February 27, 2014

The Honorable Mark Mazur
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John Koskinen
Commissioner
Internal Revenue Service
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The Honorable William J. Wilkins
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Re: Treatment under Sections 853 and 905(c) of Foreign Tax Refunds Received by RICs

Dear Messrs. Mazur, Koskinen and Wilkins:

This letter[1] makes recommendations for guidance addressing the treatment of foreign tax refunds, under Sections 853 and 905(c),[2] received by a regulated investment company ("RIC"). Depending on the outcome of certain legal developments in Europe, some RICs are expected to receive material refunds of foreign taxes previously paid by them.[3] It is unclear, however, how a RIC and its shareholders should treat such refunds if, for the year the RIC paid the refunded foreign tax, the RIC elected under Section 853(a) to have its shareholders treated as paying the foreign tax and thereby potentially eligible to claim a foreign tax credit ("FTC") or deduction in respect of such tax.

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1 The letter may be cited as NYSBA Tax Section Report No. 1298, "Recommended guidance Addressing the Treatment of Foreign Tax Refunds under Sections 853 and 905(c)" (February 4, 2014). The principal drafter of this letter was James R. Brown with substantial assistance from Robert Larimore. Helpful comments were received from Kimberly Blanchard, Stephen Land, Michael Schler, David Schnabel, Stephen Shay, Eric Sloan and Willard Taylor. This letter reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

2 Section references are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder.

3 *See* Letter from Investment Company Institute to Erik Corwin, Deputy Chief Counsel—Technical, Internal Revenue Service (Apr. 30, 2013), available at http://www.ici.org/pdf/27211.pdf (the "ICI Letter"), and Deanna Flores, Caren Shein & Daniel Dzenkowski, KPMG, *European Union Tax Refund Developments and Potential Foreign Tax Credit Implications for U.S. Mutual Funds* (Aug. 14, 2009), available at http://us.kpmg.com/microsite/taxnewsflash/2009/Aug/Fokus_Bank_Reclaim.pdf (the "KPMG Article"). We have been told informally, however, that prospect for the final resolution of these refund claims is very unclear.

This letter discusses how foreign tax refunds might be treated in that situation. It generally recommends that, for purposes of Section 853(a), the amount of foreign taxes otherwise treated as paid by a RIC (and thereby potentially eligible to be taken as a credit or deduction by its shareholders) for a current year be reduced by the amount of foreign tax refunds received by the RIC in the current year. It also generally recommends that, to the extent that the refunded tax exceeds the foreign taxes paid by the RIC in the current year, the refunded tax reduce the amount of foreign taxes otherwise treated as paid by the RIC in future years for purposes of applying Section 853 in those years.

Section 853(a) Election

Section 853 very generally allows RICs to elect to pass through to their shareholders FTCs or deductions for foreign taxes that the RIC otherwise could have claimed. Specifically, under Section 853(a), a RIC may elect, for each taxable year with respect to which certain conditions are met,[4] for Section 853 to apply "with respect to income…taxes described in section 901(b)(1), which are paid by the investment company during such taxable year to foreign countries…." This election (a "Section 853 Election") applies to all foreign taxes *paid* by the RIC that otherwise qualify for the FTC under Section 901.[5] It does not apply to *accrued* foreign taxes.

If a RIC makes a Section 853 Election for a taxable year, "each shareholder of such investment company shall include in gross income and treat as paid by him his proportionate share of such taxes" paid by the RIC during the taxable year.[6] Regulations clarify that, as a result of a RIC's Section 853 Election, the RIC's shareholder is "in effect, placed in the same position as a person directly owning stock in foreign corporations [from which the income subject to the foreign tax originated], in that he must include in his gross income… his proportionate share of such foreign taxes paid and must treat such amount as foreign taxes paid by him for the purposes of the deduction under section 164(a) and the credit under section 901."[7] Accordingly, the shareholder may claim a FTC or deduction for the amount of foreign tax it is deemed to have paid, provided that, in the case of FTCs, the shareholder satisfies a holding period requirement with respect to its RIC shares.[8]

