ACT Alliance for Competitive Taxation

February 24, 2022

The Honorable Janet L. Yellen
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: 2021 Final Foreign Tax Credit Regulations

Dear Secretary Yellen:

We are writing to you to express serious concerns regarding the impact the 2021 final foreign tax credit regulations released on December 28, 2021, will have on U.S. jobs and competitiveness.[1] These regulations (the "Final Regulations") were proposed in November 2020 and ACT submitted comments on February 10, 2021.[2]

The original impetus for these regulations was to deny a U.S. foreign tax credit for novel extraterritorial taxes, such as digital services taxes (DSTs), which were considered outside the internationally recognized income tax system and a discriminatory tax similar to a tariff imposed by foreign jurisdictions.[3] However, the Final Regulations go well beyond this original purpose and will deny foreign tax credits for taxes that have nothing to do with DSTs and that have been creditable for many years. Moreover, DSTs have been addressed through other international mechanisms.[4]

ACT believes the Final Regulations are not only overly broad in scope, but the double taxation of U.S. companies that will result represents a significant threat to the economic interests of the United States for the following reasons:

(1) The Final Regulations will cause a material amount of taxes paid on the foreign income of U.S. companies to be non-creditable, resulting in double taxation of U.S. companies – a tax burden that their foreign competitors will not bear. This will be particularly true with respect to taxes imposed by developing countries, which represent some of the fastest growing markets for U.S. companies and are markets where competition with foreign multinationals is often the most intense. For example, there is significant concern as to whether the Brazilian income tax or the services and royalty withholding taxes imposed by many South American countries would be creditable under the Final Regulations.[5] The Final Regulations will have a material and adverse effect on the ability of U.S. companies to compete and grow in critical foreign markets, resulting in fewer jobs and less investment in the United States.[6]

(2) The Final Regulations create perverse incentives for U.S. companies to shift activities and jobs from the United States to foreign locations. For example, U.S. companies will often be unable to credit foreign taxes imposed on payments for services provided from the United States to foreign customers. This will provide a tax incentive for those companies to shift jobs to the local customer markets to avoid double taxation.

(3) U.S. companies will be incentivized to shift the development and ownership of patents, copyrights, and other intellectual property (IP) to foreign countries to avoid facing non-creditable taxes on cross-border royalty payments. U.S. workers and their communities will be hurt as valuable jobs leave the United States as a result of these regulations.

ACT Alliance for Competitive Taxation

(4) The Final Regulations introduce enormous uncertainty in one of the most significant areas of tax law for globally engaged U.S. companies and one which, until now, has been among the most stable. The Final Regulations include numerous novel concepts and ambiguous terminology that will inevitably result in increased compliance costs, significant uncertainty, and protracted litigation with the Internal Revenue Service. Taxpayers will need to analyze the intent of every deduction disallowance under foreign law to determine consistency with U.S. tax principles. Notably, neither this uncertainty nor any of these added compliance burdens will be faced by the foreign competitors of U.S. companies, with the result that U.S. companies and their workers will be less able to compete and grow in markets around the world.

An appendix to this letter provides examples of common business transactions that would be subject to double taxation under the Final Regulations.

The Final Regulations represent the most significant shift in U.S. law and policy with respect to the creditability of foreign taxes in many decades. They are arguably the most significant change in this area since the foreign tax credit limitation was introduced in 1921. ACT believes that policy changes of this magnitude should only be undertaken with a clear mandate from Congress. Despite the fact that Treasury has been in detailed discussions with Congress regarding the U.S. international tax rules for more than a year, there is no evidence that Congress has been apprised of the fundamental policy issues raised by these regulations. Given the significant impact the regulations will have on the U.S. economy and on U.S. workers, we believe it is important that Congress fully understands the impact of these regulations.

We also note that the Final Regulations violate the spirit of U.S. tax treaties, including with our major trading partners, by calling into significant question whether the United States will continue to allow a credit for taxes paid by foreign subsidiaries whose income is subject to U.S. taxation under the Subpart F and GILTI rules. In effect, if foreign governments fail to change their tax laws to mimic the U.S. income tax system, global U.S. companies may suffer double taxation notwithstanding U.S. treaty commitments.

