

Chapman Client Alert

August 10, 2016

Current Issues Relevant to Our Clients

IRS Notice on RICs and Refunds of Foreign Tax

In January 2016, the Internal Revenue Service (“IRS”) issued Notice 2016-10 to address foreign tax credits and regulated investment companies (“RICs”). The Internal Revenue Code (the “Code”) does not provide guidance on the question of how a RIC should treat refunds of foreign tax when it has made an election to pass the foreign tax credit to its shareholders. Notice 2016-10 allows RICs in this situation to either use a netting method or request a closing agreement.

Background: Election to Pass Through the Foreign Tax Credit

Normally, RICs may make an election so that shareholders of the RIC are treated as if they paid a proportionate share of any foreign tax that was paid by the RIC during its tax year. When the election is made, the shareholders may take a foreign tax credit or deduction, but the RIC cannot.

Under current rules of the Code, when a foreign tax is refunded by a foreign government, the taxpayer must notify the IRS, which will redetermine the taxpayer’s U.S. tax liability for the affected years.

RICs usually do not have adjustments to foreign tax, but recently the Court of Justice of the European Union held that member states of the European Union could not impose withholding taxes on some foreign investors if substantially similar domestic investors were not subject to tax. Thus, many RICs are seeking and receiving refunds of foreign tax.

Options for RICs That Receive Refunds of Foreign Tax

Under Notice 2016-10, RICs that have elected to pass through the foreign tax credit and receive refunds of foreign tax may either use a netting method or request a closing agreement.

(1) Netting Method

Under the netting method, the RIC reduces the amount of foreign taxes it reports to its shareholders for the refund year by the amount of the foreign tax adjustment. The foreign tax adjustment equals the sum of all foreign tax refunds received by the RIC in the refund year plus all interest adjustments. The 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 the RIC receives the refund. The amount of interest is the lesser of (1) the amount that would be calculated for that period under Code 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.

The netting method may be used if all of the following requirements are met:

1. 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 taxes).
2. The RIC was not held predominately by insurance companies or fund managers.
3. The RIC made a valid election to pass through the foreign tax credit to its shareholders.
4. 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.

As a result of using the netting method, the RIC may exclude the amount of the foreign tax adjustment from income from foreign sources. Also, the amount that shareholders include in the calculation of current-year foreign taxes is reduced by the amount that is offset by the foreign tax refund. Regarding 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 Code Section 853(b)(1)(B) is reduced by the amount of the foreign tax adjustment.

A notification requirement is expected to appear in the regulations regarding Notice 2016-10. If a RIC applies the netting method, it must notify the IRS of each refund on a statement attached to Form 1118 with certain details.

(2) Closing Agreement

Alternatively, a RIC may request a closing agreement if it receives a refund of foreign tax that had been paid in a previous tax year in which an election was made.

The IRS will grant a closing agreement when it has determined that it is in the interest of sound tax administration. A closing agreement will be considered to be in the interest of sound tax administration when both of the following facts are true:

- 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 below (IRS redetermination) or the netting method.
- 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 an IRS redetermination with respect to the foreign tax credits claims by its shareholders who were treated under the election as paying the foreign tax.

The closing agreement should be requested under the normal deadlines and rules for requesting closing agreements in Rev. Proc. 2016-1. Also, 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 submit an attachment to its Form 1118 stating that a closing agreement has been requested and the date it was submitted.

(3) General Rules of IRS Redetermination

Notwithstanding the two options above, a RIC may continue to use the general rules of the Code by notifying the IRS of the refund and accepting an IRS redetermination of U.S. tax liability.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

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