A RIC making a Section 853 Election for a year is not itself allowed a deduction or FTC for any foreign taxes it has paid during the year.[9] In addition, for purposes of determining its tax liability under Section 852, the RIC's dividends paid deduction is increased by the amount of such foreign taxes paid.[10]

> Example 1. Assume a RIC with four equal shareholders earns $400 of foreign-source dividend income, which is subject to $60 of foreign tax. Provided that the RIC makes a Section 853 Election and distributes $85 of cash to each of its shareholders, each shareholder would be treated as recognizing $100 of foreign source income, paying $15 of foreign taxes and thereby potentially eligible to claim a FTC or deduction of $15. Assuming the RIC has no other income or expense, the RIC's dividends paid deduction would be $400 and it would have no tax liability.

Section 905(c) Redetermination

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[4] For a RIC to make the election, more than 50 percent of the value of the RIC's total assets at the close of the taxable year must consist of stock or securities in foreign corporations, and it must otherwise qualify to be taxed as a RIC. Section 853(a)(1) and (2).

[5] Treas. Reg. § 1.853-4(b).

[6] Section 853(b)(2)(A).

[7] Treas. Reg. § 1.853-2(b).

[8] Section 901(k)(2).

[9] Section 853(b)(1)(A).

[10] Section 853(b)(1)(B). The dividends paid deduction reduces the amount otherwise subject to tax under Section 852.

Generally, if a taxpayer claims a FTC for a foreign tax paid and the tax is later refunded, the taxpayer must recompute its taxes for the year that the taxpayer claimed the FTC (along with other years affected by such recomputation). Specifically, Section 905(c)(1)(C) requires that, "if … any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary, who shall redetermine the amount of the tax of the year or years affected." Regulations clarify that a "redetermination" of U.S. tax liability is for the year that the FTC was claimed if a "foreign tax redetermination occurs with respect to a foreign tax paid,"[11] and a "foreign tax redetermination includes: … any tax paid that is refunded in whole or in part."[12] They also specify that the "redetermination" of U.S. tax is made by the taxpayer means of filing of an amended return for the year that "redetermination of United States tax liability is required."[13]

Based on the current regulations under Section 905(c), it is unclear whether or how this provision should be applied to a RIC's receipt of refunded foreign taxes paid in a year for which its shareholders were treated as paying the foreign taxes under Section 853.[14] In particular, it is unclear whether any or all of the RIC and its shareholders who claimed a FTC must be treated as a "taxpayer," within the meaning of Section 905(c), and therefore required to amend its tax return.[15]

As currently drafted, the regulations under Section 905(c) suggest that the RIC should *not* be treated as the "taxpayer" for this purpose, since by making the Section 853 Election, it is precluded from claiming the FTC, and the requirement for a taxpayer to make a redetermination keys off of the "taxpayer" having claimed a FTC for a refunded tax. Treating the RIC as the "taxpayer" for purposes of Section 905(c) would also be inconsistent with Section 853. That is because the RIC's Section 853 Election is not the equivalent of its shareholders' claim of a FTC. The Section 853 Election permits the RIC's shareholders to alternatively deduct the foreign tax deemed paid by them, and it is clear that no redetermination under Section 905(c) is required if no FTC is claimed. For this reason alone, we do not recommend that Section 905(c) be interpreted to require a RIC redetermine its prior treatment of a refunded tax in respect of which a Section 853 Election applied.

In addition, revising the regulations under Section 905(c) to apply to the RIC (and not its shareholders) would fail to make the government whole for the refunded foreign tax for which FTCs were claimed. A redetermination of the RIC's treatment of the refunded foreign tax for the year it paid the tax would result in a reduction of the RIC's dividends paid deduction for that prior year by the portion of the refunded tax claimed as a FTC by its shareholders, requiring the RIC to determine how much of the tax its shareholders claimed as a FTC.[16]

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[11] Treas. Reg. § 1.905-3T(d)(1).

[12] Treas. Reg. § 1.905-3T(d)(1).

[13] Treas. Reg. § 1.905-4T.

