July 1, 2022

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

Re: 2021 Final Foreign Tax Credit Regulations

Dear Secretary Yellen:

On February 24, 2022, the Alliance for Competitive Taxation[1] ("ACT") sent you a letter expressing our concerns about the adverse impacts on U.S. jobs and competitiveness of the final foreign tax credit regulations ("Final Regulations") released on December 28, 2021.

We are heartened by recent comments by you and Treasury staff indicating a willingness to consider changes to the Final Regulations to address issues raised by taxpayers.

This letter sets forth a number of specific recommendations for modifying the Final Regulations that we believe would be consistent with the original purpose of these regulations (i.e., to preclude the creditability of digital services and similar taxes), would provide greater certainty, and would mitigate adverse competitive effects and administrative and compliance burdens.

We would be pleased to meet with you and your staff to discuss these important issues in greater detail.

Sincerely,

The Alliance for Competitive Taxation

cc: Lily Batchelder, Asst. Secretary, U.S. Treasury Dept.
Jose Murillo, Deputy Asst. Secretary for International Tax Affairs, U.S. Treasury Dept.
William M. Paul, Acting Chief Counsel, IRS
Peter Blessing, Associate Chief Counsel – International, IRS

[1] The Alliance for Competitive Taxation ("ACT") is a coalition of leading American companies from a wide range of industries that supports a globally competitive corporate tax system that aligns the United States with other advanced economies.

ALLIANCE FOR COMPETITIVE TAXATION RECOMMENDATIONS REGARDING 2021 FINAL FOREIGN TAX CREDIT REGULATIONS

I. Introduction

The impetus for the 2021 final foreign tax credit regulations ("Final Regulations"), released on December 28, 2021, was to deny credits for digital services taxes and similar novel extraterritorial taxes that foreign jurisdictions have imposed contrary to international norms:[2]

> "Recently, many foreign jurisdictions have disregarded international taxing norms to claim additional tax revenue, resulting in the adoption of novel extraterritorial taxes that diverge in significant respects from U.S. tax rules and traditional norms of international taxing jurisdiction. These extraterritorial assertions of taxing authority often target digital services, where countries seeking additional revenue have chosen to abandon international norms to assert taxing rights over digital service providers.
>
> The Treasury Department and the IRS have determined that it is necessary and appropriate to adapt the regulations under sections 901 and 903 to address this change in circumstances, especially in relation to the taxation of the digital economy—a sector that did not exist when the foreign tax credit provisions were first enacted. Accordingly, regulations are necessary and appropriate to more clearly delineate the circumstances in which a tax does not qualify as an income tax in the U.S. sense due to the foreign jurisdiction's unreasonable assertion of jurisdictional taxing authority."

The Final Regulations, however, deny credits for many conventional taxes that have been treated as creditable taxes by the U.S. Government for more than a century. For example:

- A country's entire income tax may be rendered non-creditable because foreign cost recovery rules for a particular expense differ from those in U.S. law (e.g., stock compensation, amortization of goodwill, etc.), even if the expense is immaterial.

- A withholding tax imposed on royalties by the country where the underlying intellectual property is used (i.e., consistent with the U.S. sourcing rule) may nevertheless be treated as non-creditable if the reason the royalty is sourced to that country is based on the residence or location of the payor.

As the Final Regulations are far more restrictive on the availability and use of foreign tax credits than international norms, they have the effect of putting U.S. multinational companies at a competitive disadvantage relative to foreign-based multinationals, particularly with respect to operations in less developed economies where the United States has limited tax treaty coverage.

Moreover, the inability to claim a credit for withholding taxes on many service payments and royalties creates an incentive for U.S. companies to provide services and develop and invest in (or acquire) patents, copyrights, and other intellectual property in a foreign country with a more robust tax treaty network than the United States to mitigate double taxation. This could result in the loss of valuable U.S. jobs and tax revenues, and harm U.S. workers and their communities. This could also prompt U.S. companies to cede participation in certain markets to foreign parties.

[2] Federal Register, Vol. 87, No. 2, January 4, 2022, U.S. Government Printing Office, p. 285.

Also concerning is the uncertainty the Final Regulations create for taxpayers and tax administrators given the lack of guidance regarding which foreign taxes are intended to be treated as non-creditable. This is an immediate concern for public companies that must issue quarterly financial reports, as the Final Regulations became effective just three days after their release, and in some cases, apply retroactively to January 1, 2020.

Recently, staff of the Treasury Department and the Internal Revenue Service have acknowledged some of the issues noted above and have indicated a willingness to consider changes to the Final Regulations. Accordingly, this letter sets forth a number of specific recommendations for modifying the Final Regulations that we believe are consistent with the original purpose of these regulations, would provide greater certainty, and would mitigate adverse competitive effects and excessive administrative and compliance burdens. Because the final regulations were immediately effective and, in some cases, had retroactive effect, taxpayers would welcome an accelerated resolution of these issues, including through the issuance of sub-regulatory guidance in advance of revisions to the regulations.

The following section of the letter sets forth ACT's specific recommendations, including their rationales, for modifying eight portions of the Final Regulations:

1. Application of Income Tax Treaties
2. Cost Recovery – Recovery of Significant Costs & Expenses
3. Withholding Tax on Royalties (Treas. Reg. § 1.901-2(b)(5)(i)(B)(2))
4. Withholding Tax on Services Payments (Treas. Reg. § 1.901-2(b)(5)(i)(B)(1))
5. Attribution Requirement – Tax on Residents (Treas. Reg. § 1.901-2(b)(5)(ii))
6. Non-duplication Requirement (Treas. Reg. § 1.903-1(c)(1)(ii))
7. Allocation and Apportionment of Foreign Tax with Respect to Remittances (Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii))
8. Separate Levies (Treas. Reg. § 1.901-2(d)(2)).

