CLIENT MEMORANDUM

IRS Issues Guidance to U.S. Mutual Funds on EU Tax Reclaims

February 4, 2016

AUTHOR

Joseph A. Riley

On January 15, 2016, the Internal Revenue Service released Notice 2016-10 to address the treatment of foreign withholding tax refunds received by U.S. regulated investment companies ("RICs"). Due to recent court rulings in the European Union that have been favorable to the interests of U.S. mutual funds, a number of European countries have begun paying refunds ("reclaims") of dividend withholding taxes that were withheld by such countries over the past several years. The Notice provides some administrative tax guidance as to acceptable methods for the U.S. mutual funds to account for such tax refunds.

Under certain conditions, a RIC may annually elect to pass through to its shareholders any foreign withholding taxes that are paid during the year and that are expected to be nonrefundable. The RIC shareholders may claim a foreign tax credit to the extent of such amounts passed through. In the event that such taxes were in fact refunded to RICs in later years, as is the case with the EU tax reclaims, there was no efficient and established process for RICs to report the refunds. The Notice outlines a temporary process for RICs to do such reporting and is expected to be followed by permanent regulations later this year.

Generally, the Notice provides RICs with two alternative reporting methods: netting or obtaining a closing agreement. In the netting method, a RIC that receives tax reclaim payments reduces amount of foreign tax credits available to be passed through by the total amount of the reclaim payments received that year. The netting method is available to a RIC only if certain requirements are met. These requirements are that (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; (2) the fund is not a variable insurance or annuity product; (3) the RIC actually does pass through any remaining foreign tax credits; and (4) the total amount of reclaims received does not exceed the foreign taxes paid that year. The RIC needs to make an interest adjustment as well for the time elapsed since the reclaimed tax was originally passed through.

The Notice's second method is for the RIC to request a closing agreement with the IRS, which would generally require the payment of a compliance fee meant to allow the IRS to recoup the tax effect of the tax credits previously passed through. Such an agreement will generally be granted if the RIC is precluded from using either the general tax rules or the netting method and if the RIC can provide sufficient information to establish a reasonable estimate of the tax effects of the tax credits previously passed through.

The Notice may generally be relied upon immediately, even for prior years.

If you have any questions regarding this memorandum, please contact Joseph A. Riley (212-728-8715, jriley@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

February 4, 2016