[14] Other pass through entities and quasi-pass through entities might also receive refunds of foreign tax in respect of which an equity owner of the entity claimed a FTC or deduction. It is also possible that in that circumstance the owner would have disposed of its interest in the pass through before the pass through receives the refund. However, outside of the Section 902 context, we are unaware of any authority that directly and explicitly addresses the treatment of such refunds under Section 905(c).

[15] If a RIC receiving a refund of foreign tax did not have in place a Section 853 Election for the year in which the tax was paid, Section 905(c) should not apply to the refund since there would have been no FTC for the tax.

[16] Because the redetermination could apply to only the portion of the foreign tax in respect of which shareholders claimed FTCs, in order to make the redetermination for its treatment of the foreign tax, the RIC would have to investigate which prior shareholders claimed FTCs. While RIC could not be required (or permitted) to make a redetermination for the refunded tax in respect of which its shareholders claimed a deduction, we believe that the RIC could be required, for the year it received the refund, to take into income the amount of foreign tax deemed paid and deducted by its shareholders, though in such event the RIC would presumably avoid tax on the income by distributing to its current shareholders as a regular dividend eligible for the dividends paid deduction for its current year. We do not recommend a RIC be required to include in income the amount of refunded tax in respect of which its shareholders claimed a deduction. As discussed, we instead recommend that the refunded tax be netted against taxes otherwise treated as paid by the RIC's shareholders under Section 853 in the year of the refund (or a later year as necessary). By reducing the amount otherwise available for a deduction or credit in the year of the refund at the shareholder level, our recommendation effectively reverses the potential prior benefit

However, that redetermination, even assuming it could be made, would not result in an income tax liability to the RIC, provided that the RIC were to pay a deficiency dividend to its current shareholders with respect to that prior year and in the amount of the FTCs claimed under Section 855.[17] And even if the RIC did not pay a deficiency dividend with respect to the additional income treated as recognized in that prior year by reason of the redetermination, for that year it would owe income tax on only that income (assuming it otherwise continued to qualify to be taxed under Section 852 after the redetermination).[18]

> Example 2. Assume the fact of Example 1 and that in the following year, when the RIC has four different equal shareholders, the RIC receives a refund of the prior year foreign taxes and earns $400 of foreign-source dividend income which is subject to $60 of foreign tax. Again assume that the RIC has no other income or expense for the year and assume all $60 of the refunded tax had been claimed as FTCs by the RIC's shareholders in the first year. Applying Section 905(c) to the RIC alone would require it to amend its prior year tax return and reduce its dividends paid deduction for that year by $60. For the RIC to avoid being subject to tax for the prior year, it would also have to pay a deficiency dividend of $60 to its current shareholders with respect to such prior year. While this result increases the amount of income subject to tax by $60 (to $460), it fails to make the government whole assuming the RIC's shareholders claimed FTCs of $60.

Applying Section 905(c) to the RIC's shareholders who claimed the FTC would seem to fit somewhat more easily within the current framework of the provision, except that the shareholders would not have received the refund[19] and may not even be shareholders when the RIC receives it. In fact, these shareholders could only know to amend their returns if new rules were adopted requiring the RIC to notify them of its receipt of the refund. And of course applying Section 905(c) to the RIC shareholders would have no effect on those that claimed a deduction instead of a FTC in respect of the refunded tax. Even if those issues could be resolved, we do not recommend applying Section 905(c) to the RIC shareholders, however, since doing so would result in significant administrative burdens for the shareholders, the RIC and the government, which would likely materially constrain the effectiveness of that approach. Moreover, since the shareholders would not have received the refund, their redetermination of tax would not include the income associated with the foreign taxes. For that income to be taxed, Section 905(c) would have to be applied to the RIC as well (in the manner explained above)

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of the foreign tax, ensuring that the government will not be harmed (except to the extent that the relative portion of the RIC's shareholder base that is tax exempt has increased). It would be virtually impossible to achieve this result through an alternative mechanic that depends on identifying what portion of the foreign taxes were deducted or claimed as FTCs in the prior year.