II. COMMENTS RELATING TO CERTAIN ASPECTS OF THE FINAL REGULATIONS

1. Application of Income Tax Treaties

<u>Final Regulations</u>

The Final Regulations provide that a foreign levy that is treated as an income tax under the relief from double taxation article of an income tax treaty that the United States has entered into with the country imposing the tax meets the definition of a foreign income tax (generally rendering the tax as creditable) if the tax is paid by a U.S. citizen or resident of the United States that elects to claim benefits under that treaty.

In addition, the preamble to the Final Regulations notes that controlled foreign corporations ("CFCs") are not treated as U.S. residents under income tax treaties and therefore are not entitled to U.S. tax treaty benefits.[3] But neither the Final Regulations nor the preamble explicitly address whether U.S. shareholders of a CFC, who are eligible for treaty benefits, are entitled to treaty benefits with respect to any foreign taxes paid by a CFC in respect of income included in the gross income of the shareholder under subpart F or the global intangible low-taxed income ("GILTI") regime. Accordingly, taxes paid to a U.S. treaty partner by a CFC do not automatically meet the definition of a foreign income tax under the Final Regulations. Instead, taxpayers must

[3] *See* Federal Register, Vol. 87, No. 2, January 4, 2022, U.S. Government Printing Office, p. 292.

consider whether these taxes qualify for a credit under the applicable treaty or alternatively must independently verify, with respect to each tax, that the tax satisfies all the requirements of the Final Regulations in order to qualify as a creditable foreign income tax.

<u>ACT Recommendation</u>

If a CFC incurs a tax that would otherwise be a "covered tax" under an applicable U.S. income tax treaty, ACT recommends the tax be deemed to be a "foreign income tax" for purposes of sections 901 and 903.

<u>Reasons for ACT Recommendation</u>

If taxes paid by CFCs are not creditable pursuant to an applicable U.S. income tax treaty, taxes deemed paid in connection with GILTI or subpart F income would be subject to the requirements of the Final Regulations. As a result, it could often be the case that taxes paid by some members of the U.S. taxpayer's worldwide group (e.g., through a foreign branch operated by a domestic corporation) would be creditable under an applicable treaty, while the very same taxes paid by another member of the group to the same country (e.g., by a CFC) would not be creditable. ACT does not believe this result represents sound tax policy. Further, such an outcome would encourage taxpayers to undertake otherwise unnecessary restructuring transactions to mitigate double taxation on foreign income.

If taxes paid by CFCs are entitled to treaty benefits, the U.S. treaty commitments will be abrogated in situations where the Final Regulations deny a credit for these taxes. The primary purpose of all income tax treaties is the avoidance of double taxation (i.e., the avoidance of one jurisdiction imposing tax on income sourced from another jurisdiction). The foreign tax credit serves as the mechanism to effectuate that commitment. ACT does not believe that the Final Regulations should attempt to usurp the commitment made by the United States to our major trading partners and other jurisdictions for which the U.S. has an income tax treaty.

Further, allowing a foreign tax credit for any tax that is a covered tax under a relevant income tax treaty would not frustrate the intent of the Final Regulations, which is to ensure that certain novel extraterritorial foreign taxes (e.g., digital services taxes) are not creditable.[4] ACT does not believe that novel extraterritorial foreign taxes, including digital services taxes, would be covered taxes under any U.S. income tax treaty and thus ACT's recommendation would not render digital services taxes creditable.[5]

ACT recommends the following marked changes be made to Treas. Reg. § 1.901-2(a)(1)(iii):

> (iii) Coordination with treaties. A foreign levy that is treated as an income tax under the relief from double taxation article of an income tax treaty entered into by the United States and the foreign country imposing the tax is a foreign income tax if paid, or deemed paid (under section 960), by a citizen or resident of the

[4] *See* Federal Register, Vol. 87, No. 2, January 4, 2022, U.S. Government Printing Office, p. 316: "A principal reason for adding the jurisdictional nexus requirement is to ensure that certain novel extraterritorial foreign taxes, such as digital services taxes, are not creditable."

[5] Generally, taxes covered under income tax treaties are explicitly listed within the relevant Article of the treaty. No U.S. tax treaty explicitly lists digital services taxes as being covered. While treaties generally allow taxes not explicitly listed to qualify as "covered taxes", such taxes must be substantially similar to the taxes explicitly covered. Arguably, digital services taxes would not be substantially similar to any tax explicitly listed in any U.S. tax treaty.

