

IRS Issued Guidance Relating to Refunds of Foreign Tax for Which an Election Was Made Under Section 853 with Notice 2016-10

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) recently issued Notice 2016-10¹ to address the application of sections 853 and 905(c) to the receipt by a regulated investment company (RIC) of a refund of a tax that was eligible for a foreign tax credit under section 901 or 903 (foreign tax) if that foreign tax, when paid by the RIC, was treated as paid by the RIC's shareholders under section 853(b)(2) because an election was made under section 853(a). The Notice describes regulations under sections 853 and 905(c) that the Treasury Department and the IRS intend to issue. The Notice also provides guidance on obtaining administrative relief through closing agreements.

The Court of Justice of the European Union held that member states of the European Union could not impose withholding taxes on certain foreign investors if substantially similar domestic investors were not subject to tax. Numerous RICs are now seeking, and some have received, refunds of foreign taxes paid to these countries. In light of these refund claims and payments, taxpayers have requested that the Treasury Department and the IRS provide guidance concerning the appropriate treatment of these refunds by RICs that made elections under section 853(a) for the years in which the taxes were originally paid.

Although such refunds are subject to section 905(c), the Code does not explicitly address how section 905(c) applies to amounts that were treated as paid by a RIC's shareholders under section 853 or the manner in which a RIC and its shareholders may satisfy their obligations under section 905(c). In general, when a foreign tax is refunded, the taxpayer must notify the IRS, which redetermines the amount of the taxpayer's US tax liability for the year or years affected, and the taxpayer must pay any redetermined amount upon notice and demand. When RICs receive refunds of foreign taxes, however, providing adequate notification to shareholders and the IRS may be impractical, given that the RICs may not know the identities or addresses of shareholders who claimed foreign tax credits in previous years. Without guidance providing alternative procedures for the particular situation of RICs that made elections under section 853 and their shareholders, the application of section 905(c) could lead to significant administrative costs and uncertainty for the US government and for RICs and their shareholders.

The Treasury Department and the IRS believe that published guidance detailing alternative methods that RICs and their shareholders may use to satisfy their obligations under sections 853 and 905(c) will promote effective tax administration. The Notice provides guidance, and describes regulations that the Treasury Department and the IRS intend to issue, in order to help affected taxpayers discharge their obligations under sections 853 and 905(c).

As an alternative to applying the general rules under section 905(c), a RIC and its shareholders may discharge their obligations under sections 853 and 905(c) with respect to foreign tax refunds described below by utilizing either the Netting of Foreign Taxes in Refund Year method ("Netting method") or the Closing Agreements method. Failure to discharge those obligations under either the general rules provided

¹ 2016-6 IRB 1.

in section 905(c) or one of the alternative methods may result in asserted deficiencies and penalties for the RIC and any shareholders of that RIC that claimed a related foreign tax credit.

NETTING OF FOREIGN TAXES IN REFUND YEAR

Eligibility to Use Netting

The regulations describing the Netting method are expected to apply if a RIC receives in a taxable year (the "refund year") a refund of foreign tax that had been paid in a taxable year in which the RIC made an election under section 853(a). These regulations are expected to provide a netting method that such RICs may apply in lieu of the general rules under section 905(c), if the following requirements are met:

- (a) The economic benefit of the refund and any related interest payment received by the RIC primarily inures to the RIC's refund-year shareholders (as opposed to, if different, shareholders in the year or years in which the RIC paid the refunded foreign taxes);
- (b) The RIC was not held predominantly by entities described in section 817(h)(4)(A) or (B) in the year in which the RIC paid the refunded foreign taxes;
- (c) The RIC makes a valid election under section 853(a) for the refund year; and
- (d) The RIC paid an amount of foreign taxes in the refund year that is equal to or greater than the amount of the foreign tax adjustment described below for that year.

Observation: A RIC cannot use the Netting method if the amount of the refund received exceeds the taxes paid in the refund year – presumably even if only by \$1. Moreover the Notice does not address any applicable carry-over mechanism. RICs that are the investment vehicles for variable annuities and variable life contracts cannot use the Netting method.

