INVESTMENT COMPANY INSTITUTE

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By Electronic Delivery

April 30, 2013

Erik Corwin
Deputy Chief Counsel—Technical
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RE: Fund Industry Solution for Foreign Tax Recoveries Under *Santander*

Dear Erik:

The Investment Company Institute ("ICI")[1] urges an administrable solution to the U.S. fund industry's anticipated receipt of withholding tax refunds following the European Court of Justice ("ECJ") decision in *Santander*.[2] The requested solution is necessary so that the U.S. government is reimbursed in an administrable manner for foreign tax credits claimed by shareholders in funds taxed as regulated investment companies ("RICs") that subsequently, pursuant to the *Santander* decision (and, perhaps, its progeny), recover the taxes for which the credits were claimed.

Specifically, we propose that RICs be required in this unique situation to reduce their foreign tax credits for the year in which the refunds are received pursuant to binding court decisions or final administrative action. The alternative approach – of these RICs entering into closing agreements and writing checks to the government on behalf of their shareholders – imposes significant burdens on RICs, their investors, and the Internal Revenue Service ("IRS"). Separate solutions will be needed for

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.7 trillion and serve over 90 million shareholders.

[2] The *Santander* decision involves joined cases C-338/11 to C-347/11. The decision was rendered in French and translated into the other languages of the European Union ("EU"). Here are the links to the decision in English and in French.

certain other situations (such as for RICs that elected to flow through foreign tax credits to their shareholders pursuant to section 853 of the Internal Revenue Code (the "Code") but do not, or cannot, make the election for the year in which they receive the previously-withheld foreign taxes).

I. Background

A. The *Santander* Decision

The *Santander* decision involved claims by ten non-French funds (two of which were U.S. funds, one of which was taxed as a RIC[3]) for recovery of French withholding taxes. The funds claimed that France was violating the free movement of capital requirement of EU law[4] by imposing withholding tax on dividends paid by French companies to non-French funds, while exempting French funds. The ECJ agreed in a sweeping opinion that is being cited by funds litigating free movement of capital claims in approximately ten other EU countries.

B. Response to the *Santander* Decision

We expect U.S. funds to receive substantial tax refunds from France over the next several years. France has established new procedures that funds must follow before they can recover the withheld taxes deemed improper under *Santander.* Certain European funds already have received refunds. France next will begin to process claims filed by U.S. funds, which is expected to begin in the coming months. Uncertainty remains, however, regarding whether France will assert that some claims are unsupported or blocked by a statute of limitations.

Recoveries also are expected, over an indeterminate period, from other countries that provided their home-country funds with a withholding tax benefit that was not provided to U.S. funds. A Swedish trial court ruled recently that two RICs were entitled to recover taxes withheld.

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[3] The other U.S. fund that was a party to the litigation was taxed as a partnership under the Code.

[4] Specifically, the claims were filed under Article 63 of the Treaty on the Functioning of the European Union ("TFEU"). Previously, the free movement of capital article was in Article 56 of the Maastricht Treaty (formally, the Treaty on European Union or TEU).

II. Alternative Approaches for Compensating U.S. Government for Tax Recoveries

A. Simplified Example

The following example illustrates (1) the relevant cash flows for a RIC that flowed through creditable foreign taxes to its shareholders and received a refund and (2) the economics of alternative approaches for reimbursing the U.S. government. This simplified example holds constant, among other things, the foreign exchange rate between the Euro and the U.S. dollar.

The fund-specific facts are as follows:

- In Year 1 a RIC receives a $400 dividend from a French company that is subject to $60 of withholding. The RIC distributes $85 to each of its four shareholders (two of which are taxable and two of which are tax-exempt). Each of the taxable shareholders receives a Form 1099 reporting $100 of dividend income (consisting of the $85 cash distribution and $15 of creditable foreign taxes that are flowed through and therefore included in the "grossed-up" dividend).

- In Year 2 the RIC receives a $400 dividend from an unrelated Canadian company that is subject to $60 of withholding. The RIC also receives a refund of $60 from France for the previously-withheld taxes. The RIC distributes $100 to its four shareholders (two of which are taxable and two of which are tax-exempt). One of the taxable shareholders and one of the tax-exempt shareholders also were shareholders in Year 1; the other two investors became shareholders on the first day of Year 2.

- Over the two-year period, the RIC received cash totaling $740 (a $340 dividend in Year 1 from the French company, a $340 dividend in Year 2 from the Canadian company, and a $60 refund in Year 2 from France). The RIC also flowed through $60 of creditable foreign taxes in Year 1 (only $30 of which – to the taxable shareholders – could be used to reduce federal income tax liabilities). The RIC also may have $60 of creditable foreign taxes in Year 2 – attributable to the Canadian taxes – depending on whether the French tax recovery reduces the Year 2 creditable foreign tax amount or not.

