Analysis: Foreign tax refunds, RIC election made under section 853(a)

Notice 2016-10, released by the IRS on January 15, 2016, provides guidance for regulated investment companies (RICs) on how to account for refunds of foreign withholding taxes under sections 853 and section 905(c). The guidance is expected to be included in future regulations.

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Notice 2016-10 [PDF 50 KB} provides two alternative methods of complying with section 905(c) when a RIC receives a refund of foreign withholding taxes that it elected to pass through to shareholders in a prior year under section 853(a)—a netting approach or a closing agreement.

The rules in Notice 2016-10 are effective for refunds received in tax years ending on or after February 8, 2016—the date when the notice is to appear in the Internal Revenue Bulletin. For refund years ending before the effective date of Notice 2016-10, taxpayers may apply the netting approach with certain modifications.

Printable version of this report is available here [PDF 66 KB]

Background

Many U.S. RICs hold stock in corporations resident in EU Member States and are subject to foreign withholding taxes on dividend distributions. Generally, a RIC deducts foreign taxes in computing its net income available to distribute to its shareholders. If more than 50% of a RIC's assets consist of foreign stocks and securities, however, the RIC may elect to pass through these foreign withholding taxes to its shareholders, who then may choose to claim a U.S. foreign tax credit or deduction.

If a RIC makes an election under section 853(a) to pass through foreign taxes to its shareholders, section 853(b)(2)(A) requires the shareholders to include their proportionate shares of the RIC's foreign taxes in gross income. Each shareholder can then choose to credit the taxes under section 901 or deduct them under section 164. Although it is not itself claiming a foreign tax credit, the RIC must provide certain information regarding its foreign taxes paid and passed through to shareholders and must file Form 1118, *Foreign Tax Credit – Corporations.*

Over the past several years, RICs have challenged some of the withholding taxes imposed by EU Member States as violating EU law, and recently some funds have begun to receive refunds. Read a May 2015 report [PDF 567 KB] prepared by KPMG LLP.

Section 905(c) provides that if a taxpayer pays or accrues a foreign tax for a year and claims a foreign tax credit, and there is a

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subsequent change in its foreign tax liability for that year (referred to in the regulations as a "foreign tax redetermination"), the taxpayer must notify the IRS, and the IRS will then redetermine the amount of foreign taxes paid for the year or years affected.* Under the regulations, a taxpayer generally notifies the IRS by filing an amended return for the year to which the change in foreign tax relates.

*Different rules may apply to foreign taxes paid by a foreign corporation and deemed to be paid by a U.S. corporate shareholder under section 902. As these rules are not relevant here, they are not discussed further.

If the shareholders of a RIC who claim a foreign tax credit for withholding taxes imposed on the RIC are treated as the "taxpayer" for section 905(c) purposes, then under the statute and regulations, they would be required to file amended returns for the year or years to which the refund relates to correct the amount of foreign tax credits claimed.

RICs, however, may have hundreds of shareholders and frequent ownership changes. As an administrative matter, requiring a RIC to determine who was a shareholder when foreign taxes were passed through (which may be a very different group than the shareholders in the year a refund is received), and notify those shareholders of the refund, is generally impractical.

Notice 2016-10

The IRS recognized the administrative difficulties and uncertainty for RICs and their shareholders, and for the IRS of requiring a RIC to comply with the general rules under section 905(c) with respect to foreign tax refunds. Notice 2016-10 thus provides two prospective alternative regimes that RICs may use to meet the requirements of section 905(c). In addition, Notice 2016-10 provides guidance on how to account for refunds received prior to the effective date of the notice. If a RIC does not elect to apply one of the alternative methods described in Notice 2016-10, then the general section 905(c) rules apply.

The following discussion first describes the prospective alternatives, and then discusses the rules in Notice 2016-10 for refunds already received by a RIC.

Alternative #1 – Netting approach: The netting method broadly nets the RIC's current year foreign taxes paid against refunds received, and the RIC passes through only the net amount to its shareholders in the current year. More specifically, the RIC reduces its foreign taxes paid in the year it receives a refund (the "refund year") by the "foreign tax adjustment." The foreign tax adjustment is the sum of all refunds received during the year plus the "interest adjustment."

The interest adjustment is the lesser of the interest that would be due on the underpayment of U.S. tax arising from the refund, or the amount of interest paid by the foreign country on the refund. Thus, if the foreign country does not pay interest on a refund, the interest adjustment is zero. And, if the foreign country pays interest but at a lower rate than the deficiency interest the IRS could collect under the Code, the interest adjustment is the smaller amount.

