

Part III – Administrative, Procedural, and Miscellaneous

Guidance Relating to Refunds of Foreign Tax for Which an Election Was Made Under Section 853

Notice 2016-10

SECTION 1. OVERVIEW

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) are issuing this notice to address the application of sections 853 and 905(c) of the Internal Revenue Code 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). This notice describes regulations under sections 853 and 905(c) that the Treasury Department and the IRS intend to issue. This notice also provides guidance on obtaining administrative relief through closing agreements.

RICs do not generally have changes to their foreign tax liabilities, as described in section 905(c), both because foreign withholding taxes, which RICs generally pay, are usually determinable at the time the income from which the tax is withheld is paid or accrued, and because section 986(a)(1)(E) provides that a RIC reporting income using an accrual method translates foreign income taxes into dollars using the exchange rate as of the date the income accrues. Therefore, both the amount of the foreign tax, as denominated in the foreign currency, and the appropriate exchange rate for the tax are typically ascertainable before the RIC furnishes statements to shareholders or files its income tax return.

Recently, however, 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 U.S. 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, including because 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 U.S. 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. This 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).

Section 2 provides background information with respect to sections 853 and 905(c). Section 3 provides that RICs and their shareholders may satisfy their obligations under sections 853 and 905(c) under two alternative methods—following a netting method or obtaining a closing agreement. These two alternatives are described in sections 4 and 5. Section 6 describes the expected effective date of the regulations described in section 4 and the effective date of the guidance in section 5. Section 7 solicits comments and provides contact information for purposes of submitting comments. Section 8 relates to requirements under the Paperwork Reduction Act.

SECTION 2. BACKGROUND

.01 The Election Provided in Section 853

Section 853 allows a RIC that meets certain requirements to make an annual election under which the RIC's shareholders are treated as if they paid a proportionate share of any foreign tax that was paid by the RIC during the RIC's taxable year to which the election relates. The election is available to a RIC if: (1) more than 50 percent of the value of its assets, at the close of the taxable year, consists of stock or securities in foreign corporations, and (2) the RIC has complied with the requirements in section 852(a) and § 1.852-1(a) of the Income Tax Regulations. If the RIC makes this election

for a taxable year, it forgoes a deduction or credit for foreign taxes. Instead, under section 853(b)(2)(A), the RIC's shareholders are required to include in their gross income and treat as paid by them their proportionate shares of the foreign taxes and, accordingly, are eligible to claim either a deduction or credit for those foreign taxes in accordance with sections 164 and 901. In addition, each shareholder of an electing RIC, under section 853(b)(2)(B), must treat as gross income from sources without the United States the sum of the shareholder's proportionate share of the foreign taxes and the portion of any dividend paid by the RIC that represents income derived from sources without the United States.

A RIC that makes the election under section 853(a) must provide certain information to its shareholders and the IRS. First, under section 853(c) and the regulations thereunder, the RIC must identify, in a written statement furnished to each shareholder, each shareholder's proportionate share of foreign taxes paid by the RIC and each shareholder's proportionate share of the RIC's income derived from sources without the United States. Under § 1.853-4(a), the RIC must file a statement as part of its income tax return (Form 1120-RIC, "U.S. Income Tax Return for Regulated Investment Companies," or its successor) that sets forth the total amount of income received from sources without the United States; the total amount of foreign taxes paid; the amount, if any, of the foreign taxes paid that are not eligible for the section 853(a) election; the date, form, and contents of the written statement furnished to its shareholders; and the proportionate share of income received and taxes paid during the taxable year that are attributable to one share of its stock. Under § 1.853-4(d), the RIC

must also file, as part of its return for the taxable year, a Form 1118, “Foreign Tax Credit—Corporations.”

.02 Requirements under Section 905(c)

Under section 905(c), if a taxpayer claims a credit for taxes paid or accrued under section 901 (or deemed paid under section 902 or 960) and that foreign tax is refunded, the taxpayer generally must notify the IRS, which shall redetermine the amount of the taxpayer’s U.S. tax liability for the year or years affected. Any U.S. tax due by reason of the foreign tax refund must be paid upon notice and demand. Interest accrues under section 6601 on the amount of tax due, but under section 905(c)(5), the amount of interest is capped for the period prior to the receipt of the refund at the amount of interest paid by the foreign country or possession of the United States on the refund.

.03 Exchange Rates and Foreign Currency Gain or Loss

For purposes of calculating the U.S. dollar amount of a refund received by a RIC of foreign tax that is denominated in a foreign currency and the RIC’s basis in the foreign currency refunded, a RIC 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. See sections 986(a)(1)(E) and 986(a)(2)(B)(ii). Upon disposition of the foreign currency refunded, the RIC must recognize any foreign currency gain or loss. See section 988(c)(1)(C) and the regulations under that section.