[17] Generally, if a RIC fails to distribute all of its income in a year, it can distribute the income in a later year as a deficiency dividend under Section 855 and have the later distribution be treated as having been made in the earlier year for purposes of determining the RIC's income tax liability (and qualification to be taxed as a RIC) for the earlier year.

[18] It would also owe interest on the deficiency dividend as provided under Section 855.

[19] We note that the ICI Letter and KPMG Article include illustrations in which the RIC distributes the refunded tax to shareholders that previously claimed FTCs pursuant to Section 853. We have not addressed that hypothetical fact pattern because we are unfamiliar with the legal rationale under which a RIC would be permitted to distribute a foreign tax refund to investors on the basis of how much of the foreign tax they were deemed to have paid or claimed as a FTC under Section 853. Under their organizational documents and applicable securities laws, RICs must generally redeem shareholders based on the net asset value of their fund shares and are permitted to pay dividends to only their current shareholder based on their currently outstanding shares. A RIC generally can make retroactive adjustments to amounts previously distributed to shareholders only if it made a material error in the pricing of its shares. Any such adjustment to take account of a tax refund would be based on how the tax was originally accrued into the value of the RIC's shares and not based on how much foreign tax any shareholder was deemed to have paid or claimed a FTC for under Section 853. For this reason, we have assumed for purposes of this letter that, regardless of how the refund is treated for tax purposes, the RIC would never pay the refund to prior investors based on the amount of imputed foreign tax paid or claimed as a FTC by them under Section 853. We have instead assumed that, when the refund is accrued by the RIC in determining its share value, only the RIC's current shareholders would have a claim to that value based on their right to redeem their shares at their net asset value and their right to participate in dividends paid by the RIC pro rata to their ownership of shares.

so that the RIC either becomes liable for the tax on the additional income or, to avoid that liability, distributes the additional income as a deficiency dividend, causing its current shareholders be taxed on it.

> Example 3. Assume the facts of Example 2 and assume all of the RIC's shareholders in the first year claimed FTCs for the taxes deemed paid by them under Section 853. Applying Section 905(c) to the RIC's shareholders would require the RIC to notify them of the refund and for them to amend their returns to reduce their income and FTCs by $15 each. Assuming all of the shareholders were to actually amend their prior year's tax returns, this would result in only $340 of the RIC's $400 of prior year income being subject to tax in the hands of those shareholders. The other $60 would be subject to tax only if Section 905(c) were to be also applied to the RIC, as illustrated in Example 2.

As this Example 3 illustrates, when FTCs are claimed as a result of a RIC's Section 853 Election and the RIC later receives a refund of the credited tax, applying Section 905(c) to require a retroactive redetermination will generally never put the RIC's shareholders in the same place as they would have been had the refunded tax not been paid in the first place. For the shareholders to be put in the same place by such a retroactive redetermination, the RIC's relative ownership must remained unchanged from the time it passes through the foreign tax payment to the time that it distributes the refund (or at least took account of refund in the net asset value of its shares) so that they economically participate in the refund in the same proportions as they participated in the deemed payment of foreign tax in the prior year.

Recommendation

To address these uncertainties, we recommend that guidance be issued providing that:

1. If a RIC receives a refund of foreign tax that it paid in a year for which it made a Section 853 Election, the amount of the refund must reduce, in the year it is received, the amount of foreign taxes that are otherwise treated as "paid" by the RIC for purposes of Section 853, and the amount of refund will not be treated as income to the RIC regardless of whether any RIC shareholder claimed a deduction for such refunded tax under Section 853.[20]

2. If the amount of the refund exceeds the amount of foreign taxes actually paid by the RIC and otherwise eligible to be passed through to its shareholders under Section 853, the excess must be carried forward until it reduces to zero the future amount of foreign taxes otherwise treated as "paid" by the RIC under Section 853.

3. If, pursuant to this guidance, a RIC reduces the amount of foreign taxes that it is treated as paying by the amount of its foreign tax refunds, the Internal Revenue Service (the "Service") will not use Section 905(c) to challenge a shareholder's claim of a FTC in respect of the refunded tax or require the RIC or the shareholder to file an amended return for the year the shareholder claimed the FTC.