United States (as determined under such income tax treaty) that elects benefits under the treaty. In addition, a foreign levy paid by a controlled foreign corporation that is modified by an applicable income tax treaty between the foreign jurisdiction of which the controlled foreign corporation is a resident and the foreign jurisdiction imposing the tax may qualify as a foreign income tax notwithstanding that the unmodified foreign levy does not satisfy the requirements in paragraph (b) of this section or the requirements of §1.903-1(b) if the levy, as modified by such treaty, satisfies the requirements of paragraph (b) of this section or the requirements of §1.903-1(b). See paragraph (d)(1)(iv) of this section for rules treating as a separate levy a foreign tax that is limited in its application or otherwise modified by the terms of an income tax treaty to which the foreign country imposing the tax is a party.[6]

2. Cost Recovery – Recovery of Significant Costs & Expenses

<u>Final Regulations</u>

Prior to the Final Regulations, Treas. Reg. § 1.901-2(b)(4) provided that a foreign tax met the net income test (and thus was a creditable foreign tax) if, judged on the basis of its predominant character, foreign tax law permitted the recovery of the taxpayer's significant costs and expenses (including significant capital expenditures) attributable to the gross receipts subject to tax. Following the Final Regulations, the predominant-character standard was removed, and Treas. Reg. § 1.901-2(b)(4)(i)(A) now requires the recovery of specifically identified significant costs and expenses (including significant capital expenditures). As amended, Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) provides that costs and expenses "related to capital expenditures, interest, rents, royalties, wages or other payments for services, and research and development are always treated as significant costs or expenses" that must be recoverable.[7]

<u>ACT Recommendations</u>

1. *Per se* significant costs (i.e., capital expenditures, interest, rents, royalties, wages or other payments for services, and research and development) should *not* be treated as significant costs or expenses under Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) if quantitatively immaterial;

2. Immaterial limitations on the deductibility of significant costs and expenses (including *per se* significant costs) should not be viewed as preventing the recovery of a significant cost or expense;

3. Costs and expenses that are not *per se* significant should be rebuttably presumed not to be significant;

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[6] The amendment to Treas. Reg. § 1.901-2(a)(1)(iii) should be accompanied by a corresponding amendment to Treas. Reg. § 1.901-2(g)(5) to remove the language defining "paid", "payment", and "paid by" to not include foreign taxes deemed paid under section 960.

[7] Treas. Reg. § 1.901-2(b)(4)(i)(C)(3) goes on to require that a foreign tax law permit recovery of significant costs and expenses not so much later than they are recovered under the Code (for example, after the property becomes worthless or is disposed of) as to effectively constitute a denial of such recovery. Thus, a permanent disallowance of a deduction, or a failure to allow recovery until after the disposition of an asset when the Code permits recovery over time, appears not to constitute recovery of a significant cost or expense for these purposes.

4. Whether a foreign law expense disallowance is consistent with the principles underlying disallowances in the Code should be determined based on the policy rationale articulated in the foreign law legislative and regulatory history related to the disallowance, regardless of the manner in which it is implemented. In the absence of a clear policy rationale for a disallowance, taxpayers should be able to presume a rationale based on the manner in which the disallowance applies; and

5. Additional examples in the Final Regulations are needed of foreign tax laws that disallow recovery of significant costs and expenses in a manner that differs from U.S. tax law, but nevertheless are consistent with the principles underlying the Code.

<u>Reasons for ACT Recommendations</u>

There is ambiguity in how Treas. Reg. §§ 1.901-2(b)(4)(i)(A) and 1.901-2(b)(4)(i)(C) may be read. Clarification is needed as to the intended application of these provisions both for taxpayers and the IRS.

One interpretation is that Treas. Reg. § 1.901-2(b)(4)(i)(A) provides a general rule that suggests only <u>significant</u> capital expenditures need to be considered as a significant cost and expense that must be recovered. Another interpretation is that Treas. Reg. § 1.901-2(b)(4)(i)(C) states, without any quantitative qualification, that “capital expenditures” are significant costs and expenses that must be recovered, suggesting that even immaterial capital expenditures are considered *per se* significant costs and expenses that must be recovered. While this ambiguity is starkest in the case of capital expenditures,[8] these provisions could be read either to imply that (1) only significant items in the *per se* list described in Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) must be recovered, or (2) every dollar of every item on that list must be recovered.[9]

Further, the Final Regulations do not define “recovery.” Nothing in the regulation specifies whether every dollar of a significant cost or expense must be deductible for the cost or expense to be treated as “recovered.” One could interpret this language to require all but an immaterial portion of a class of costs or expenses to be deductible under foreign law. Whether a limitation on deductibility under the foreign tax is insignificant could be determined in a manner consistent with the exception for insignificant nonrealization events under Treas. Reg. § 1.901-2(b)(2)(i) (*i.e.*, as judged based on the application of the foreign tax to all taxpayers subject to the foreign tax).

To address these ambiguities, ACT recommends the following marked changes be made to the language of Treas. Reg. §§ 1.901-2(b)(4)(i)(A) and 1.901-2(b)(4)(i)(C):

(i) Treas. Reg. § 1.901-2(b)(4)(i)(A) Cost recovery requirement--(i) Costs and expenses that must be recovered—

[8] ACT notes that the term “capital expenditure” is undefined. While restricting expenditures that may be capital in nature to a single definition does not, in ACT’s opinion, promote good tax administration, clarification as to how to interpret the term may be warranted. Such clarification may be general in nature, or more specific in cases where the term is not defined under foreign income tax law.

[9] Compare this ambiguity that arises when interpreting Treas. Reg. § 1.901-2(b)(4)(i)(A) and (C) with the specificity from the all-or-nothing rule in the dual consolidated loss (“DCL”) context, Treas. Reg. § 1.1503(d)-3(a)(1)): “…a foreign use of a DCL shall be deemed to occur when **any portion** of a deduction or loss taken into account…” (emphasis added). (dealing with Foreign Base Company Sales and the computation of rate disparity); AM 2011-002 (Aug. 5, 2011) (dealing with separate return limitation year (“SRLY”) registers in the DCL context).

