Foreign Tax Credit Proposal Is Some Help, But More Is Needed

By **Adam Halpern, David Forst and Mike Knobler** (December 1, 2022)

Adam Halpern

David Forst

Mike Knobler

In the newly released proposed foreign tax credit regulations, the U.S. Department of the Treasury provided some measure of relief on cost recovery and royalty withholding, two of the most troublesome aspects of the final foreign tax credit regulations that were published in January.[1]

However, these changes do not go nearly far enough. There are many other issues with the final foreign tax credit regulations that still remain.

Cost Recovery Requirement

The final foreign tax credit regulations significantly tightened the long-standing requirement that foreign taxes are generally only creditable against U.S. tax liability if they tax net income rather than gross income. They replaced the generic requirement that the tax reach net income under reasonable principles with a more stringent cost-recovery requirement that makes substantial changes in Treasury Regulation Section 1.901-2(b)(4).

In response to taxpayer comments to the 2020 proposed regulations, the final foreign tax credit regulations made three changes.

First, the cost recovery allowed under the foreign tax must be in a manner that conforms in essential respects to the determination of taxable income under the U.S. Internal Revenue Code's principles-based exception.

Second, the analysis of whether a tax allows for the recovery of significant costs and expenses is based on whether the costs and expenses are significant for all taxpayers in the aggregate to which the foreign tax applies, rather than on a taxpayer-by-taxpayer basis.

Third, they added a list of costs and expenses that are per se significant, regardless of the amount at stake.

Following the publication of the final foreign tax credit regulations, taxpayers requested relief and more guidance on foreign disallowances. The new proposed foreign tax credit regulations provide limited relief by allowing credibility if the foreign tax allows recovery of substantially all of each item of significant cost or expense.

Furthermore, the proposed foreign tax credit regulations would establish a safe harbor under which the "substantially all" requirement is met for foreign taxes that disallow no more than 25% of any item or items of significant cost or expense.

Also, a foreign tax would not become noncreditable merely because it imposes a cap on the deductibility of a single category of significant cost or expense, (1) as long as that cap is not less than 15% of gross receipts, gross income or a similar measure; or (2) in the case of a cap based on a percentage of taxable income or a similar measure, the cap is not less than 30%.

The proposed foreign tax credit regulations incorporate two technical corrections to the final foreign tax credit regulations, published in July. The technical corrections expanded the principles-based exception by providing that the disallowance of cost recovery does not render a foreign tax noncreditable if the disallowance is consistent with "any principle" — rather than "the principles" — underlying the disallowances required under the Code.

The technical corrections also provided that the timing of cost recovery generally is disregarded unless the time of recovery under foreign law is so much later as to effectively constitute a denial of recovery.

Under the proposed foreign tax credit regulations, the any-principle exception still applies in cases where a foreign tax does not satisfy the new substantially-all requirement, and two new examples establish that "any principle" is intended to be interpreted broadly.

Under one example, a foreign tax is creditable if the disallowance of cost recovery is the result of an anti-hybrid rule, as the principle of limiting base erosion or profit shifting is found in Section 267A.

Another example provides that a foreign tax can be creditable even if it permits no deduction for any stock-based payments for services, because Sections 162(m) and 280G contain targeted disallowances or limits on deductibility based on non-tax-policy reasons, including influencing the amount or use of certain types of compensation in the labor market.

These examples are helpful, but uncertainty regarding the application of the principles-based exception will remain until the Internal Revenue Service and the courts begin to apply it.

Certain costs and expenses are always treated as significant under the newly proposed substantially-all requirement, whether or not they are actually significant: capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation.

In contrast, the following costs do not need to be recovered for a foreign tax to be creditable: costs and expenses attributable to wage income or to investment income that is not derived from a trade or business.

Furthermore, the creditability of a tax does not depend on whether it allows a deduction for other taxes that would qualify as foreign income taxes or whether it is deductible in the calculation of such other taxes.

A taxpayer may choose to rely on the proposed foreign tax credit regulations' cost-recovery provisions for foreign taxes paid in taxable years beginning on or after Dec. 28, 2021, and ending before the effective date of final regulations.

Royalty Attribution

The final foreign tax credit regulations added an attribution requirement in Treasury Regulation Section 1.901- 2(b)(5), which requires a foreign country imposing tax to allocate taxing jurisdiction in a manner reasonably similar to how the Code allocates taxing jurisdiction.

The Treasury stated that the purpose of the attribution requirement is to allow a foreign tax

credit only if the country imposing the tax has sufficient nexus to the taxpayer's activities or investment of capital that generates the income included in the tax base.

In the case of royalty payments, this means that foreign law must source royalties based on the place of use of, or the right to use, the intangible property, consistent with how the Code sources royalty income.

