notices to the payee (over a period of at least 120 days) regarding the underreporting; and (3) the IRS has assessed a deficiency in tax attributable to the underreporting. The IRS then notifies the payee and his payors that the payee is subject to backup withholding due to notified payee underreporting. See §§ 3406(a)(1)(C) and 3406(c) of the Code and §31.3406(c)-1 of the Regulations.
- The payee fails to certify that he is not subject to backup withholding due to notified payee underreporting. This rule does not apply to accounts opened prior to 1984. See § 3406(a)(1)(D) of the Code and § 31.3406(d)-2 of the Regulations.

We cannot determine what condition, if any, exists that requires backup withholding in this instance. ██████ should contact his broker and find out why the broker is backup withholding. As noted above, backup withholding is required if ██████ failed to: provide his social security number, certify that it is correct, or certify that he is not subject to backup withholding under notified payee underreporting. Backup withholding is also required if ██████ furnished an incorrect TIN to his broker; however, in that case, ██████ should have received at least one “B” notice from the broker and been given the opportunity to execute a new Form W-9 to correct his TIN and avoid backup withholding. Finally, if ██████ is subject to backup withholding due to notified payee underreporting, he would have received numerous notices from the IRS regarding the underreporting and the initiation of backup withholding.

Backup withholding on 1999 dividend payments is shown on the Form 1099-DIV provided by the broker, and reported by ██████ on his 1999 tax return as Federal tax withheld (line 57 of Form 1040). Likewise, ██████ will report any backup withholding on 2000 payments on his tax return for 2000. If the 2000 backup withholding is erroneous, the payor may, at its option, refund it to ██████ before the end of 2000. If the backup withholding is not erroneous, ██████ can take the appropriate steps to stop the withholding, such as providing necessary certification.

The designation of the backup withholding as “TEFRA tax” on the brokerage statement is inaccurate. The broker may have done this because prior to the enactment of the current backup withholding provision, a statute requiring withholding on all interest and dividend payments was enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). That provision was later repealed and replaced by backup withholding.

I hope this information is helpful. Please contact me or Nancy Rose at (202) 622-4910 if we may be of further assistance.

Sincerely,

George J. Blaine  
Chief, Branch 1  
Income Tax & Accounting Division