In general. A foreign tax satisfies the cost recovery requirement if the base of the tax is computed by reducing gross receipts (as described in paragraph (b)(3) of this section) to permit recovery of a substantial portion of the significant costs and expenses ~~(including significant capital expenditures)~~ described in paragraph (b)(4)(i)(C) of this section attributable, under reasonable principles, to such gross receipts. A foreign tax need not permit recovery of significant costs and expenses, such as certain personal expenses, that are not attributable, under reasonable principles, to gross receipts included in the foreign taxable base. A foreign tax whose base is gross receipts, with no reduction for costs and expenses, satisfies the cost recovery requirement only if there are no significant costs and expenses attributable to the gross receipts included in the foreign tax base that must be recovered under the rules of paragraph (b)(4)(i)(C)(1) of this section. See paragraph (b)(4)(iv)(A) of this section (Example 1). A foreign tax that provides an alternative cost allowance satisfies the cost recovery requirement only as provided in paragraph (b)(4)(i)(B) of this section. See paragraph (b)(4)(i)(D) of this section for rules regarding principles for attributing costs and expenses to gross receipts.

- and –

(ii) Treas. Reg. § 1.901-2(b)(4)(i)(C) Significant costs and expenses--(1) Amounts that must be recovered -

Whether a cost or expense is significant for purposes of this paragraph (b)(4)(i) is determined based on whether, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayers' total costs and expenses. Costs and expenses (as characterized under foreign law) related to capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation are always treated as significant costs or expenses for purposes of this paragraph (b)(4)(i), and other costs and expenses will be rebuttably presumed not to be significant...

Example – Goodwill Amortization

Based on ACT's review of various foreign country (referred to below as "Country X") tax laws, there are several different approaches to disallow or defer the recovery of acquired goodwill. Those approaches include, but are not limited to:

1. No recovery of the cost of goodwill over time, or upon a later disposition of the business, and value received for goodwill is subject to foreign tax upon disposition of the business (e.g., Mexico).

2. No recovery of the cost of goodwill over time, or upon a later disposition of the business, but also no foreign tax imposed on value received for goodwill upon disposition of the business (e.g., Singapore and Malaysia).

3. No recovery of the cost of goodwill over time, but recovery provided on later disposition of business, and such later disposition is subject to foreign tax (e.g., Australia, France, India, South Africa, and the United Kingdom).

Utilizing ACT's amended language above, if acquired goodwill as a component of total capital expenditures is an insignificant capital expenditure, as determined based on analysis of all taxpayers in the aggregate to which the foreign tax applies, Country X's failure to allow for the amortization of goodwill should not prevent the Country X income tax from meeting the cost recovery requirement under Treas. Reg. § 1.901-2(b)(4).

Recovery of Costs and Expenses

Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) provides that a foreign country's disallowance of the recovery of all or a portion of certain costs or expenses does not preclude creditability of the foreign tax "if such disallowance is consistent with the principles underlying the disallowances required under the [Code], including disallowances intended to limit base erosion or profit shifting." How broadly or narrowly this language should be interpreted, as well as how a taxpayer determines the principles underlying a particular disallowance under foreign law (or U.S. law), is unclear.

Further, the disallowance of interest expense is administered in a variety of different manners across the globe. The example discussing interest expense disallowances provided in Treas. Reg. § 1.901-2(b)(4)(i)(C), in ACT's opinion, is promulgated too narrowly. Interpreting the language narrowly could result in certain interest expense disallowances being inconsistent with U.S. tax principles even if in practice the disallowance is consistent with the principles of section 163(j).

To address these uncertainties, ACT recommends the following marked changes be made to the language of Treas. Reg. § 1.901-2(b)(4)(i)(C):

> ...Foreign tax law is considered to permit recovery of significant costs and expenses even if recovery of all or a portion of certain costs or expenses is disallowed, if the policy rationale for such disallowance is consistent with the principles underlying the disallowances required under the Internal Revenue Code, including disallowances intended to limit base erosion or profit shifting. For example, a foreign tax is considered to permit recovery of significant costs and expenses if the foreign tax law limits interest deductions based on a percentage of a financial metric, a ratio of debt to equity, or some other manner to reduce the tax incentives for excess leverage ~~so as not to exceed 10 percent of a reasonable measure of taxable income (determined either before or after depreciation and amortization) based on principles similar to those underlying section 163(j)~~, disallows interest and royalty deductions in connection with hybrid transactions based on principles similar to those underlying section 267A, disallows deductions attributable to gross receipts that in whole or in part are excluded, exempt or eliminated from taxable income, or disallows certain expenses based on public policy considerations similar to those disallowances contained in section 162, regardless of the manner in which such limitation or disallowance applies. See paragraph (b)(4)(iv)(C) of this section (Example 3).

Utilizing the example outlined above, and assuming acquired goodwill is a component of total capital expenditures, the failure to allow recovery of expenditures for acquired goodwill may be consistent with the principles underlying limitations on the deductibility of indefinitely lived or nonwasting assets under the Code.[10] If so, Country X's failure to allow for the amortization of goodwill should not prevent the Country X income tax from meeting the cost recovery requirement under Treas. Reg. § 1.901- 2(b)(4).