SECTION 3. APPLICATION

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 method described in section 4 or the method described in section 5. Failure to discharge those obligations under either the general rules provided in section 905(c) or one of the alternative methods described in sections 4 and 5 may result in asserted deficiencies and penalties for the RIC and any shareholders of that RIC that claimed a related foreign tax credit.

SECTION 4. NETTING OF FOREIGN TAXES IN REFUND YEAR

.01 Eligibility to Use Netting

The regulations described in this section 4 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 in section 4.03 for that year.

.02 Netting Procedure

The regulations are expected to provide that, if a RIC applies the method described in this section 4, 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 in section 4.03.

.03 Foreign Tax Adjustment

(a) Components of the 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 in section 4.03(b).

(b) Interest Adjustment Defined

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.)

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.

.04 Effects of Netting

(a) The RIC shall not include as income from sources without the United States the amount of the foreign tax adjustment.

(b) The shareholders of the RIC shall 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 shall be excluded from the amount of income reported to the shareholders under § 1.853-3. The shareholders of the RIC shall 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 shall be included in the amount of income reported to shareholders under § 1.853-3.

(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) shall be reduced by the amount of the foreign tax adjustment as defined in section 4.03 for that taxable year.

.05 Notification Requirement for RICs Utilizing Netting

The regulations are expected to provide that, if a RIC applies the netting method described in this section 4, 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 as defined in section 4.03.

.06 Example: Netting Refunds Against Foreign Taxes Paid

(a) Facts. Corporation L, a RIC, invests in country P stocks in each of taxable years 1 through 6 and makes a valid election under section 853(a) for all years. In each of years 1 through 5, Corporation L earned 1,000u of dividend income from country P stocks and paid 100u in foreign tax. In each of years 1 through 5, the applicable exchange rate is 1u = \$1. With respect to years 1 through 5, Corporation L distributed \$900 to shareholders and reported to shareholders their aggregate proportionate shares of foreign source income and foreign taxes paid of \$1,000 and \$100, respectively. Corporation L also reported \$1,000 of dividend income and claimed \$1,000 in dividends paid deductions (\$900 from the distribution made to shareholders and \$100 under section 853(b)(1)(B) for the foreign taxes paid) with respect to each of years 1 through 5.

In year 6, Corporation L receives dividend income of 1,000u, pays 100u in foreign taxes, and also receives a refund of 55u of the foreign tax it paid in year 1. In year 6, the applicable exchange rate is 1u = \$2. Country P paid to Corporation L interest of 1u on the foreign tax refund, which was less than the amount of interest adjustment that would be calculated for the interest adjustment period under section 6601 with respect to an underpayment of tax equal to \$55 (55u translated at the applicable exchange rate for year 1). Corporation L exchanges the 956u (900u dividends received, net of withholding tax, plus 55u received as a refund of foreign tax and 1u received as interest on the foreign tax refund) for \$1,912 and distributes \$1,912 to its shareholders with respect to year 6 (\$1,800 from dividends received that year, net of withholding tax, plus \$110 received as a refund of foreign tax and \$2 received as interest on the foreign tax refund). Assume that Corporation L has no expenses allocated and apportioned to the dividend income and that it meets the requirements for netting under section 4.01 of this notice.

(b) Results. Corporation L received a refund and applies netting under section 4. For purposes of furnishing statements to shareholders, Corporation L must reduce the \$200 of foreign tax paid in year 6 by the foreign tax adjustment as determined under section 4.03 of this notice. The foreign tax adjustment is the sum of the refund and the interest adjustment, or \$57 (a \$55 refund and a \$2 interest adjustment).

The exchange of the refunded amount for dollars results in \$55 of foreign currency gain under section 988 (\$110 value of refunded foreign currency in year 6 less \$55 basis from year 1). Corporation L must report \$2,000 of dividend income and \$55 of foreign currency gain but does not include as additional income the amount of the foreign tax adjustment.

Corporation L may claim \$2,055 in dividends-paid deductions (\$1,912 from the actual distribution to year 6 shareholders, plus \$143 (\$200 foreign taxes paid less \$57 foreign tax adjustment) of foreign taxes paid under section 853(b)(1)(B)). See section 4.04 of this notice.