The fund-shareholder-specific facts are as follows:

- The RIC shareholder who is taxable and was a shareholder in both Year 1 and Year 2 ("TAX1"):
  - had an economic (pre-foreign-tax) return of $200 attributable to TAX1's allocable share of the $800 dividends (in total) received from the French (Year 1) and Canadian (Year 2) companies;

  - received cash totaling $170 (excluding the treatment of the French withholding tax refund); and
  - is treated as having paid foreign tax of $15 that TAX1 used as a credit against his or her federal tax liability in Year 1.

- The RIC shareholder who is taxable and was a shareholder in Year 1 only ("TAX2"):
  - had an economic (pre-foreign-tax) return of $100 attributable to TAX2's allocable share of the $400 dividend received from the French (Year 1) company;
  - received cash totaling $85;
  - reported taxable income of $100 in Year 1; and
  - is treated as having paid foreign tax of $15 that TAX2 used as a credit against his or her federal tax liability.

- The RIC shareholder who is taxable and was a shareholder in Year 2 only ("TAX3"):
  - had an economic (pre-foreign-tax) return of $100 attributable to TAX3's allocable share of the $400 dividend received from the Canadian (Year 2) company (plus the possibility of some return attributable to the refunded French tax);
  - received cash totaling $85 (excluding the treatment of the French withholding tax refund); and
  - is treated as having paid foreign tax of $15 attributable to the Canadian dividend that could be used as a credit against his or her federal tax liability – subject to a possible reduction attributable to the refund of the French tax.

- The RIC shareholder who is tax-exempt and was a shareholder in both Year 1 and Year 2 ("TEX1"):
  - had an economic (pre-foreign-tax) return of $200 attributable to TEX1's allocable share of the $800 dividends (in total) received from the French (Year 1) and Canadian (Year 2) companies;
  - received cash totaling $170 (excluding the treatment of the French withholding tax refund); and
  - has no tax liability that could be offset by an creditable foreign taxes that the fund flows through to its shareholders.

- The RIC shareholder who is tax-exempt and was a shareholder in Year 1 only ("TEX2"):
  - had an economic (pre-foreign-tax) return of $100 attributable to TEX2's allocable share of the $400 dividends received from the French (Year 1) company;
  - received cash totaling $85; and

  - has no tax liability that could be offset by an creditable foreign taxes that the fund flows through to its shareholders.

- The RIC shareholder who is tax-exempt and was a shareholder in Year 2 only ("TEX3"):
  - had an economic (pre-foreign-tax) return of $100 attributable to TEX3's allocable share of the $400 dividends received from the Canadian (Year 2) company (plus the possibility of some return attributable to the refunded French tax);
  - received cash totaling $85 (excluding the treatment of the French withholding tax refund); and
  - has no tax liability that could be offset by an creditable foreign taxes that the fund flows through to its shareholders.

This example illustrates that a RIC's shareholders are subject to six different possible outcomes depending on whether they are taxable or tax-exempt and whether they were shareholders (1) both when the RIC received the dividend on which foreign tax was withheld and when the refund was received, (2) when the foreign tax was withheld but not when it was refunded, or (3) when the foreign tax was refunded but not when it was withheld.

As discussed below,[5] it is not feasible to return each shareholder to the precise economic position that he, she, or it would have occupied had the French tax never been withheld. To do so, the fund would need to calculate each shareholder's allocable share of the refund and then pay the appropriate amount to each shareholder. In many cases, payments would need to be made to tens or hundreds of thousands of shareholders; some of these persons no longer would be invested in the fund. Each taxable shareholder then would need to file an amended tax return that the IRS would need to process.

A more detailed example is provided in Appendix A.[6] Note that Table A summarizes the shareholder-specific results for each example. Table B demonstrates that, based solely on economic outcomes, the U.S. government should be indifferent between the feasible approaches and that each

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[5] See discussion under heading "B. Approaches to Compensating the U.S. Government—*3. All RIC Shareholders File Amended Returns."*

[6] These examples make certain simplifying assumptions to facilitate discussion of the basic issues. Neither takes into account, for example, foreign exchange rate fluctuations, possible changes in the taxable portion of a RIC's shareholder base, time value of money, changes in tax rates, or the need to book any reserves for possible appeals by an EU government. Additionally, in the event that a fund receives refunds in excess of its foreign tax credits in the current year, the fund would need to continue to reduce its tax credits in the next year.

approach reimburses the IRS fully for all tax that would have been collected had the impermissible withholding rules not been in force.

Our proposal, as discussed below, attempts to maximize the fairness to all six of these different categories of investors without imposing undue burden on either the fund shareholders or the IRS.