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[10] *See*, e.g., the "anti-churning rule," which provides that the term "amortizable section 197 intangible" does not include goodwill, going concern value or any other asset for which depreciation or amortization was not allowable prior to the enactment of section 197 if such assets were held or used during the transition period (July 25, 1991, through August 10, 1993). Section 197(f)(9)(A); see also, *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993).

Example -- Stock-Based Compensation

ACT's amended language also would apply outside of the capital expenditure context, including foreign tax law denial of a deduction for stock-based compensation as a component of wages.

Assume Country X tax law does not allow for the deduction of stock-based compensation paid to employees of Country X residents. This may be the case regardless of the manner in which the Country X resident acquires the stock,[11] only in circumstances where the Country X resident does not incur an economic cost to acquire the stock,[12] or only in circumstances where some other condition is not satisfied.[13]

Multiple interpretations of existing Treas. Reg. § 1.901-2(b)(4)(i) could permit the Country X tax to satisfy the cost recovery requirement. First, if Country X tax law does not treat stock-based compensation as a cost, or does not treat it as wages, then stock-based compensation would not be a *per se* significant cost or expense. In that case, if stock-based compensation does not constitute a cost, it therefore should not be considered a significant cost or expense under Treas. Reg. § 1.901-2(b)(4)(i)(C), in which case the fact that Country X does not allow a deduction for stock-based compensation should not prevent the Country X income tax from meeting the cost recovery requirement under Treas. Reg. § 1.901-2(b)(4).

Alternatively, under ACT's recommendation, if (1) stock-based compensation is treated as a component of total wages under Country X tax law, (2) wages are generally deductible under Country X tax law, and (3) stock-based compensation does not constitute a significant portion of Country X taxpayers' total costs and expenses *for wages and other payments for services*, then the non-deductibility of stock-based compensation would not taint the entire *per se* category.

Finally, even if considered a significant cost or expense, the denial of a deduction for stock-based compensation may be consistent with the principles in the Code underlying limitations on deductibility of items (1) excluded from employees' taxable income, (2) that constitute excess remuneration, or (3) for which there is no cash outlay under the Code.[14] Consequently, Country X's failure to allow a deduction for stock-based compensation should not prevent the Country X income tax from meeting the cost recovery requirement under Treas. Reg. § 1.901-2(b)(4) in the cases described above.

Additional Regulatory Examples

ACT appreciates the examples provided in the Final Regulations related to certain foreign tax laws disallowing recovery of significant costs and expenses as they help to eliminate certain

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[11] As appears to be the case in the Netherlands.

[12] Based on our review of various foreign country tax laws, this is the case in a number of countries, including Colombia, Costa Rica, Ecuador, Germany, India, Italy, South Africa, and Thailand.

[13] For example, we understand that Canadian tax law allows a deduction for stock option benefits that exceed an annual vesting limit of $200,000 (subject to certain other restrictions).

[14] The Code provides several limitations regarding the deductibility of compensation. See, e.g., sections 162(m) (providing that no deduction is permitted for employee compensation paid with respect to certain executives in excess of $1 million), 280G (providing no deduction is allowable for excess parachute payments in the context of a change of control), 162(a)(1) (generally limiting deductibility of salaries and other compensation to "reasonable" amounts for services rendered). In general, the stated principle of such restrictions is to limit what is considered "excessive" compensation paid to top executives. See, e.g., H.R. Rep. 103-111 (1993). In addition, certain provisions of the Code may limit the deductibility of expenses that are paid with stock, such as interest under section 163(l).

ambiguities that exist within the regulatory language and provide insight into how taxpayers should interpret a regulation that is subjective in nature. However, taxpayers (and the IRS) would benefit from further examples illustrating the application of the rule when the disallowance of the recovery of certain costs and expenses for foreign law purposes diverges from U.S. tax law. Such examples should seek to reduce the amount of subjectivity needed to appropriately interpret the regulation.

While Treas. Reg. § 1.901-2(b)(4)(iv)(C) is helpful in determining whether a foreign tax law, addressing hybridity and interest expense limitations, is consistent with the principles under sections 163(j) and 267A, taxpayers and the IRS would benefit from understanding how the regulation would address other areas of the Code, such as stock-based compensation and goodwill that foreign law may take into account when determining taxable income.[15] Further, it would be helpful to have examples that address foreign laws that disallow deductions based on a fixed percentage of certain metrics (e.g., sales, gross income, taxable income, etc.).[16] Examples illustrating these fact patterns would help diminish the subjectivity of determining whether a particular foreign expense deduction disallowance is consistent with principles under the Code.[17]

3. Withholding Tax on Royalties (Treas. Reg. § 1.901-2(b)(5)(i)(B)(2))

<u>Final Regulations</u>

The Final Regulations introduce a new attribution requirement for certain foreign taxes to qualify as foreign income taxes under section 901 or 903. Specifically, Treas. Reg. § 1.901-2(b)(5)(i)(B) provides that a foreign tax imposed on a nonresident will satisfy this attribution requirement if the tax is imposed on income on the basis of its source and if the foreign jurisdiction's sourcing rules are reasonably similar to those of the United States. The Final Regulations provide "[a] foreign tax law's application of such sourcing rules need not conform in all respects to the application of those sourcing rules for Federal income tax purposes."

However, under Treas. Reg. § 1.901-2(b)(5)(i)(B)(2), in order for a foreign jurisdiction's sourcing rule to be reasonably similar to the U.S. sourcing rule for royalty income, the income "must be sourced based on the place of use of, or the right to use, the intangible property." In other words, if the sourcing rule for royalties in the foreign country is not substantially similar to the U.S. sourcing rule for royalties, any withholding tax imposed on the royalty payment would not be creditable (absent application of an income tax treaty).

