IRS Publishes Guidance for RICs that Receive Foreign Tax Credit Refunds

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***IRS* announces the issuance of new regulations that will provide relief for certain regulated investment companies that receive foreign tax refunds by either netting the refund against foreign taxes paid in the year of the refund, or allowing certain RICs to pursue a closing agreement.**

The US Internal Revenue Service (IRS) recently issued an advanced publication of Guidance Relating to Refunds of Foreign Tax for Which an Election Was Made under Section 853 (Notice 2016-10).

Notice 2016-10 describes new regulations to be issued under Sections 853 and 905(c) of the Internal Revenue Code of 1986, as amended (the Code) that will permit certain eligible Regulated Investment Companies (RICs) to net foreign tax credit refunds received against foreign taxes paid in the year that a RIC receives the refund (Netting Method). Notice 2016-10 also describes procedures for obtaining administrative relief through closing agreements for those RICs that are ineligible to use the Netting Method (Closing Agreement Method).

Background

In recent years, the Court of Justice of the European Union has issued two opinions (in *DFA Emerging Markets* and *Santander*) that effectively provide that EU member nations cannot impose a withholding tax on foreign investors unless substantially similar domestic investors are also subject to the tax. Consequently, many RICs that have been withheld upon by EU member states have sought refunds for withholding taxes (also referred to as a “reclaim”). The receipt of a reclaim or refund by a RIC raises significant administrative burdens and complexities for any RIC that has made an election under Section 853 of the Code.

RICs are entitled to claim credits or deductions at the entity level for foreign taxes paid. However, a RIC that is eligible to make an election under Section 853 of the Code to pass through the tax benefit to shareholders (Section 853 Election) generally makes the election because a RIC does not have a pre-credit tax liability against which to offset the foreign tax credit, whereas its shareholders that often have pre-credit tax liabilities could potentially utilize the credit. A RIC is entitled to make a Section 853 Election if more than 50% of the value of its total assets at the close of its taxable year consists of stocks or securities of foreign corporations. In doing so, a RIC causes its shareholders to include in their income their share of the foreign taxes paid by the RIC and permits the shareholders to take either a credit or deduction, subject to certain limitations. The RIC also forgoes a deduction or credit at the entity level for foreign taxes when making the Section 853 Election.

Under Section 905(c) of the Code, however, any taxpayer that claims a foreign tax credit and then receives a refund for those foreign taxes paid must notify the IRS to make a redetermination of its prior tax liability. The taxpayer must then pay the redetermined tax (including interest) upon demand by the IRS. Under Section 905(c), when a RIC has made a Section 853 Election and receives a refund on foreign taxes paid, each shareholder of the RIC would theoretically be required to notify the IRS to have the shareholder’s tax liability redetermined. In the case of most RICs, it would be practically impossible to identify and to notify the potentially thousands of current and former shareholders that would need to have their tax liability adjusted pursuant to section 905(c).

In response to concerns raised by the industry and practitioners, the IRS and the Treasury Department published Notice 2016-10 to address the anticipated administrative burden that both the IRS and the industry would have faced in complying with the requirements of Section 905(c) of the Code in connection with reclaims of EU taxes. Specifically, Notice 2016-10 explains that regulations will be forthcoming that will enable RICs that have made a Section 853 Election and receive a refund to follow two alternative methods to satisfy their own and their shareholders’ obligations under Sections 853 and 905(c) of the Code. As a third alternative (or where they do not qualify for the use of either of the first two alternatives), a RIC and its current and/or former shareholders may follow the “general rules provided in section 905(c),” meaning that each relevant shareholder must notify the IRS to trigger an individual tax redetermination.

The Netting Method

Pursuant to the Netting Method under the forthcoming regulations, in lieu of applying Section 905(c) of the Code, a RIC must reduce the amount of foreign taxes it reports to its current shareholders in the refund year by the refund amount plus any accrued interest received on the refund. In general, to be eligible to apply the Netting Method, the following criteria must be met:

1. The economic benefit of the refund and any related interest payment received by the RIC must primarily inure to the RIC’s refund-year shareholders as opposed to prior-year shareholders.

2. The RIC must not have been “held predominately by” insurance companies and certain other holders in the year that it paid the foreign taxes.