In addition, we note that prior to the release of the Final Regulations, 137 countries, including the United States, recently agreed to an OECD/G20 Statement. Both Pillars One and Two of this Statement call for changes to the taxing rights of countries with respect to cross-border income – changes that are fundamentally *inconsistent* with the rules provided in the regulations.[7]

The Final Regulations go well beyond addressing the digital services taxes that were their original impetus, arguably make the most significant changes to the regulations in over a century, advantage foreign competitors of US multinationals, create an incentive to move valuable jobs and IP offshore, are inconsistent with the OECD/G20 two-pillar agreement, and took effect only three days after they were released for calendar year taxpayers. For these reasons, *ACT urges Treasury to immediately withdraw the Final Regulations and to issue revised regulations in proposed form that take into account the issues identified in this letter.* ACT further urges Treasury to consult closely with Congress on any future legislation or regulations in this area.

We would be pleased to meet with you or your staff to discuss these important issues.

Sincerely,

Alliance for Competitive Taxation

cc: Rep. Richard Neal, Chairman of the Ways and Means Committee
Sen. Ron Wyden, Chairman of the Senate Finance Committee
Rep. Kevin Brady, Ranking Member of the Ways and Means Committee
Sen. Mike Crapo, Ranking Member of the Senate Finance Committee

[1] The Alliance for Competitive Taxation ("ACT") is a coalition of leading American companies across a broad array of industries whose principal mission is securing an internationally competitive tax system. ACT believes a corporate tax system that is aligned with the tax systems of our major trading partners will promote greater U.S. investment, increased employment, and higher wages.

[2] Few revisions were made to the Final Regulations in response to taxpayer comments on the proposed regulations.

[3] See 2020 proposed foreign tax credit regulations (REG-101657-20) at page 117, "However, the adoption or potential adoption by foreign countries of novel extraterritorial foreign taxes that diverge in significant respects from these norms of taxing jurisdiction now suggests that further guidance is appropriate to ensure that creditable foreign taxes in fact have a predominant character of 'an income tax in the U.S. sense'."

[4] The multilateral convention that will implement Pillar One will require all parties to remove digital services taxes and all other relevant measures. As a result, the multilateral convention, when it comes into force, will address the novel extraterritorial taxes that were the original rationale for the regulations. Even if the multilateral convention were not to come into force in 2024, as contemplated by the Statement, section 301 of the Trade Act of 1974 provides a tariff remedy to address digital services taxes and other unreasonable or discriminatory taxes that burden or restrict U.S. commerce. Under the authority of section 301, the U.S. Government has imposed and temporarily suspended duties in response to the digital services taxes enacted by Austria, France, India, Italy, Spain, Turkey, and the United Kingdom. These tariffs may be activated if the digital services taxes are not withdrawn under the terms of Pillar One.

[5] Many taxes imposed by advanced economies also may be non-creditable under the regulations.

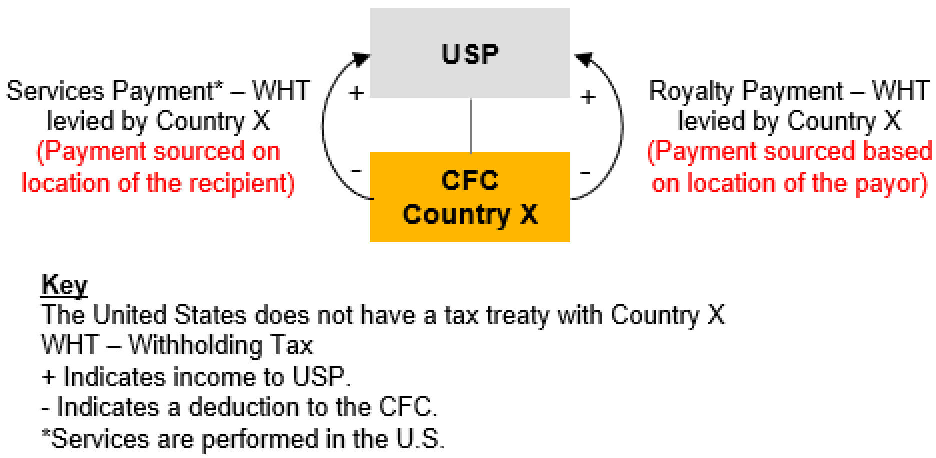
[6] While the economic effects are not quantified, Treasury and the Internal Revenue Service ("IRS") acknowledge the regulations may reduce the international activity of U.S. companies. Economic research has found that the foreign and domestic investment of U.S. companies are overall complements, implying that domestic investment and employment also may be reduced by the regulations.