The preamble elaborates that "the final regulations do not require that the foreign law, in determining the place of use of an intangible in a particular transaction or fact pattern, reach the same conclusion as the IRS in a particular revenue ruling or a U.S. court in a particular case."[18] Accordingly, whether the place of use determination under foreign law is the same as under U.S. law does not govern whether the requirement is met. Rather, the fact that the sourcing rule is *per se* based on place of use, or right to use intangible property is the *only* relevant fact in determining creditability. Treas. Reg. § 1.903-1(d)(4) (Example 4) illustrates that where foreign law treats royalties paid by a resident of that jurisdiction as sourced therein on the basis of the

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[15] ACT notes that additional examples are needed in other areas of the Final Regulations (e.g., an example illustrating the impact inflationary adjustments have on the realization requirement under the Final Regulations).
[16] Examples of countries that limit certain deductions based on a fixed percentage of a class of expenses or some other financial metric include Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Germany, and Italy.
[17] ACT can submit examples for consideration by the Treasury and the IRS.
[18] *See* Federal Register, Vol. 87, No. 2, January 4, 2022, U.S. Government Printing Office, p. 288.

residence of the payor, the foreign sourcing rule is *not* reasonably similar to that of the United States, and the attribution requirement is not met. This is also the case where the royalty agreement limits the use of the intellectual property to the country of the payor.

ACT Recommendation

ACT recommends that the "place of use" standard of Treas. Reg. § 1.901-2(b)(5)(i)(B)(2) be satisfied when (1) the foreign sourcing rule takes into account the place of use of the intangible property even if it also allows consideration of other factors, (2) the effect of the foreign sourcing rule is based on place of use of the intangible property even if the rule does not specify such terminology, or (3) the intangible property is available for use by the foreign licensee in the jurisdiction imposing the tax. ACT further recommends that the regulations provide that the intangible property is considered "used" in a jurisdiction where the licensee is a third party operating in that jurisdiction, or in the case of a related party, a majority of "use" of the intangible property occurs in that jurisdiction.

Reasons for ACT Recommendation

The Final Regulations do not expressly address circumstances in which a foreign jurisdiction's sourcing rules contain multiple bases for sourcing royalty income. For example, in a number of countries, and consistent with the language of many U.S. tax treaties, royalty income is treated as sourced in that country if it is derived from use of the licensed intangible property in that country or if it is paid by a resident of that country. In these cases, the sourcing rule is based on both the place of use of the intangible property and the residence of the payor. In many cases, a royalty will factually be paid by a resident of the foreign country for the use of the licensed intangible property in that foreign country, such that either sourcing rule could apply. Such a case is distinguishable from that in Example 4 because the local sourcing rule is *not* based solely on the residence of the payor, but is also based on the place of use of the intangible property. Absent clarification, taxpayers and the IRS may encounter difficulty determining whether the foreign law meets the attribution requirement set forth in Treas. Reg. § 1.901-2(b)(5)(i)(B).

In other cases, one of the bases for sourcing royalty income under foreign law may not use the terminology "place of use" but nonetheless achieves a substantially similar effect, such as where the source of the royalty income paid to the licensor mirrors that of the income of the payor against which the royalty expense is allocated.

In other cases, the sourcing of royalty income may be based on factors other than place of use or right to use the intangible property. However, factually the intangible property may only be used within the jurisdiction imposing the tax either because of valid commercial reasons or because of agreements between the licensee and the owner of the intangible property.[19]

An approach based on the notion of "use" can also create profound adverse commercial consequences for U.S. licensees relative to their competitors from all other countries. For example, it is very common for third party licensees to seek the rights to use intangible property in deals covering more than just one jurisdiction. Such a rule would severely limit U.S. companies from entering into *any* multi-country, regional or global rights with specific entities as this rule would effectively require separate direct licenses with every jurisdiction in order to achieve creditability. In many situations, this will not be feasible or even possible unless the licensee establishes entities in every jurisdiction where the intellectual property will be

[19] In all of these cases, the inability to claim a credit for royalty withholding taxes creates an incentive for U.S. companies to develop intellectual property outside the United States in a foreign country with a more robust treaty network.

exploited. This complexity may provide a significant competitive advantage to non-U.S. competitors that are able to offer regional or global deals to customers in one simple contract.

This restriction may also encourage planning that involves locating new or existing intellectual property rights, and the jobs that support them, and corresponding tax revenues, outside the United States.

Denial of withholding tax credits in these common circumstances goes well beyond a limitation for "novel, extra-territorial taxes". In order to allow creditability in appropriate circumstances, the regulations should provide that intangible property is considered "used" in a jurisdiction where the licensee is a third party operating in that jurisdiction, or in the case of a related party, a majority of "use" of the intangible property occurs in that jurisdiction.

ACT believes that in all fact patterns described above, any withholding tax imposed on the royalty payments should be creditable for U.S. federal income tax purposes as (1) the rules align with the sourcing rule of the U.S. in most material manners, and (2) the result is consistent with the policy objective of the Final Regulations.[20] ACT believes the following marked amendment to Treas. Reg. § 1.901-2(b)(5)(i)(B)(2) would address the recommendation:

> Royalties. A foreign tax on gross income from royalties must be sourced based on the place of use of, or the right to use, the intangible property. This test will be met when: (1) the foreign sourcing rule takes into account the place of use of the intangible property even if it could also be based on other factors; (2) the effect of the foreign sourcing rule is based on the place of use of the intangible property even if the rule does not specify such terminology; or (3) the intangible property is available for use by the foreign licensee in the jurisdiction imposing the tax. The intangible property is considered "used" in a jurisdiction where the licensee is a third party operating in that jurisdiction, or in the case of a related party a majority of "use" of the intangible property occurs in that jurisdiction.