A RIC that passed through foreign taxes to its shareholders in an earlier year that have now been refunded may use the netting method only if:

- The economic benefit of the refund and any interest payment received by the RIC primarily inures to the benefit of the RIC's shareholders in the refund year;
- The RIC was not predominantly owned by insurance companies or fund managers (or their affiliates) in the year the RIC paid the refunded taxes;
- The RIC makes a valid election under section 853(a) to pass through foreign taxes to its shareholders for the refund year; and
- The RIC pays an amount of foreign taxes in the refund year at least equal to the foreign tax adjustment.

KPMG observation: Further guidance is needed regarding how a RIC can demonstrate that the benefit of a foreign tax refund primarily inures to the benefit of the shareholders in the refund year. If a RIC's payment of foreign taxes in the refund year is less than the amount of the foreign tax adjustment by any amount (for example, $1), then the RIC could not apply the netting approach. In addition, it would be helpful for the IRS to define how much ownership by insurance companies and fund managers would constitute "predominant" ownership.

If the RIC applies the netting rule, it does not include the foreign tax adjustment in its gross income for the year, and its dividends paid deduction is reduced by the amount of foreign taxes paid in the refund year that are offset by the foreign tax adjustment. At the shareholder level, the shareholders do not include current year foreign taxes in gross income to the extent offset by the tax refund component of the foreign tax adjustment. The shareholders must, however, include in gross income current year foreign taxes that are offset by the interest adjustment component (and the RIC must separately identify these components in its notice to the shareholders under Reg. section 1.853-3).

Consistent with the rules under Reg. section 1.905-4T for notifying the IRS of a foreign tax redetermination, Notice 2016-10 requires that a RIC applying the netting method for a year must attach a statement to its Form 1118 setting out the following information:

- The amount and date of each refund received during the year;
- The date or dates on which the RIC paid each tax refunded and the year or years in which the RIC reported the taxes paid to the shareholders;
- The amount of interest paid by the foreign country or countries with respect to each refund amount;
- The exchange rates used to translate any foreign currency amounts into U.S. dollars; and
- With respect to each refunded amount, the amounts included in the foreign tax adjustment.

KPMG observation: Separately reporting each date on a which a RIC paid refunded foreign taxes and the amount of interest paid by each foreign country with respect to each refunded amount could require significant volumes of data to be reported by a RIC to the IRS.

Alternative #2 – Closing agreement: A RIC that receives a refund of foreign tax paid in a prior year or years that it passed through to its shareholders under section 853(a) may request a closing agreement to address the treatment of the refund. The IRS will grant a request for a closing agreement when doing so is in the interest of sound tax administration. Notice 2016-10 states that a closing agreement generally will be considered to be in the interest of sound tax administration if the RIC can show:

- That it is precluded from, or it is not reasonably practical for it to

apply the general section 905(c) rules and the netting method; and

- The RIC can provide information sufficient to establish the aggregate adjustments that would be due with respect to the foreign tax credits claimed by its shareholders (including former shareholders) who were treated under section 853 as paying the foreign tax.

KPMG observation: Additional guidance is needed from the IRS regarding both of the above requirements for a RIC to show that a closing agreement will be considered to be in the interest of sound tax administration.

The general rules for requesting a closing agreement (set out most recently in Rev. Proc. 2016-1) apply. The IRS recommends that the request be filed at a pre-submission conference or as soon as possible after a RIC receives a foreign tax refund, perhaps even if the RIC has not yet determined whether netting is possible.

If a closing agreement has not been agreed to or completed before the due date of the return for the refund year, the RIC must so indicate on its tax return and also attach the same information to its Form 1118 as required for a RIC applying the netting method.

Refunds received in years before Notice 2016-10 is effective

A RIC may apply the netting method for pre-effective date years as described above or with one of two modifications. Under the first available modification, instead of excluding only the tax refund component of the foreign tax adjustments from gross income, a RIC's shareholders may exclude the full amount of foreign taxes offset by the foreign tax adjustment. Under the second available modification, the RIC may apply a different approach that is expected to produce substantially the same U.S. federal income tax liability for the shareholders as under Notice 2016-10.

Request for comments

The IRS and Treasury Department request comments on several specific areas of Notice 2016-10 and on additional guidance needed. Specifically, comments are requested concerning:

- Whether and to what extent netting should be permitted in a year in which the foreign tax adjustment exceeds foreign taxes paid and if excess refunds should be allowed as carry overs to a future year
- How to account for interest adjustments for periods prior to and after the date on which the RIC receives a refund of foreign tax (Notice 2016-10 addresses only the pre-refund period)
- How and whether closing agreements related to these issues could be standardized
- Whether guidance is needed on how to apply the section 905(c) rules if neither netting nor a closing agreement is possible

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