3. The RIC must have made a valid election under Section 853(a) for the refund year.

4. The RIC must have paid an amount of foreign taxes in the refund year that is equal to or greater than the amount of the "foreign tax adjustment" for that year.

The regulations will require RICs to make other adjustments to ensure that the proper amount is reported to refund-year shareholders and to provide an adjustment to a RIC's dividends paid deduction to reflect the netting. For example, a RIC will not include as income from foreign sources the amount of the foreign tax adjustment, and shareholders will not include in income the amount of foreign taxes that are netted by the foreign tax refund part of the adjustment. However, shareholders are required to include in income the amount of foreign taxes that are netted against any interest adjustment. In addition, a RIC using the Netting Method, instead of paying (or having its shareholders pay) "pre-refund" interest to the IRS—that is, interest on the US tax deficiency arising from the refund of the foreign tax for the period ending with the receipt of the refund—nets such amount (as well as the refunded foreign tax) against the foreign taxes paid by the RIC for the year of the refund. However, the RIC (or its shareholders) must apparently still account for "post-refund" interest without regard to the use of the Netting Method. The IRS has solicited comments as to whether such post-refund interest could also be netted against foreign taxes paid by the RIC and, if so, how that would be accomplished mechanically.

The regulations will also require a RIC to comply with certain requirements in notifying the IRS of a refund. Questions still remain as to how a RIC is to determine whether the benefit of the refund "primarily inures to the RIC's refund-year shareholders" in order to be eligible to apply the Netting Method. It is not entirely clear how the reference to RICs "held predominantly by" insurance companies and certain other entities should be interpreted, since the statutory and regulatory provisions applicable to insurance-dedicated RICs do not use that language.

The Closing Agreement Method

According to Notice 2016-10, if a RIC requests a closing agreement from the IRS, the IRS will enter into a closing agreement with the RIC if the RIC has made a Section 853 Election and can demonstrate that

- either it is precluded from applying, or it is not reasonably practical for it to apply, the general rules under Section 905(c) of the Code or the Netting Method described above; and
- it can provide information sufficient to establish a reasonable estimate of the adjustments that would be due under Section 905(c) with respect to the foreign tax credits claimed by its shareholders (including former shareholders).

Notice 2016-10 encourages RICs to request tentative closing agreements as soon as they receive a refund and to do so by following the standard pre-submission conference procedures applicable to all types of IRS ruling requests. It appears from the wording of Notice 2016-10 that the IRS expects RICs to request such closing agreements from the IRS National Office rather than Field offices; however, this point is not clear. The tentative request should propose a method for determining the required adjustment under Section 905(c) and provide details regarding the supporting information to make the determination. There is also a procedure for filing a return when a RIC has requested a closing agreement but has not yet received a finalized adjustment.

One observation in this area is that Notice 2016-10 does not offer a de minimis standard for requesting closing agreements. Therefore, it would appear that any RIC that receives a refund and which is ineligible to apply the Netting Method would either need to request a closing agreement or attempt to apply the rules under Section 905(c), even if the relevant amounts are immaterial. Another observation is that Notice 2016-10 requests comments about whether the netting of a refund should be permitted if the current-year taxes are less than the refund, and whether a carryover of the excess should be permitted.

Key Dates

The regulations described in Notice 2016-10 are expected to apply to any refund year ending on or after February 4, 2016 (the expected date of publication of Notice 2016-10), and taxpayers are permitted to rely on the Netting Method described in Notice 2016-10 if the refund year ends before proposed or temporary regulations are issued. The Closing Agreement Method described above will also apply to any requests submitted on or after February 4, 2016. In addition, Notice 2016-10 indicates that future regulations will permit a RIC that has a refund year ending before February 4, 2016, to follow the Netting Method in Notice 2016-10 with modifications or apply “an approach that is expected to produce substantially the same US Federal income tax liability that the RIC’s shareholders would have had in the aggregate” under Notice 2016-10. Notice 2016-10, however, does not appear to address situations in which RICs would not have been eligible to have applied the Netting Method due to already having received refunds that exceeded the foreign taxes paid in a refund year that ended prior to the publication of Notice 2016-10.

Conclusion

Notice 2016-10 will provide welcome relief to the many RICs that are expecting refunds from EU member nations and that are eligible for the Netting Method. For those not eligible for the Netting Method, assurances from the IRS that they intend to enter into closing agreements will also be a welcome relief.

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