Netting Procedure

The regulations are expected to provide that, if a RIC applies the Netting method, then for purposes of section 853, the RIC must reduce the amount of foreign taxes reported by the RIC to its shareholders for the refund year by the amount of the foreign tax adjustment defined below.

Foreign Tax Adjustment

The foreign tax adjustment for a refund year is equal to the sum of:

- (1) All foreign tax refunds received by the RIC in the refund year; and
- (2) All interest adjustments, as defined below.

An interest adjustment period begins on the date on which the RIC made a payment of foreign tax related to the refund and ends on the date on which the RIC receives the refund. Each payment of foreign tax that relates to a refund produces one or more separate interest adjustment periods. (Foreign tax amounts paid in the same taxable year may have been refunded on different dates during the refund year at issue, and foreign taxes refunded on a single date may have been paid on different dates and in different taxable years.)

Observation: Post-refund period interest is not included.

The amount of the interest adjustment, calculated for each interest adjustment period, is an amount equal to the lesser of:

- (1) The amount of interest that would be calculated for that period under section 6601 with respect to an underpayment of tax equal to the amount of the associated foreign tax refund; or
- (2) The amount of interest paid by a foreign country or possession of the United States to the RIC with respect to the associated foreign tax refund for that period.

Effects of Netting

The effects of utilizing the Netting method include the following:

- (a) The RIC will not include as income from sources without the United States the amount of the foreign tax adjustment. (Not Foreign Source Income)

(b) The shareholders of the RIC will not include in their gross income under section 853(b)(2)(A) and § 1.853-2(b) the amount of the current year foreign taxes that are offset by the foreign tax refund component of the foreign tax adjustment, and that amount will be excluded from the amount of income reported to the shareholders under § 1.853-3. The shareholders of the RIC will include in their gross income under section 853(b)(2)(A) and § 1.853-2(b) the amount of the current year foreign taxes that are offset by the interest adjustment component of the foreign tax adjustment, and that amount will be included in the amount of income reported to shareholders under § 1.853-3. (Included and excluded from taxable income)

(c) To determine the dividends paid deduction, the amount of the foreign taxes paid in the refund year for which an addition to the dividends paid deduction otherwise would be allowed under section 853(b)(1)(B) will be reduced by the amount of the foreign tax adjustment for that taxable year. (Dividends paid deduction)

Notification Requirement for RICs Utilizing Netting

The regulations are expected to provide that, if a RIC applies the Netting method, the RIC must notify the IRS of each refund on a statement attached to a Form 1118, or its successor, for the refund year. This statement must include the following information:

- (a) The amount of each refund;
- (b) The date on which each refund was received;
- (c) The date or dates on which the RIC paid the foreign tax to which each refund relates;
- (d) The taxable year or years with respect to which the foreign tax to which each refund relates was reported to shareholders;
- (e) The amount of interest paid by the foreign country or possession of the United States with respect to each refunded amount;
- (f) The exchange rates used to translate any foreign currency amounts into dollars; and
- (g) With respect to each refunded amount, the amounts included in the foreign tax adjustment.

Observation: RICs must translate the refunded foreign tax into dollars using the same exchange rate that it used to translate the foreign taxes into dollars when such taxes were originally reported as paid, and compute exchange gain or loss under section 988 on the exchange of the refunded amount for dollars.

CLOSING AGREEMENTS

A RIC that receives a refund of foreign tax that had been paid in a prior taxable year in which an election was made under section 853(a) may request a closing agreement addressing the treatment of the refund. A request for a closing agreement will be granted when such an agreement is determined by the IRS to be in the interest of sound tax administration.

A closing agreement generally will be considered to be in the interest of sound tax administration when:

- (a) the RIC has demonstrated that either it is precluded from applying, or it is not reasonably practical for it to apply, the general rules under section 905(c) or the Netting method; and
- (b) the RIC can provide information that is sufficient to establish, to the satisfaction of the IRS, a reasonable estimate of the aggregate adjustments that would be due under section 905(c) 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.