This rule raises a number of practical issues. For example, when the final regulations were issued, it appeared that a taxpayer would be required to investigate the laws of every foreign country to claim foreign tax credits when the treaty exception does not apply. In the new regulations, the Treasury offers a limited single-country exception for certain licensing arrangements that give rise to royalty income.

The single-country exception applies if the taxpayer can substantiate that a withholding tax is imposed on royalties received in exchange for the right to use intellectual property solely within the territory of the taxing jurisdiction. If the taxpayer can do this, then the taxpayer need not investigate local country tax law to determine the sourcing answer.

The proposed foreign tax credit regulations provide for a single-country license — requiring the taxpayer to have a written license agreement that provides for the payment of the royalty, and that limits the use of the IP giving rise to the royalty to the territory of the foreign country imposing the tax.

Further, a payment, or portion of a payment, may be treated as made pursuant to a single-country license even if the written agreement is not so limited, provided the agreement separately states the portion — whether as a specified amount or as a formula — of the royalty payment subject to the tested foreign tax is with respect to the single country.

An anti-abuse rule provides a payment is treated as not made pursuant to a single-country license if the taxpayer knows, or has reason to know, that the required agreement misstates the territory in which the IP is used or overstates the amount of the royalty with respect to the single country.

The single-country license agreement must be executed no later than the date on which the royalty is paid. However, a transition rule applies for royalties paid on or before May 17, 2023.

In that case, the required agreement must be executed no later than May 17, 2023, and the agreement must state — whether in the terms of the agreement or in recitals — that royalties paid on or before the execution of the agreement are considered paid pursuant to the terms of the agreement. Therefore, taxpayers would be well advised to review licensing agreements that give rise to foreign withholding tax.

A Limited Tweak Made to Allocation of Foreign Taxes Under Treasury Regulations Section 1.861-20

In addition to the substantive changes regarding the attribution and cost recovery requirements, the proposed foreign tax credit regulations also revisit the rules for allocating foreign taxes among income groups under Treasury Regulations Section 1.861-20. Instead of any significant revisions, the proposed regulations would make a limited technical tweak.

In relevant part, the existing final foreign tax credit regulations allocate foreign taxes imposed on remittances of property based on the asset method of apportionment under

Treasury Regulation Section 1.861-9.

This rule allocates taxes on a remittance from a disregarded entity based on the tax basis of assets of the disregarded entity, or DRE, rather than the sources from which the disregarded entity's accumulated earnings arise.[2] Taxpayers rightly criticized this rule as distortive.

To the extent the DRE held its retained earnings in the form of cash, the tax basis of cash would attract an allocation of foreign income taxes to the passive category, even though little or none of the DRE's income was passive income. We hoped that this rule would have been changed.

Instead, the new proposed foreign tax credit regulations only modify the way in which disregarded payments are treated for measuring a DRE's assets.

Generally, if one DRE makes a payment to another DRE of the same owner, this disregarded payment — a so-called reattribution payment — can cause the income of the payor DRE to be reallocated to the recipient DRE. They also adjust the assets of the two DREs — so-called reattribution assets — to match the attribution of income to the two DREs.

The proposed foreign tax credit regulations limit the scope of reattribution assets to exclude assets exchanged in a disregarded sale or exchange of property. The preamble posits a fact pattern where a manufacturing DRE sells inventory to a distributor DRE of the same taxpayer.

The goal of the change is to prevent a shifting of cash from the manufacturer DRE to the distributor DRE and vice versa with respect to inventory. The proposed foreign tax credit regulations request comments as to whether additional limits on the scope of reattribution assets would be appropriate.

Conclusion

While these proposed foreign tax credit regulations provide some limited relief, as we and many other practitioners observed over two years ago, the Treasury lacks the statutory authority to impose an attribution requirement in the regulations. Sections 901 and 903 of the Code allow a credit for all foreign income taxes, and an attribution requirement conflicts with that clear language and congressional intent.

For years, the Treasury has chosen to take an expansive view of its own authority, and we are now beginning to see taxpayers successfully challenge unauthorized Treasury regulations. We will see more.

Many of the challenges to date have involved regulations focusing on specific transactions that the Treasury does not like: the Section 7874 anti-inversion regulations and planning around the effective date of Section 245A. A great many taxpayers have no economic interest in these areas.

In the foreign tax credit area, by contrast, every U.S.-parented multinational group has something at stake. Many taxpayers are harmed by the final foreign tax credit regulations even with the changes in the new proposed foreign tax credit regulations. Litigation is sure to follow.

Adam Halpern is a partner and the chair of the tax group, David Forst is a partner, and Mike Knobler is an associate at Fenwick & West LLP.

Fenwick partners Larissa B. Neumann, Julia Ushakova-Stein and William R. Skinner contributed to this article.

[1] Proposed Foreign Tax Credit ("FTC") Regulations, https://public-inspection.federalregister.gov/2022-25337.pdf.

[2] See Treas. Reg. § 1.861-20(g)(11), Example 11.