Corporation L must attach a statement to its Form 1118 for year 6 that includes the information listed in section 4.05 of this notice. After netting, Corporation L's shareholders are deemed to have paid foreign taxes in year 6 of \$143 (\$200 foreign taxes paid less \$57 foreign tax adjustment). Corporation L must report to its year 6 shareholders \$2,057 of gross foreign source income (\$1,912 from the distribution plus \$145 from the foreign taxes paid in year 6 (\$200 foreign taxes paid in year 6 less \$55 foreign tax refund under section 4.04(b) of this notice)) and \$143 of foreign tax, and Corporation L's year 6 shareholders must include such income in their gross income and treat such foreign tax as paid by them.

SECTION 5. CLOSING AGREEMENTS

.01 General Rules for Closing Agreements under this Notice

Under this section, 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 method described in section 4; 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.

.02 Requirements for, and Timing of, Requesting a Closing Agreement

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 this section 5 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.

.03 Notification Requirement for RICs Requesting Closing Agreements

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 in paragraphs (a) through (f) of section 4.05, 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.

SECTION 6. EFFECTIVE DATES

.01 In General

Except as otherwise provided in this section 6, the regulations described in section 4 are expected to apply to any refund year ending on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT]**.

The guidance described in section 5 applies to requests for closing agreements filed on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT]**.

.02 Taxpayer Reliance on Section 4

For refund years ending before the issuance of any proposed regulations or temporary regulations described in this notice, taxpayers may rely on the rules described in section 4.

*.03 Special Rules for Taxpayers Applying the Rules Described in Section 4 to Refund Years Ending Before **INSERT DATE OF PUBLICATION OF THIS DOCUMENT***

The regulations described in section 4 are expected to provide that a RIC may apply the regulations to refund years ending before **INSERT DATE OF PUBLICATION OF THIS DOCUMENT**.

The regulations also are expected to provide that, if a RIC applies the netting method described in section 4 with respect to refund years ending before **INSERT DATE OF PUBLICATION OF THIS DOCUMENT**, then for such refund years the RIC may, as an alternative to applying the rules described in section 4.04(b):

(a) apply the rules described in section 4.04(b) 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 U.S. Federal income tax liability that the RIC's shareholders would have had, in the aggregate, under either section 4.04(b) or 6.03(a).

An example of a possible approach under section 6.03(b) 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 U.S. 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 U.S. Federal income tax liability that the RIC's shareholders would have had, in the aggregate, under section 6.03(a).

SECTION 7. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS solicit comments on the rules described in this notice. The Treasury Department and the IRS specifically solicit comments on 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 year, 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.

The Treasury Department and the IRS also solicit comments on the principles to be applied to interest adjustments for periods prior to and after the date on which the refund of foreign tax is received by the RIC. In order to approximate the U.S. tax consequences that would arise had the foreign tax refunds been paid directly to the shareholders who originally claimed the foreign tax credits, the interest adjustment would need to account for the fact that interest generally would run on a redetermination under section 905(c) from the due date of the taxpayer's return on which the credit was claimed until the date on which the redetermined amount is actually paid. This period is divided into two separate periods under section 905(c) -- the "pre-refund" period (which is subject to the limitation under section 905(c)(5)) and the "post-refund" period. This Notice only addresses interest during the pre-refund period. Accordingly, the Treasury Department and the IRS are considering whether an approach should be developed to take post-refund interest into account and how to make any such approach administrable for both the IRS and for RICs and their shareholders. In that respect, the Treasury Department and the IRS request comments regarding the date on which the underpayment should be deemed to be satisfied under the netting method (such as

April 15 of the following calendar 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.

The Treasury Department and the IRS also solicit comments on 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 a calculation is appropriate.

In addition, the Treasury Department and the IRS solicit comments as to whether guidance is needed to clarify how the generally applicable rules of section 905(c) operate with respect to both a RIC that makes an election under section 853(a) and its shareholders.

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Larry R. Ponders, Internal Revenue Service, IR-4549, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice.comments@irsounsel.treas.gov. Comments will be available for public inspection and copying. For further information regarding this notice, contact Mr. Ponders of the Office of Associate Chief Counsel (International) at (202) 317-5465 (not a toll-free call).

SECTION 8. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-0123. An agency may not

conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is under sections 4.05 and 5.03.

This information is required to allow the IRS to verify the calculations made by the RIC, and to verify the appropriate amount of gross foreign source income and foreign tax credits available to shareholders. The likely respondents are RICs that invest in foreign securities. The estimated total annual reporting recordkeeping burden is 15,000 hours. The estimated annual burden per respondent/recordkeeper is 10 hours. The estimated number of respondents/recordkeepers is 1,500.

The estimated frequency of responses is occasional.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential as required by 26 U.S.C. § 6103.