A request for a closing agreement must comply with applicable guidance relating to such requests, including, but not limited to, Revenue Procedure 2016-1, 2016-1 I.R.B. 1, or its successor, as well as any future guidance published in the Internal Revenue Bulletin applicable to closing agreements on this issue. Due to applicable deadlines for tax reporting, a tentative request for a closing agreement under the Notice should be initially submitted in accordance with the pre-submission conference procedures provided in Revenue Procedure 2016-1 or other applicable guidance in the Internal Revenue Bulletin, as soon as possible after the receipt of the refund of foreign tax. The tentative request should propose a method for

calculating the aggregate adjustment and should include details regarding the information available to make such calculations and the information that reasonably could be obtained.

If a RIC has submitted a request for a closing agreement but the IRS has not yet determined whether a closing agreement is in the interest of sound tax administration, then the RIC must attach a statement to its Form 1118 for the refund year containing the information required under the Netting method, along with a statement that a closing agreement has been requested, that the request has not been withdrawn or denied, and the date on which the request was submitted.

Observation: Treasury Department and IRS are soliciting comments on whether and in what respects closing agreements relating to these issues could be standardized.

EFFECTIVE DATES

In general, the regulations described for the Netting method are expected to apply to any refund year ending on or after February 8, 2016. The guidance described for Closing Agreements applies to requests for closing agreements filed on or after February 8, 2016.

For refund years ending before the issuance of any proposed regulations or temporary regulations described in the Notice, taxpayers may rely on the rules described for the Netting method.

Observation: RICs may generally utilize any appropriate netting approach that produces substantially the same US tax result that the RIC shareholders would have had, in the aggregate, under either of the two methods specified in the Notice.

The regulations described for the Netting method are expected to provide that a RIC may apply the regulations to refund years ending before February 8, 2016. The regulations also are expected to provide that, if a RIC applies the Netting method with respect to refund years ending before February 8, 2016, then for such refund years the RIC may, as an alternative to applying the rules described under the Netting method:

- (a) apply the rules described under the Netting method by excluding from the amount included in the shareholder's gross income under section 853(b)(2)(A) and § 1.853-2(b) the full amount of the current year foreign taxes that are offset by the foreign tax adjustment, rather than just the amount of the current year foreign taxes that are offset by the foreign tax refund component of the foreign tax adjustment; or
- (b) 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 either the Netting method or the method mentioned above under (a).

An example of a possible approach under (b) mentioned above would be for the RIC to include the interest adjustment in the shareholders' gross income, but reduce the amount of the foreign tax adjustment associated with such interest by an amount that reasonably approximates the US income tax that would be collected from the RIC's shareholders on that income. This approach would only be permissible, however, if it was expected to produce substantially the same US Federal income tax liability that the RIC's shareholders would have had, in the aggregate, under the method mentioned above under (a).

Request for Comments

The Treasury and the IRS are soliciting requested comments on the rules described in the Notice for the following topics:

1. Whether, and to what extent, netting of a refund should be permitted if the foreign tax adjustment exceeds the foreign taxes paid in the refund, and whether excess refunds should be allowed to carry over to a subsequent year or years and netted against foreign taxes paid in those years.
2. Whether an approach should be developed to take post-refund interest into account and how to make any such approach administrable for the IRS and for RICs and their shareholders.
3. Date on which the underpayment deemed satisfied under the Netting method (such as April 15 of the following year) and how interest could be calculated for the period between the date on which the refund is received by the RIC and the date on which the underpayment is deemed to be satisfied under the Netting method.

4. Whether and in what respects closing agreements relating to these issues could be standardized and what information, if any, can be reasonably and uniformly relied upon for calculating the aggregate adjustment relating to such refunds at the RIC level, as opposed to at the shareholder level, when such calculation is appropriate.
5. Whether guidance is needed to clarify how generally section 905(c) would operate with respect to both a RIC that makes an election under section 853(a) and its shareholders.

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