In our view, these recommendations, if adopted, would adequately protect the government's interests in most cases, treat the RIC's shareholders fairly and be less burdensome that any alternative approach for dealing with a RIC's receipt of refunded foreign taxes. We also believe that their adoption is well within the Treasury Department's authority.

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[20] We discuss at the end of this letter what might be done if a RIC receives a refund of a foreign tax in a year when it either cannot or does not have in place a Section 853 Election and it paid the refunded tax in a year when a Section 853 Election was in place.

Our first recommendation can be illustrated as follows:

> Example 4. Assume the facts of Example 3 except that the RIC adjusts the amount of foreign taxes it is treated as paying in accordance with our recommendation. In the second year, the RIC would simply distribute $100 in cash to each of its shareholders, who would recognize $100 of income but not be entitled to claim a FTC or deduction in respect of any foreign taxes paid by the RIC. The tax position of the RIC's shareholders in the first year would remain unchanged. The tax position of the RIC's shareholders in the second year is no worse than it would have been had they received a distribution of $85 in cash and $15 of deemed distribution in respect of foreign taxes paid by the RIC, which is what their position would have been if the refunded tax had never been paid.

This recommendation in effect proposes that, under Section 853, all creditable foreign taxes, regardless of when paid or to whom paid, should be treated as fungible. By treating these taxes as fungible for this purpose, it necessarily follows that foreign tax refunds should be netted against foreign tax payments in determining the amount treated as "paid" under Section 853, since a foreign tax cannot be treated as paid if it is refunded. In other words, under this approach, the total amount of foreign tax otherwise treated as "paid" by the RIC during a year and eligible to be claimed as a FTC or deduction by the RIC's shareholders would be reduced by any foreign tax refunded to the RIC during that year, even if the refunded tax was actually paid by the RIC in a prior year and even if it was paid to a country other than the country to which other taxes were paid during the year. In our view, treating all foreign taxes as fungible for purposes of applying Section 853, and thus netting payments and refunds on a current basis, is consistent with the provision's statutory structure and purpose.[21]

One of Section 853's important design features is that it avoids redeterminations attributable to adjustments to accruals of foreign taxes. Section 853 does this by basing the amount of foreign tax eligible to be passed through to shareholders exclusively on foreign tax *payments* and ignoring accruals. This mechanic for accounting for foreign taxes is different than how other taxpayers take into account foreign taxes for purposes of measuring their FTCs. Other taxpayers are permitted to claim FTCs when the associated foreign taxes are paid *or accrued*, but under the "relation-back doctrine"[22] and Section 905(c), they must generally associate the claim of such FTC with the recognition of the related income, including when doing so requires a retroactive redetermination to account for adjustments to accruals taken into account in claims of FTCs on a prior tax return. By ignoring accruals of foreign taxes, Section 853 explicitly avoids the question of whether or how the relation-back doctrine and Section 905(c) should affect adjustments to accruals. The rationale for this feature of Section 853 seems to be that making retroactive adjustments to foreign tax accruals would be virtually impossible for RICs and their shareholders to administer.[23] By interpreting Section 853 to measure current foreign taxes "paid" as being net of current refunds, our recommendation reinforces effectiveness of this important design feature.

It follows from our proposed interpretation of Section 853 that Section 905(c) should not apply to refunds of foreign taxes previously claimed as FTCs pursuant to Section 853. That is because, under our interpretation of Section 853, the refund would be effectively treated as a refund of taxes that are otherwise deemed to have been

[21] Also consistent with the provision's purpose, however, our recommendation proposes that this interpretation of "foreign taxes paid during a year" not apply to refunded taxes paid in years for which no Section 853 Election applied, since no FTC or deduction could have been claimed by a shareholder for such refunded taxes. Instead, such refund should simply be income to the RIC when it is accrued or received, assuming that the RIC deducted the foreign tax in determining its income subject to tax under Section 852, which would be the case in virtually all cases since the calculation of tax liability under Section 852 effectively precludes the RIC level utilization of FTCs.