Additional examples demonstrating that the marked language above would cover the fact patterns described in the ACT recommendation would provide welcome certainty for taxpayers in applying this revised standard.[21]

4. Withholding Tax on Services Payments (Treas. Reg. § 1.901-2(b)(5)(i)(B)(1))

Final Regulations

The Final Regulations introduce a new attribution requirement for certain foreign taxes to qualify as foreign income taxes under section 901 or 903. Specifically, Treas. Reg. § 1.901-2(b)(5)(i)(B) provides that a foreign tax imposed on a nonresident will satisfy this attribution requirement if the tax is imposed on income on the basis of its source and if the foreign jurisdiction's sourcing rules are reasonably similar to those of the United States. Under Treas. Reg. § 1.901-2(b)(5)(i)(B)(1), in order for a foreign jurisdiction's sourcing rule to be reasonably similar to that of the United States with respect to services income, the income must be sourced "based on where the services are performed, as determined under reasonable principles (which

[20] *See* Federal Register, Vol. 87, No. 2, January 4, 2022, U.S. Government Printing Office, p. 316: "A principal reason for adding the jurisdictional nexus requirement is to ensure that certain novel extraterritorial foreign taxes, such as digital services taxes, are not creditable."
[21] ACT can submit examples for consideration by the Treasury and the IRS.

do not include determining the place of performance of the services based on the location of the service recipient)."

ACT Recommendation

ACT recommends that withholding taxes with respect to payments for services are deemed to meet the attribution requirement except with respect to payments related to digital services taxes and other novel extraterritorial taxes.

Reasons for ACT Recommendation

Under the Final Regulations unless services income is sourced based on where the services are performed, any withholding taxes associated with the services payment will not be creditable and thus lead to double taxation. Sourcing services income based on where the services are performed is far from the international norm. For example, many South American countries source services income based on criteria other than where the services are performed. Denying foreign tax credits, and thus subjecting taxpayers to double tax on services income from these countries, provides foreign competitors an advantage over U.S. companies and creates an incentive for U.S. companies to move jobs overseas. While tax treaties may be helpful in treating certain withholding taxes on services as creditable, the U.S. does not have a robust tax treaty network.

ACT does not believe that tax withheld on the vast majority of services payments are analogous to the novel extraterritorial taxes that the Final Regulations are meant to address. However, ACT understands that certain services taxes would raise the policy concerns expressed in the preamble to the Final Regulations. Accordingly, ACT accepts that if a withholding tax is in effect a digital services tax or novel extraterritorial tax , such tax would not meet the attribution requirement of the Final Regulations and thus would not be considered creditable for U.S. tax purposes.

To address ACT's recommendation the following marked changes are recommended to the language of Treas. Reg. § 1.901-2(b)(5)(i)(B)(1):

> Services. Under the foreign tax law, gross income from services must be sourced ~~based on where the services are performed, as determined~~ under reasonable principles ~~(which do not include determining the place of performance of the services based on the location of the service recipient)~~. If the recipient of the services is located in the jurisdiction imposing the tax and such recipient is the primary beneficiary of the service (for example, the recipient does not market or sell such services outside of such jurisdiction), the services shall be considered to be sourced to such jurisdiction under reasonable principles. Notwithstanding the preceding sentence, in the case of services provided over the internet or via similar medium, reasonable principles *do not* include sourcing income based on the location of users of a social media platform, viewers of online content (including online advertising), users of online search engines, or purchasers or sellers of goods or services on online intermediation platforms.

ACT's recommendation prevents U.S. multinational corporations from being placed at a competitive disadvantage with respect to the supply of most cross-border services while simultaneously ensuring that foreign tax credits are not granted for novel extraterritorial taxes.

5. Attribution Requirement – Tax on Residents (Treas. Reg. § 1.901-2(b)(5)(ii))

Final Regulations

The Final Regulations introduce a new attribution requirement for certain foreign taxes to qualify as foreign income taxes under section 901. Specifically, Treas. Reg. § 1.901-2(b)(5)(ii) provides that a foreign tax imposed on residents of the foreign country imposing the foreign tax must provide that any allocation to or from the resident of income, gain, deduction, or loss with respect to transactions with commonly controlled parties (that is, any allocation made pursuant to the foreign country's transfer pricing rules) "is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion."

ACT Recommendation

ACT recommends that a country's entire income tax imposed on resident companies not be rendered non-creditable because the country requires transfer pricing that deviates from arm's length principles in certain circumstances, if a company in fact uses arm's length principles for transfer pricing (or has no controlled transactions). Further, if a country allows for certain safe harbors in calculating the arm's length standard, such safe harbors should not deem the country's transfer pricing policies to permit a non-arm's length methodology if economically the arm's length standard is achieved. If a foreign tax does not satisfy these criteria, the foreign tax should be treated as non-creditable to the extent the amount of tax paid exceeds the amount that would have been paid had arm's length principles been applied.