B. Approaches to Compensating the U.S. Government

1. *Credit-Offset Approach*

The most administrable approach for resolving this issue is to allow each RIC that flowed through foreign tax credits to reduce its credits in the year previously-withheld taxes are recovered (the "credit-offset approach"). Under this credit-offset approach, the U.S. Government is compensated for the earlier tax credits (that were claimed for foreign taxes withheld but subsequently refunded pursuant to a court decision) by higher tax revenues attributable to lower foreign tax credits claimed in the year the EU taxes are recovered. In the simple example, the RIC would reduce its creditable foreign taxes in Year 2 from $60 (for the Canadian taxes) to $0 (to reflect the $60 refund of French tax). For the two-year period, the RIC informed its shareholders that they had only $60 of creditable foreign taxes (attributable to the $120 of foreign taxes withheld less the $60 of foreign taxes refunded pursuant to the court decision). Thus, the federal government effectively would recover in Year 2 the taxes that would have been paid in Year 1 had France not withheld the tax that the court later would require it to refund to the fund.

The credit-offset approach has three distinct advantages over the other alternatives. First, the credit-offset approach provides greatly simplified book and tax accounting treatment of the refunded amounts. Second, this approach does not raise the administrative complexities of (i) determining which shareholders benefited from the original tax credits or (ii) entering into a closing agreement with the IRS. Third, the credit-offset approach does not cause tax-exempt investors to bear the economic burden of taxable shareholders' tax liabilities. These advantages are discussed in detail in Section III below.

2. *Check-Writing Approach*

An alternative approach would be for each RIC to enter into a closing agreement and write a check to the IRS each year it receives a refund from any EU country – based upon assumptions about the taxable portion of each RIC's shareholder base in the year the withholding tax was paid (the "check-writing approach"). Under this check-writing approach, the U.S. Government obviously is compensated directly. In the simple example, the RIC would write the government a check in Year 2 for the foreign tax credits claimed by its two taxable shareholders in Year 1.

While this approach is potentially administrable, we submit that the considerable additional administrative burdens imposed on the government and the funds make it the less desirable way to address this issue. The original foreign tax credit calculations were accurate under the then-existing EU law. Given that the credit-offset approach clearly offers a more attractive alternative, it is unnecessary to undertake the burdens of the closing agreement process when no party erred in determining its tax obligations. The check-writing approach also is less desirable because (as discussed below) it causes the tax-exempt shareholders to bear an economic burden arising from the taxable shareholders' tax obligations.

3. *All RIC Shareholders File Amended Returns*

For all shareholders to be placed in precisely the economic position they would have occupied had France and other EU jurisdictions not withheld taxes improperly, (1) the fund would need to refund to each shareholder his, her, or its allocable share of the refunded tax (that already was included in taxable income pursuant to the gross-up) and (2) every taxable shareholder would need to file an amended return for each year for which a tax was withheld and then refunded and reduce his, her, or its tax credit or tax deduction by the allocable share of the amount refunded. Refunding cash and amending returns is the only way to achieve absolute precision because (i) any taxable shareholder who deducted the foreign taxes benefited at his or her marginal tax rate (rather than on the dollar-for-dollar basis, which would be the case if the shareholder credited the foreign tax against U.S. tax liability), and (ii) as illustrated in the simple example, the shareholder base will have changed between the time credits were claimed and refunds are received.

Requiring all shareholders to file amended tax returns – in an attempt to recover the precise amount of the previously-claimed tax benefit – is not administrable. Many shareholders have invested in multiple affected funds, which in turn have investments in multiple affected EU countries that will pay refunds over multiple affected years. Requiring shareholders to amend returns each time a refund is received creates a cascading administrative burden for RICs, shareholders, and the government that is unmanageable.

III. Advantages Conferred by the Credit-Offset Approach

A. Accounting Issues

1. *Financial Accounting Issues*

The most significant benefit of the credit-offset approach, from the industry's perspective, is the real-time, straight-forward accounting treatment of refunded amounts. Under the credit-offset approach, the full amount of any recovered tax is included in the RIC's net asset value ("NAV") on

the day the payment is received without impairment;[7] tax attributes such as foreign tax credit amounts are not included in the NAV calculation. The amount of foreign taxes that shareholders may claim as a credit simply is reduced by the amount recovered.

Under the check-writing approach, in contrast, the fund would be required to estimate the amount that the IRS would require during the closing agreement process. Specifically, the fund would record as an asset the full amount of any recovered tax and record as a liability the estimated amount of the eventual payment to the U.S. Government. Because fund shares are purchased and sold at NAV, which is calculated based entirely on assets and liabilities, accuracy is essential. If the estimated liability is too high or too low, investors purchasing or redeeming fund shares before the tax liability is finalized could end up paying or receiving either too much or too little for their shares.

Therefore, fund managers must know at the time they first receive any EU reclaim whether or not they must accrue a liability against the recovered amounts under the check-writing approach.