[22] *See, e.g.*, Rev. Rul. 70-290, 1970-1 C.B. 160, clarified by Rev. Rul. 84-125, 1984-2 C.B. 125. *See also, e.g.,* IBM Corp. v. United States, 38 Fed Cl. 661 (1997).

[23] Kuntz & Peroni, U.S. International Taxation ¶B4.02[9][b] (Thomson Reuters/WG&L, 2013, with updates through November 2013).

paid by shareholders in the year of the refund (or later year) and therefore would not treated as a refund of taxes paid in a prior year (even if in fact the refunded tax was actually paid in a prior year). Since, under this interpretation of Section 853, the refunded tax would not be treated as a refund of prior year taxes, it likewise should not trigger a retroactive redetermination under Section 905(c) by either the RIC or its shareholders. We recognize that this proposed reconciliation of Section 905(c) with Section 853 would be arguably contrary to the relation-back doctrine embodied in Section 905(c), since the refunded tax would have actually been paid in a prior year. In the RIC context, however, we do not believe that rigorous adherence to that doctrine (by requiring a retroactive redetermination) justifies the burden that would result. In view of that burden, we believe that Section 853's imperative of accounting for foreign tax on an exclusively current basis should take precedent over the relation-back doctrine and thereby inform how Section 905(c) is applied to refunds received by RICs. Our third recommendation suggests that this result under Section 905(c) be explicitly clarified in guidance.

We also believe that, on the basis of Section 853, there is ample statutory authority to interpret Section 905(c) as we have proposed. A useful analogy is the history of the regulations issued to deal with refunds of taxes for which FTCs were claimed pursuant to Section 902 ("Section 902 Credits").[24] In 1988, the Service issued temporary regulations providing for a new method by which certain foreign tax redeterminations in respect of Section 902 Credits (e.g., those due to refund of foreign taxes) would be accounted for through adjustments to multi-year pools of foreign taxes and earnings and profits.[25] This method replaced the general treatment of these credits under Section 905(c), which required taxpayers who had claimed Section 902 Credits to redetermine the credits on certain events, including upon the foreign corporation's receipt of a refund of the foreign tax associated with the claimed Section 902 Credit. Though arguably contrary to the relation-back doctrine built into Section 905(c), these regulations were issued with little explicit statutory authorization.[26] By contrast, the guidance we are proposing could easily rely on the language and purpose of Section 853, which is designed to limit the applicability of the relation-back doctrine to RICs. We also believe that the tax policy justification for avoiding retroactive redeterminations in the context of Section 853 is at least as (or more) compelling than the tax policy justification for avoiding them in the context of Section 902 Credits.

We recognize that, under our recommendation, the taxable shareholders of a RIC receiving a foreign tax refund would be potentially treated differently than they would have been if Section 905(c) were applied to require retroactive redeterminations in respect of the portion of a refunded tax claimed as a FTC.[27] In our view,

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[24] Section 902 very generally permits a 10 percent U.S. shareholder of a foreign corporation to be treated as paying its share of foreign taxes paid by the foreign corporation when the shareholder receives a dividend from the corporation and in that regard functions similarly to Section 853.

[25] T.D. 8210, 53 Fed. Reg. 23613 (June 23, 1988).

[26] When these regulations were issued in 1988, the statutory language contained in Section 905(c) did not distinguish between how direct FTCs should be treated as a result of a refund and how Section 902 Credits should be treated as a result of a refund. The preamble to the regulations referred to Section 989(c)(4) as their statutory basis. That section authorizes regulations for addressing certain issues relating to foreign currency transactions, including under Section 905(c). Presumably, the link between Section 989(c)(4) and the regulation's mandate to treat refunds prospectively only is that refunds, when received in foreign currency, must be translated into U.S. dollars. However, the regulations, which in this respect were identical to the current regulations, did not seem to limit this prospective treatment to refunds received as foreign currency. (One might go so far as to argue that Section 989(c)(4) provides identical support for our recommendation, since RICs also likely receive tax refunds in the form of foreign currency.) Only in 1997, after the issuance of these regulations, did Congress provide a clear statutory basis for this prospective treatment by amending Section 905(c) to provide that the Secretary may "prescribe adjustments to [a foreign corporation's] pools of post-1986 foreign income taxes and the pools of post-1986 undistributed earnings under section[] 902" when a foreign tax is refunded in whole or in part, in effect retroactively approving the temporary Section 905 regulations. Taxpayer Relief Act of 1997, Pub. L. 105-34 (Aug. 5, 1997).