[7] The preamble to the Proposed Regulations stated that if an agreement that includes the United States is reached with respect to the two-pillar OECD project, further changes would be required to the foreign tax credit system to reflect that agreement and that these regulations were "necessary and appropriate to require that a foreign tax conform to traditional international norms of taxing jurisdiction…" Simultaneously, the United States continues to be intensely involved in negotiating the details of Pillars One and Two at the OECD, which will redefine the very international norms the Final Regulations seek to memorialize.

ACT Alliance for Competitive Taxation

APPENDIX
Examples of How the Final Regulations Affect Ordinary Business Transactions

For purposes of illustrating the effect of the Final Regulations on ordinary business transactions of U.S. multinational companies, we consider the following: a domestic corporation ("USP") wholly owns a controlled foreign corporation ("CFC") organized under the laws of Country X, which does not have a tax treaty with the United States. The Country X CFC pays local country tax on income generated in the current year, and USP recognizes a Global Intangible Low-Taxed Income ("GILTI") inclusion with respect to the income. The Country X CFC also pays USP a royalty for the use of intellectual property ("IP") held by USP in the United States and a services payment related to services performed by USP in the United States. Country X imposes withholding taxes on both payments. Country X's sourcing provisions source the royalty payment based on residence of the payor and source the services payment based on location of the recipient of the services. The example is illustrated below:



The Final Regulations provide a complicated architecture for determining whether a foreign tax is creditable for U.S. federal income tax purposes. Under the Final Regulations, for a foreign tax to be creditable, it generally must satisfy several requirements, including the "net gain requirement," which has four components: (i) realization, (ii) gross receipts, (iii) cost recovery, and (iv) attribution.

While each separate requirement has its own complexity and uncertainty, the cost recovery and attribution requirements described above present particular challenges. These requirements will lead to uncertainty, double taxation, and perverse incentives for U.S. companies to move IP and the performance of services offshore, resulting in harm to the competitiveness of U.S. multinationals and their U.S. employees. In particular, the requirement that foreign countries use the arm's length standard to determine the scope of their tax base will be extremely challenging to apply in practice and may lead to significant double taxation.

1. Cost recovery requirement

A foreign income tax meets the cost recovery requirement if the tax base is reduced by significant costs and expenses that are attributable under reasonable principles to the gross receipts included in the tax base. This standard will frequently require taxpayers to analyze whether the relevant costs or expenses are significant based on whether, for <u>all</u> taxpayers in the aggregate to which the foreign tax applies, the costs or expenses constitute a significant portion of the taxpayers' total costs and expenses, requiring knowledge of local law that neither the taxpayer nor the IRS will possess. The Final Regulations provide that foreign tax law is considered to permit recovery of significant costs and expenses, even if a portion of the costs or expenses is disallowed, if such disallowance is consistent with principles underlying the disallowances required under the Internal Revenue Code. Accordingly, taxpayers must analyze the intent behind each foreign law disallowance rule to determine whether the foreign disallowance is consistent with the principles of U.S. disallowance rules.