2. *Tax Accounting Issues*

The credit-offset approach prevents funds, investors, and the government from having to address complex tax accounting and reporting questions. Under the credit-offset approach, tax reclaims are able to be directly offset against other creditable foreign taxes. RICs will not need to reflect book-tax differences on their income tax and excise tax returns and shareholders will not receive distributions with a nonstandard tax character.

Under the check-writing approach, in contrast, the fund must make accounting adjustments to properly reflect the tax-effected nature of the reclaimed taxes. Because shareholders' income was grossed-up by the amount of the creditable foreign taxes that flowed through the RIC, any approach that included the reclaimed taxes in taxable income would result in double taxation. Avoiding double taxation requires recording a permanent book-tax difference and characterizing the distribution attributable to the refunded taxes as neither a dividend (including for purposes of the dividends paid deduction of section 561 of the Code) nor a return of capital. These adjustments are illustrated in Appendix B.

We submit that it is far more administrable to adopt the credit-offset approach and to let two tax-effected amounts directly offset one another, rather than attempting to offset non-tax-effected amounts by tax-effected refunds.

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[7] Because of the substantial confusion regarding the likelihood for recovering withheld taxes, and the amount of any recovery, we submit that this approach is appropriate both for refund purposes and for purposes of determining whether taxes withheld by foreign governments (potentially in violation of EU law) are voluntary payments.

B. Determining Taxable Shareholders

Another benefit of the credit-offset approach, from the industry's perspective, is that funds are not required to determine the portion of taxable shareholders in a fund during each year that the refunded foreign taxes were withheld. This approach, instead, implicitly assumes that the portion of the RIC's shareholder base consisting of taxable investors remains constant between the date the foreign taxes initially were claimed as a credit and the date the refunds are received. The taxable shareholders whose foreign tax credits are reduced in the year refunds are received are presumed to represent the same portion of the fund as was held by taxable shareholders in the year the foreign tax credits previously were claimed.

Under the check-writing approach, in contrast, a fund would estimate the portion of its taxable shareholders each year that foreign tax credits were claimed for amounts subsequently refunded and then negotiate an "agreed" percentage with the IRS in a closing agreement. The estimation process is complicated, among other things, by the large percentage of fund shares typically held in nominee ("street name") accounts. The last time the industry faced a similar issue, involving UK and Singapore taxes, the process of getting reliable information from the nominees was so difficult that simplifying assumptions had to be made.[8] Considerable time and energy would be spent by both the IRS and the industry, if this approach is adopted again, in the frustrating process of reaching agreed-upon estimates of the taxable-shareholder percentage.[9]

C. Disadvantaging Tax-Exempt Shareholders Relative to Taxable Shareholders

A third benefit of the credit-offset approach is that it does not impose on tax-exempt shareholders the economic disadvantages that are imposed by the check-writing approach. Under the credit-offset approach, all of the "detriment" arising from the need to compensate the U.S. Government for previously-claimed foreign tax credits falls on taxable shareholders – the group of shareholders who benefited from the credits claimed previously for foreign taxes now refunded.

Under the check-writing approach, in contrast, the payment to the U.S. Government is borne equally, on a per-share basis, by taxable shareholders (who benefited from the now-overstated foreign tax credits) and by tax-exempt shareholders (who could not claim foreign tax credits and hence did not benefit from them).[10] To the extent that other adjustments are made—for example, to account

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[8] The check-writing approach, given the assumptions required regarding nominee accounts, provides no more assurance of accuracy than does the credit-offset approach, which assumes a static taxable shareholder base.

[9] Despite the considerable effort expended to obtain these estimates, such estimates ultimately would have to rely on arbitrary assumptions regarding nominee accounts.

[10] Note that this issue did not exist when addressing the prior issues in the UK and Singapore. In those cases, the management companies, rather than the funds, agreed to compensate the IRS directly. This represented a windfall for the

for foreign exchange rate fluctuations—then tax-exempt investors will also be made to bear the economic burden of such adjustments under the check-writing approach.

These effects, illustrated in the two examples in Appendix A, are summarized in Table A. Please note that, in these examples, existing and new taxable shareholders receive less cash under the check-writing approach than under the credit offset approach. However, they receive a larger foreign tax credit. Ultimately, taxable shareholders are better off under the check writing approach. On the other hand, tax-exempt shareholders are worse off: they receive less cash and cannot benefit from the larger foreign tax credit. Thus, under the check writing approach, the tax-exempt shareholders are inappropriately harmed and taxable shareholders are inappropriately benefited. As noted above, this disparity is not present in the credit offset approach. We submit that causing tax-exempt investors to bear the economic cost of taxable shareholders' tax liabilities is not an appropriate result.

* * *

The best approach for addressing this issue, we submit, is the fairest and most administrable approach. The credit-offset approach, as demonstrated above, therefore should be adopted. Please feel free to contact me at any point for additional information or to discuss our proposals. My direct dial number is 202/326-5832. Many thanks.