[27] This type of mismatch is also present under Section 905(c) in the context of its application to controlled foreign corporations ("CFCs"). The preamble to the temporary regulations referenced an issue that commentators raised, where a U.S. shareholder in a CFC claimed Section 902 Credits, but then sold its interest in the CFC to a second U.S. shareholder.[27] If the parties' agreement allocated refunds from the pre-sale period to the seller (as is commonly the case), then any refund of foreign tax would be economically attributable to the seller, but would reduce the pools in the CFC on a going forward basis (i.e., to the buyer's detriment). Treasury and the Service

however, this is not a reason to reject the recommendation. No alternative approach (including one that requires a retroactive redetermination under Section 905(c)) would put those shareholders in the place they would have been in had the tax not been paid in the first place, as illustrated by Example 3, and in our view our recommended approach would not represent any "unfairness" to any shareholder group. In fact, as compared to requiring a retroactive determination, our recommendation has the advantage of more closely associating the reduction in foreign tax available for FTCs with the economic receipt of the refund, since for the RIC's shareholders both would occur in the year of the refund.[28] While our recommendation would not result in perfect matching, its treatment of shareholders would comport with how Subchapter M and Section 853 function more generally.[29] And most importantly, this treatment would not harm any shareholder group relative to each other, as illustrated by Example 4.[30]

We also recognize that, if the proportion of a RIC's shareholder base that is tax exempt versus taxable changes from the time that its shareholders are deemed to have paid a refunded tax to the time that the refunded tax reduces the amount of foreign taxes otherwise treated as paid by the RIC, then the government would collect more or less tax under our proposal as compared to requiring the RIC's shareholders and the RIC to make retroactive redeterminations under Section 905(c) to account for the refund. We do not believe, however, that it is practical for RICs to engage in the kind of tax planning whereby this difference is likely to be exploited by taxpayers. Moreover, in our view the burden of requiring retroactive redeterminations under Section 905(c), which would be unmanageable, outweighs that risk to the government.

Finally, we recognize that there are tax policy reasons for limiting the class of RICs that can rely on our proposed guidance to only those RICs that have in place a Section 853 Election for the year of the refund.[31] If that limitation is adopted as part of the guidance, we suggest consideration be given to allowing other RICs (i.e., those that do not have in place a Section 853 Election in the year of the refund) to voluntarily enter into a closing agreement to avoid the application of Section 905(c) to their shareholders who claimed a FTC for the refunded tax whereby the RIC would pay an estimate of the amount of FTCs likely claimed by its shareholders and the Service would agree not to challenge the shareholders' claim of such FTCs under Section 905(c).[32] For RICs with tax

declined to write a rule that would create an exception to the pooling rules, e.g., that would instead require a redetermination of the seller's tax liability prior to the sale, although the preamble notes that they are continuing to study the issue.

[28] Tax exempt investors are of course economically in a different place that they would have been if the refunded tax have never been paid. Tax exempt investors that are shareholders when the refund is received (but not when the tax was paid) are better off, and tax exempt investors that are shareholders when the refunded tax is paid (but not when the refund is received) are worse off. However, the tax treatment of the refund has no bearing on that economic difference.