Taxpayers will inevitably interpret "significant" in different manners, leading to variation among taxpayers as to whether commonly imposed foreign taxes are creditable for U.S. federal income tax purposes. Taxpayers will be uncertain as to whether a tax is creditable until IRS examination or determination by a court if the issue is litigated. Notwithstanding Treasury's assertion in the preamble to the Final Regulations that prior law was difficult to apply, the experience of ACT members is that the standards in the prior regulations were straightforward and gave rise to very few disputes with the IRS. The adoption of a completely new standard that incorporates imprecise terminology, by contrast, is likely to inject new and substantial uncertainty into this area for years to come.

Further, the cost recovery requirement creates a "cliff effect" in determining whether a tax is creditable. If a taxpayer (or the IRS) determines that foreign tax law does not permit the recovery of a significant cost or expense, and such denial is not consistent with principles underlying the disallowances required under the Internal Revenue Code, it appears the entire foreign tax will not be creditable for U.S. federal income tax purposes, even if, under a particular taxpayer's factual situation, that "significant" cost or expense is not relevant.

In the example above, if Country X permits the recovery of significant costs and expenses attributable to gross receipts included in the Country X tax base, but limits the recovery of royalty expense paid to related persons based on a reasonable measure of the CFC's taxable income, there is uncertainty as to whether the cost recovery requirement can be met because there generally is no analogous disallowance for royalty expense under U.S. law.[1]

Sovereign nations have enacted income taxes with their own varied deduction disallowance rules. While the Treasury may want countries to conform their income taxes to U.S. tax rules, U.S. taxpayers bear the cost if countries fail to do so. Narrowing the foreign tax credit to apply only to income taxes that mimic numerous features of the Internal Revenue Code, and include no deduction disallowance rules that Congress has (yet) enacted, needlessly punishes U.S. companies in favor of foreign competitors.

Even if the United States has a treaty with the foreign country that explicitly provides that a foreign tax is an income tax under the double taxation article, the treaty may not apply unless the U.S. company (not one of its foreign subsidiaries) paid the tax.[2] For example, if the United States had a treaty with Country X, the treaty may not apply to permit a foreign tax credit for taxes paid by the Country X CFC for purposes of determining USP's GILTI tax liability, because the foreign subsidiary of the U.S. company is the payor of such foreign taxes.

In the facts above, if Country X has a disallowance provision that violates the cost recovery requirement, a treaty between the United States and Country X may not apply to treat the foreign corporate tax paid by the Country X CFC as creditable because USP did not pay the Country X tax on the Country X CFC's operating income. The result is double taxation that is limited solely to U.S. multinationals. More generally, it will often be the case that taxes paid by some members of the U.S. taxpayer's worldwide group will be creditable under an applicable treaty, while the very same taxes paid by another member of the group might not be creditable.[3] It is difficult to believe this standard can be administered in a straightforward manner by taxpayers or the IRS.

2. **Attribution Requirement - Non-residents**

The attribution requirement is applied separately with respect to non-residents and residents of a foreign taxing jurisdiction. With respect to taxes on non-residents, the attribution requirement generally requires gross receipts and costs attributable to each of the items of income that is included in the base of the foreign tax to satisfy one of three requirements: the activities-based, source-based, or situs-based requirement. For purposes of this appendix, we focus on the source-based requirement.

The source-based attribution requirement provides that the income sourcing rules under foreign tax law must be reasonably similar to those that apply for U.S. federal income tax purposes. The Final Regulations explicitly require that: (1) income from services be sourced based on the place of performance of the service (not the location of the service recipient or the payor of the service); (2) royalty income be sourced where the use of, or the right to use, the intangible property is located; and (3) sales income cannot be sourced based on place of destination or use.

a. **Royalties**

In the example above, the Country X CFC pays a royalty to USP for the use of IP held in the United States. The foreign withholding tax on gross income from the royalty is sourced under Country X law to the residence of the payor, which departs from the U.S. sourcing rule that sources the royalty by reference to the place of use, or the right to use, the IP. Accordingly, it appears the Country X withholding tax on the royalty would not be a creditable tax for U.S. federal income tax purposes (even if the IP were used exclusively within country X) because it does not meet the source-based attribution requirement.[4]