Sincerely,

Keith Lawson
Senior Counsel – Tax Law

Enclosure

cc: Sergio Arellano
Susan Baker
Steven Balahtsis
Theodore Curtis
Deirdre Donnelly
Barbara Felker

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taxable shareholders, who received the foreign tax credits, but did not disadvantage the tax-exempt shareholders. This was considered appropriate because the issue arose from errors on the part of the management companies.

Terry Hughes
Mark Perwien
Rosemary Sereti
Oleida Sullivan

Appendix A: Reclaim Procedure Examples

Base Case: Impermissible Withholding Rules Not In Force

Year 1:

<u>Fund Level</u>. In Year 1 the EU Markets fund receives a $100,000 dividend from a French company that is subject to no withholding. The fund has no other income, gains or losses for the year.

The fund's net asset value ("NAV") at the beginning of Year 1 is $1 million. NAV increases to $1.1million following the receipt of the dividend. The fund distributes the entire dividend to the shareholders and the fund closes Year 1 with NAV of $1 million.

<u>Shareholder Level</u>. The EU Markets fund has 1,000 shareholders who each hold one share that was purchased in Year 1 for $1,000. Half of the shareholders are taxable and half are tax-exempt.

Following Year 1, each taxable shareholder receives a 1099 that reports $100 of dividend income. Each shareholder also receives a distribution from the fund of $100, which no shareholder elects to reinvest. Each shareholder closed the year with a share-level NAV and adjusted basis of $1,000.

Year 2:

<u>Fund Level</u>. In Year 2 the EU Markets fund receives a $100,000 dividend from Canada that is subject to $15,000 of withholding.

The fund's NAV at the beginning of Year 2 is $1 million. NAV increases to $1.085 million following the receipt of the Canadian dividend. The fund distributes all cash from the dividend to the shareholders and the fund closes Year 2 with NAV of $1 million.

<u>Shareholder Level</u>. In Year 2 the EU Markets fund has 1,000 shareholders who each hold one share. 990 of the shareholders invested in Year 1 for $1,000 (the "existing shareholders"). Ten of the shareholders invested at the beginning of Year 2 for $1,000 (the "new shareholders"). Half of each group of shareholders is taxable and half is tax-exempt.

- <u>Existing Taxable Shareholders</u>. Each existing taxable shareholder (a "TAX1 Shareholder") is treated as receiving $100 of dividend income and as having paid $15 of foreign taxes. Each TAX1 Shareholder receives a cash distribution of $85, which no TAX1 Shareholder elects to reinvest. At the end of Year 2 each TAX1 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TAX1 Shareholder (i) received a $185 cash return on investment, (ii) realized $200 of taxable income, and (iii) received $15 worth of FTC.

- Existing Tax-Exempt Shareholders. Each Existing Tax-Exempt Shareholder (a "TEX1 Shareholder") is treated as receiving $100 of dividend income and as having paid $15 of foreign taxes. Each TEX1 Shareholder receives a cash distribution of $85, which no TEX1 Shareholder elects to reinvest. At the end of Year 2 each TEX1 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TEX1 Shareholder (i) received a $185 cash return on investment, (ii) realized $200 of income that was not subject to tax, and (iii) received $15 worth of FTC that did not offset any U.S. tax liabilities.

- New Taxable Shareholders. Each new taxable shareholder (a "TAX3 Shareholder") is treated as receiving $100 of dividend income and as having paid $15 of foreign taxes. Each TAX3 Shareholder receives a cash distribution of $85, which no TAX3 Shareholder elects to reinvest. At the end of Year 2 each TAX3 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TAX3 Shareholder (i) received an $85 cash return on investment, (ii) realized $100 of taxable income, and (iii) received $15 worth of FTC.

- New Tax-Exempt Shareholders. Each new tax-exempt shareholder (a "TEX3 Shareholder") is treated as receiving $100 of dividend income and as having paid $15 of foreign taxes. Each TEX3 Shareholder receives a cash distribution of $85, which no TEX3 Shareholder elects to reinvest. At the end of Year 2 each TEX3 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TEX3 Shareholder (i) received an $85 cash return on investment, (ii) realized $100 of income that was not subject to tax, and (iii) received $15 worth of FTC that did not offset any U.S. tax liabilities.

Example #1: Foreign Tax Credits Reduced in Current Year

Year 1:

Fund Level. In Year 1 the EU Markets fund receives a $100,000 dividend from a French company that is subject to $15,000 of withholding. The fund has no other income, gains or losses for the year.

The fund's NAV at the beginning of Year 1 is $1 million. NAV increases to $1.085 million following the receipt of the dividend. The fund distributes the entire dividend to the shareholders and the fund closes Year 1 with NAV of $1 million.

Shareholder Level. The EU Markets fund has 1,000 shareholders who each hold one share that was purchased in Year 1 for $1,000. Half of the shareholders are taxable and half are tax-exempt.