[29] Subchapter M makes little (or no) effort to match the amount, timing or character of income recognized by a RIC with the timing, amount or character of any particular shareholder's recognition of income based on how or when the shareholder economically participated in that income. Section 853 in fact assigns shareholders FTCs arbitrarily based on their relative interest in the RIC when they are deemed to receive the related dividend and without regard to whether they were even shareholders when the RIC actually paid the foreign tax. Subchapter M aims simply to pass through the amount, and to a limited extent the timing and character, to a RIC's shareholders as a group and generally without regard to any shareholder's individual participation.

[30] If a refund exceeds the amount of foreign taxes paid in the year of the refund and the excess is carried over under our second recommendation, the shareholders affected by the excess in the carryover year would not have necessarily received the economic benefit of the refund. As noted, however, this is a necessary feature of Subchapter M more generally and should not be regarded as a reason to reject this recommendation.

[31] If the amount of foreign taxes passed through by a RIC to its shareholders is not reduced by its refunds of foreign taxes (and if there is not otherwise any adjustment to reverse the benefit of FTCs claimed for the refunded tax), then there would have been potentially FTCs claimed for more foreign taxes than the amount of foreign taxes actually paid.

[32] We note that the ICI Letter suggests that, as an alternative to adopting guidance that requires refunds to offset the amount of taxes permitted to be passed through under Section 853, the government may adopt procedures whereby any RIC receiving a refund for foreign taxes previously passed through to its shareholders under Section 853 might enter into a closing agreement and pay an estimate of the value of the FTCs made available to its shareholders (referred to as the "Check-Writing Approach" in the ICI Letter). We have serious doubts, however, about the legal basis for interpreting Section 905(c) in a manner that would require a RIC to pay tax other than

exempt shareholders, requiring the RIC to pay over all or some portion of the refund to the government would have the significant disadvantage of penalizing those shareholders.

Our second recommendation addresses the situation in which, for a given year, refunds of foreign tax to a RIC making a Section 853 Election exceeds the amount of foreign taxes actually paid by the RIC. Under our recommendation, the excess would be carried forward and offset foreign taxes otherwise treated as paid under Section 853 in future years, for the same reasons applicable to our first recommendation. We recognize, however, that our second recommendation would result in the government losing the time value of how the excess refund would be treated if it had been claimed as a FTC and the taxpayer making the claim were required under Section 905(c) to make a redetermination for the year of the claim. Under Section 905(c), interest charges on the adjusted tax liability resulting from a redetermination generally begin when the refund is received. Under our recommendation, however, the time value attributable to the excess would not be taken into account until the excess actually reduces the amount of foreign taxes available for FTCs. Our recommendation does not contemplate the imposition of interest charges with respect to the excess because, other than by requiring a redetermination or entering into a closing agreement, it is unclear how the government could capture this time value under current law.

For these reasons, we recognize that our second recommendation is more compelling in situations in which the excess refund is relatively small (as compared to the portion of the refund offset by actual taxes paid in the year of the refund) and can be absorbed in a short period of time after the refund.[33] One way to limit the government's exposure to lost revenue in this situation might be to permit carryovers only for a certain number of years and require any remaining excess after that period be paid to the government as part of a voluntary closing agreement in order for the RIC's shareholders to be protected against potential retroactive redeterminations under 905(c). Whether or not this or some other qualification to our second recommendation is adopted, however, we caution against a total rejection of our second recommendation and adoption of our first recommendation for only RICs with no excess refunds because we fear that doing so would severely limit the utility of the first recommendation.

We appreciate your consideration of our comments. Please let us know if you would like to discuss them or if we can assist you in any other way.

Respectfully submitted,

David H. Schnabel
Chair

cc: Michael Danilack
Deputy Commissioner (International) LB&I
Internal Revenue Service

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on income for which a dividends paid deduction is unavailable. In addition, the Checking-Writing Approach penalizes shareholders that are not subject to tax, as noted in the ICI Letter.

[33] One alternative for limiting the government's exposure might be to require the RIC to enter into a closing agreement with respect to the excess if it is not absorbed within a certain number of years after the year that the refund is received, assuming that the closing agreement approach is adopted more generally for situation in which a RIC receives a refund in a year in which it does not make a Section 853 Election and the refunded tax was previously treated as paid by the RIC's shareholders under Section 853.

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