To avoid double taxation of the royalty associated with the withholding tax, USP has an incentive to migrate the IP to Country X (e.g., through a related-party sale of the IP from USP to Country X). Following this migration, there would no longer be a need for the Country X CFC to compensate USP for the use of the IP (as Country X would own the IP). Accordingly, there would be no royalty payment, no withholding tax levied by the Country X taxing authority, and thus no double taxation. The U.S. economy would lose the jobs associated with managing, enhancing, and protecting the IP. ACT does not believe such a result is consistent with U.S. interests.

b. **Services**

A similar issue arises with respect to payments for services performed outside the taxing jurisdiction. In the example above, USP performs a service in the United States for Country X CFC. Country X CFC compensates USP for the services with a cash payment. Country X withholds tax on the payment. Country X sources the payment based on the location of the service recipient (i.e., Country X), rather than where the services were performed (i.e., the United States).

Under the Final Regulations, the withholding tax on the payment is not creditable by USP because the sourcing rules for services between Country X and the United States differ.[5] In order to mitigate the double taxation on the services payment, the services could be performed in Country X by CFC X employees. As a result, the Final Regulations incentivize USP to move the jobs from the United States to Country X.

3. **Attribution Requirement - Residents**

The attribution requirement is satisfied with respect to taxes imposed on residents of a foreign jurisdiction if the allocation of income, gain, deduction, or loss between a resident taxpayer and a related or controlled entity under the foreign country's transfer pricing rules follow the arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion. This is the standard adopted by the IRS for implementing the clear reflection of income principle for related party transactions under Code section 482.

In the example, if Country X levies a tax on the Country X CFC (i.e., a resident of Country X) and in doing so requires the income subject to tax be apportioned between related parties on a formulary basis (rather than on an arm's length basis), a question arises as to whether the tax can meet the attribution requirement. The taxpayer must analyze whether the formulaic approach taken by Country X is consistent with the arm's length principles in the U.S. regulations. While the ultimate allocation of income, gain, deduction, or loss may be similar to the allocation of each item under arm's length principles, because Country X uses a different allocation methodology, there is inherent uncertainty as to whether the tax imposed by Country X can satisfy the attribution requirement.

Absent a change to the Final Regulations, to avoid double taxation, USP would need to relocate Country X CFC's operations to earn the income in a jurisdiction that conforms to the arm's length principle. Practically speaking, this may require abandoning a market jurisdiction and ceding ground to foreign competitors.

4. Conclusion

The Final Regulations create uncertainty with respect to almost every foreign levy imposed around the world. Such uncertainty could lead to decades of litigation that would be costly for both taxpayers and the IRS.

In addition, the Final Regulations encourage offshoring of services jobs and the ownership of IP to the detriment of the U.S. economy and will create an unlevel tax playing field for U.S. companies in markets around the world.

[1] Interest and royalty expense may be disallowed in connection with hybrid transactions under U.S. tax law.
[2] The Final Regulations explicitly provide under Treas. Reg. § 1.901-2(g)(5) that the term paid "does not include foreign taxes deemed paid under section 904(c) or section 960."
[3] For example, the creditability of the same foreign tax imposed on a foreign branch and a foreign subsidiary of a U.S. parent company may vary. As another example, the creditability of a withholding tax imposed by a foreign country on a foreign subsidiary may differ from a withholding tax imposed on a U.S. parent company by the same foreign country with respect to the same type of payment (e.g., a royalty).
[4] The withholding tax imposed by Country X may nevertheless be creditable under an applicable income tax treaty. However, the United States does not have tax treaties with every jurisdiction. In particular, the United States has relatively few tax treaties with developing countries in Asia, Latin America, and Africa. Accordingly, for countries with which the United States does not have a tax treaty, creditability of any tax is determined only under the Final Regulations.
[5] Similar to taxes imposed on royalty payments, the tax imposed on payments related to services may nevertheless be creditable under an income tax treaty.