Following Year 1, each taxable shareholder receives a 1099 that reports $100 of dividend income and a $15 FTC. Each shareholder also receives a distribution from the fund of $85, which no shareholder elects to reinvest. Each shareholder closed the year with a share-level NAV and adjusted basis of $1,000.

Year 2:

Fund Level. In Year 2 the EU Markets fund receives a $15,000 refund from France. The fund also receives a $100,000 dividend from Canada that is subject to $15,000 of withholding.

The fund's NAV at the beginning of Year 2 is $1 million. NAV increases to $1.1 million following the receipt of the French refund and the Canadian dividend. The fund distributes all cash from the refund and the dividend to the shareholders and the fund closes Year 2 with NAV of $1 million.

Shareholder Level. In Year 2 the EU Markets fund has 1,000 shareholders who each hold one share. 990 of the shareholders invested in Year 1 for $1,000 (the "existing shareholders"). 10 of the shareholders invested at the beginning of Year 2 for $1,000 (the "new shareholders"). Half of each group of shareholders is taxable and half is tax-exempt.

- Existing Taxable Shareholders. Each existing taxable shareholder (a "TAX1 Shareholder") is treated as receiving $100 of dividend income and as having paid no foreign taxes. Each TAX1 Shareholder receives a cash distribution from the fund of $100, which no TAX1 Shareholder elects to reinvest. At the end of Year 2 each TAX1 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TAX1 Shareholder (i) received a $185 cash return on investment, (ii) realized $200 of taxable income, and (iii) received $15 worth of FTC.

- Existing Tax-Exempt Shareholders. Each existing tax-exempt shareholder (a "TEX1 Shareholder") is treated as receiving $100 of dividend income and as having paid no foreign taxes. Each TEX1 Shareholder receives a cash distribution from the fund of $100, which no TEX1 Shareholder elects to reinvest. At the end of Year 2 each TEX1 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TEX1 Shareholder (i) received a $185 cash return on investment, (ii) realized $200 of income that was not subject to tax, and (iii) received $15 worth of FTC that did not offset any U.S. tax liabilities.

- New Taxable Shareholders. Each new taxable shareholder (a "TAX3 Shareholder") is treated as receiving $100 of dividend income and as having paid no foreign taxes. Each TAX3 Shareholder receives a cash distribution from the fund of $100, which no TAX3 Shareholder elects to reinvest. At the end of Year 2 each TAX3 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TAX3 Shareholder (i) received a $100 cash return on investment, (ii) realized $100 of taxable income, and (iii) received $0 worth of FTC.

- New Tax-Exempt Shareholders. Each new tax-exempt shareholder (a "TEX3 Shareholder") is treated as receiving $100 of dividend income and as having paid no foreign taxes. Each TEX3 Shareholder receives a cash distribution from the fund of $100, which no TEX3 Shareholder elects to reinvest. At the end of Year 2 each TEX3 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TEX3 Shareholder (i) received an $100 cash return on investment, (ii) realized $100 of income that was not subject to tax, and (iii) received $0 worth of FTC.

Example #2: Prorated Refund Paid Directly to IRS

Year 1:

The facts for Year 1 are the same as in Example #1.

Year 2:

Fund Level. In Year 2 the EU Markets fund receives a $15,000 refund from France. The fund also receives a $100,000 dividend from Canada that is subject to $15,000 of withholding.

The fund's NAV at the beginning of Year 2 is $1 million. NAV increases to $1.1 million following the receipt of the French refund and the Canadian dividend. The fund distributes $7,500 (50% of the $15,000 refund) to the shareholders and pays the other $7,500 directly to the IRS. This $7,500 payment compensates the government for the foreign tax credits claimed in Year 1 by the fund's taxable shareholders (who owned 50% of the fund's shares). The net amount of the Canadian dividend is distributed to the shareholders. The EU Markets fund closes Year 2 with NAV of $1 million.

Shareholder Level. In Year 2 the EU Markets fund has 1,000 shareholders who each hold one share. 990 of the shareholders invested in Year 1 for $1,000 (the "existing shareholders"). 10 of the shareholders invested at the beginning of Year 2 for $1,000 (the "new shareholders"). Half of each group of shareholders is taxable and half is tax-exempt.

- Existing Taxable Shareholders. Each existing taxable shareholder (a "TAX1 Shareholder") is treated as receiving $100 of dividend income and as having paid $15 of foreign taxes (attributable to the Canadian dividend). Each TAX1 Shareholder receives a cash distribution from the fund of $92.50,[11] which no TAX1 Shareholder elects to reinvest. At the end of Year 2 each TAX1 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TAX1 Shareholder (i) received a $177.50 cash return on investment, (ii) realized $200 of taxable income, and (iii) received $30 worth of FTC.

- Existing Tax-Exempt Shareholders. Each existing tax-exempt shareholder (a "TEX1 Shareholder") is treated as receiving $100 of dividend income and as having paid $15 of foreign taxes (attributable to the Canadian dividend) – although the FTC has no value to the tax-exempt shareholders. Each TEX1 Shareholder receives a cash distribution from the fund of $92.50, which no TEX1 Shareholder elects to reinvest. At the end of Year 2 each TEX1 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

[11] The $85 Canadian dividend + $7.50 French refund.

Following these events, each TEX1 Shareholder (i) received a $177.50 cash return on investment, (ii) realized $200 of income that was not subject to tax, and (iii) received $30 worth of FTC that did not offset any U.S. tax liabilities.

- New Taxable Shareholders. Each new taxable shareholder (a "TAX3 Shareholder") is treated as receiving $100 of dividend income and as having paid $15 of foreign taxes (attributable to the Canadian dividend). Each TAX3 Shareholder receives a cash distribution from the fund of $92.50, which no TAX3 Shareholder elects to reinvest. At the end of Year 2 each TAX3 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TAX3 Shareholder (i) received a $92.50 cash return on investment, (ii) realized $100 of taxable income, and (iii) received $15 worth of FTC.

- New Tax-Exempt Shareholders. Each new tax-exempt shareholder (a "TEX3 Shareholder") is treated as receiving $100 of dividend income and as having paid $15 of foreign taxes (attributable to the Canadian dividend) – although the FTC has no value to the tax-exempt shareholders. Each TEX3 Shareholder also receives a cash distribution from the fund of $92.50, which no TEX3 Shareholder elects to reinvest. At the end of Year 2 each TEX3 Shareholder sells his or her shares for $1,000, realizing no gain or loss.

  Following these events, each TEX3 Shareholder (i) received a $92.50 cash return on investment, (ii) realized $100 of income that was not subject to tax, and (iii) received $15 worth of FTC that did not offset any U.S. tax liabilities.

Table A: Summary of Results on Per Shareholder Basis

	Base Case: Proper Withholding	Example #1: Credit-Offset	Example #2: Check-Writing
TAX1 Shareholder (i.e. existing taxable shareholder)	$200 Taxable Income $185 Cash $15 Net FTC $200 Total Return (cash + net FTC)	$200 Taxable Income $185 Cash $15 Net FTC $200 Total Return	$200 Taxable Income $177.50 Cash $30 FTC $207.50 Total Return
TAX2 Shareholder (i.e., Year 1 only)	$100 Taxable Income $100 Cash $0 Net FTC $100 Total Return (cash + net FTC)	$100 Taxable Income $85 Cash $15 Net FTC $100 Total Return	$100 Taxable Income $85 Cash $15 Net FTC $100 Total Return
TAX3 Shareholder (i.e., Year 2 only)	$100 Taxable Income $85 Cash $15 Net FTC $100 Total Return (cash + net FTC)	$100 Taxable Income $100 Cash $0 Net FTC $100 Total Return	$100 Taxable Income $92.50 Cash $15 Net FTC $107.50 Total Return
TEX1 Shareholder (i.e. existing tax-exempt shareholder)	$200 Tax-Exempt Income $185 Cash $15 Net FTC (unutilized) $185 Total Return (cash only)	$200 Tax-Exempt Income $185 Cash $15 Net FTC (unutilized) $185 Total Return	$200 Tax-Exempt Income $177.50 Cash $30 FTC (unutilized) $177.50 Total Return
TEX2 Shareholder (i.e., Year 1 only)	$100 Tax-Exempt Income $100 Cash $0 Net FTC (unutilized) $100 Total Return (cash only)	$100 Tax-Exempt Income $85 Cash $15 Net FTC (unutilized) $85 Total Return	$100 Tax-Exempt Income $85 Cash $15 Net FTC (unutilized) $85 Total Return
TEX3 Shareholder (i.e., Year 2 only)	$100 Tax-Exempt Income $85 Cash $15 Net FTC (unutilized) $85 Total Return (cash only)	$100 Tax-Exempt Income $100 Cash $0 Net FTC $100 Total Return	$100 Tax-Exempt Income $92.50 Cash $15 Net FTC (unutilized) $92.50 Total Return

Table B: Summary of Results to U.S. Government[12]

	Base Case	Example #1	Example #2
495 TAX1 Shareholders			
Taxable Income	$99,000	$99,000	$99,000
Net FTC	($7,425)	($7,425)	($14,850)
5 TAX2 Shareholders			
Taxable Income	$500	$500	$500
Net FTC	$0	($75)	($75)
5 TAX3 Shareholders			
Taxable Income	$500	$500	$500
Net FTC	($75)	$0	($75)
U.S. Government			
Total Taxable Income	$100,000	$100,000	$100,000
Direct Payment from Fund	$0	$0	$7,500
Net Utilized FTC	($7,500)	($7,500)	($15,000)
Net FTC + Direct Payment	($7,500)	($7,500)	($7,500)

[12] Results in Table B exclude tax-exempt shareholders.

Appendix B: Accounting Adjustment Examples

The facts are the same as in Examples #1 and #2 in Appendix A.

- In Year 1 the EU Markets fund receives a $100,000 dividend from a French company that is subject to $15,000 of withholding. The fund has no other income, gains or losses for the year.
- In Year 2 the EU Markets fund receives a $15,000 refund from France. The fund also receives a $100,000 dividend from Canada that is subject to $15,000 of withholding.

Year 1 Accounting Treatment

Book Treatment. In Year 1 the fund has book net income of $85,000.[13] An $85,000 dividend is distributed to the shareholders.

Tax Treatment. No book-tax adjustments are required. The fund's excise tax return shows investment company taxable income of $85,000, which is reduced by a dividends paid deduction of $85,000. The net result is that no excise tax is due.

The fund's income tax return shows taxable income of $100,000,[14] which is reduced by a dividends paid deduction of $85,000 and a $15,000 deduction for the foreign tax credits flowed through to shareholders. The net result is that no income tax is due.

The shareholders collectively report $100,000 of ordinary income and $15,000 of foreign tax paid.

Year 2 Accounting Treatment – Credit-Offset Approach

Book Treatment. In Year 2 the fund has book net income of $100,000.[15] A $100,000 dividend is distributed to the shareholders.

Tax Treatment. No book-tax adjustments are required. The fund's excise tax return shows investment company taxable income of $100,000, which is reduced by a dividends paid deduction of $100,000. The net result is that no excise tax is due.

The fund's income tax return shows taxable income of $100,000, which is reduced by a dividends paid deduction of $100,000. The net result is that no income tax is due.

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[13] The $100,000 French dividend less $15,000 foreign taxes withheld.

[14] Book net income of $85,000 is grossed-up for foreign taxes by $15,000.

[15] The $100,000 Canadian dividend less the $15,000 foreign taxes withheld plus the $15,000 French refund.

The shareholders collectively report $100,000 of ordinary income and no foreign tax paid.

Year 2 Accounting Treatment – Check-Writing Approach

Book Treatment. In Year 2 the fund has book net income of $92,500.[16] $92,500 is distributed to the shareholders.

Tax Treatment. A -$7,500 permanent book tax difference is recorded for both excise and income tax purposes.[17] Of the $92,500 distributed by the fund, only $85,000 is deemed to be a dividend for purposes the dividends paid deduction. The remaining $7,500 distributed by the fund is neither a dividend nor a return of capital for tax purposes.[18]

The fund's excise tax return shows investment company taxable income of $85,000,[19] which is reduced by a dividends paid deduction of $85,000. The net result is that no excise tax is due.

The fund's tax return shows taxable income of $100,000,[20] which is reduced by a dividends paid deduction of $100,000.[21] The net result is that no income tax is due.

The shareholders collectively report $100,000 of ordinary income and $15,000 of foreign tax.

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[16] Equal to the sum of (i) the $100,000 Canadian dividend less $15,000 Canadian taxes withheld, (ii) the $15,000 French refund, and (iii) the -$7,500 payment to the IRS to compensate for the portion of the refund attributable to the taxable shareholders.

[17] The adjustment reflects the sum of the $15,000 refund and the -$7,500 payment to the IRS. This adjustment prevents double taxation of the income that gave rise to the refund.

[18] This $7,500 represents the portion of the refund that was not paid directly to the IRS and that, to prevent double taxation, will not be reflected in income due to the book-tax adjustment. The amount of the distribution not treated as a dividend mirrors the amount of the book-tax difference, because it prevents an imbalance from arising on the excise or income tax returns. While these adjustments avoid taxing the income that gave rise to the original foreign tax credit twice, they require complicated communications to shareholders regarding the character of the nonstandard distribution they receive.

[19] $92,500 of book net income less the $7,500 book-tax difference.

[20] $92,500 of book net income less the $7,500 book-tax difference plus the $15,000 gross-up for current year foreign taxes.

[21] The $85,000 of distributions deemed to be a dividend for purposes of the dividends paid deduction plus $15,000 of foreign taxes.

Table C: Total IRS Receipts

	Base Case	Credit-Offset	Check-Writing
Year 1 Taxable Income	$100,000	$100,000	$100,000
Year 1 Foreign Tax Credit	$0	-$15,000	-$15,000
Year 2 Taxable Income	$100,000	$100,000	$100,000
Year 2 Foreign Tax Credit	-$15,000	$0	-$15,000
Total Net Taxable Income	$185,000	$185,000	$170,000
50% Taxable Shareholders	$92,500	$92,500	$85,000
Direct payment	$0	$0	$7,500
IRS' Total	**$92,500**	**$92,500**	**$92,500**