Reasons for ACT Recommendation

Under the Final Regulations, if a country's transfer pricing principles permit non-arm's length methodology, it seems that the country's entire income tax imposed on resident companies is rendered non-creditable. This loss of credits for U.S. tax purposes would result if a company had no related party transactions subject to transfer pricing or in fact uses arm's length principles in its own transfer pricing (and files local returns and pays local taxes on that basis), or if the utilized transfer pricing methodology results in an underpayment of local taxes relative to the tax liability that would have resulted if arm's length principles had been used. This means that U.S. companies with affiliates in affected countries who do not have related party transactions or in fact allocate income and deductions from controlled transactions consistent with arm's length principles will be denied foreign tax credits and subjected to double tax, even though the local tax law that permits a non-arm's length methodology for controlled transactions had zero impact on the resident company's tax liability.

ACT does not believe that result is appropriate if in fact arm's length principles (as determined under U.S. tax law) are being observed. Accordingly, ACT recommends that the attribution requirement for resident companies be revised to allow for the creditability of foreign taxes if arm's length principles are mandated under local law, or are in fact utilized by resident companies in computing their local tax liabilities (or if resident companies have no controlled transactions). In addition, the attribution requirement for resident companies should be revised to provide that foreign taxes are creditable to the extent that such taxes would be due if controlled transactions were conducted on an arm's length basis. These recommendations, if adopted, would prevent double taxation while ensuring that foreign tax credits are only available for foreign income taxes due which are calculated in accordance with U.S. tax principles.

Further, ACT believes that if a foreign jurisdiction provides safe harbors to be used in calculating the arm's length standard, such safe harbors should not deem the foreign jurisdiction to have transfer pricing principles that are non-arm's length if the result is actually consistent with an arm's length standard. For example, in certain fact patterns, the U.S. provides for a safe harbor in determining an arm's length rate of interest on indebtedness (generally providing that the rate of interest will be arm's length if the rate is not less than 100% of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate). ACT believes safe harbors (including the example provided above) should not be determinative as to whether the transfer pricing policies as a whole are deemed to be arm's length and thus should not be determinative as to whether a foreign tax is creditable.

ACT's recommendation could be adopted with the following marked changes to Treas. Reg. § 1.901-2(b)(5)(ii):

> Tax on residents. The base of a foreign tax imposed on residents of the foreign country imposing the foreign tax may include all of the worldwide gross receipts of the resident, but must provide that any allocation to or from the resident of income, gain, deduction, or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (that is, any allocation made pursuant to the foreign country's transfer pricing rules) is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.
>
> If a foreign tax provides otherwise, it does not satisfy the attribution requirement, and thus is not an income tax, to the extent that the amount of foreign tax paid by a taxpayer exceeds the amount of foreign tax that would be imposed if the foreign country's transfer pricing rules were consistent with arm's length principles. Thus, for example, if a foreign tax uses transfer pricing rules that allocate profits to a resident on a formulary basis (rather than on the basis of arm's length prices), such as through the use of fixed margins in a manner that is not consistent with arm's length principles, the foreign tax imposed on residents is not an income tax to the extent that the foreign country's transfer pricing rules require allocations inconsistent with the allocations, if any, that would be determined under arm's length principles, and the foreign country's allocations thereby increase foreign tax.[22]

6. Non-duplication Requirement (Treas. Reg. § 1.903-1(c)(1)(ii))

<u>Final Regulations</u>

The Final Regulations introduce new requirements for certain foreign taxes imposed "in lieu of" an income tax to qualify for creditability under section 903. Specifically, Treas. Reg. § 1.903-1(c)(1)(ii) provides that for a foreign tax to be considered a section 903 tax the non-duplication requirement must be satisfied, which requires that "neither the generally-imposed net income tax nor any other separate levy that is a net income tax is also imposed, in addition to the tested foreign tax, by the same foreign country on any persons with respect to any portion of the

[22] *See* comment submitted June 3, 2022 by Ivins, Phillips & Barker, Re: Supplement to APA Petition for Review of Final Regulations under Sections 901 and 903 – T.D. 9959.

income to which the amounts (such as sales or units of production) that form the base of the tested foreign tax relate (the "excluded income")."

ACT Recommendation

ACT recommends that a taxpayer be allowed a section 903 credit if an "in lieu of" tax is imposed in substitution for (and not in addition to) one of a series of generally imposed net income taxes.

Reasons for ACT Recommendation

Under the Final Regulations, if a country imposes multiple generally imposed net income taxes, and a taxpayer who is subject to one generally imposed net income tax pays, in addition to such net income tax, an "in lieu of" tax in substitution for another generally imposed income tax, the non-duplication provision potentially would not be satisfied and the "in lieu of" tax would not be creditable under section 903. That result is inequitable when you compare the foreign tax credits which would be available to a different taxpayer who is not subject to the "in lieu of" tax and instead pays the multiple generally imposed income taxes, who is not subject to the non-duplication provision and would have foreign tax credits available for all of the income taxes which are paid.

For example, assume Country X imposes two generally imposed net income taxes on corporations, Tax A and Tax B, which each meet the definition of a creditable foreign income tax within the meaning of section 901 and the Final Regulations thereunder. With respect to certain taxpayers in specific industries, Country X imposes a gross basis tax (Tax C) that is in lieu of Tax B. Taxpayers subject to Tax A and Tax B will have a foreign tax credit available for both taxes. However, Tax C appears to fail the non-duplication requirement because it substitutes for only Tax B, so taxpayers subject to Tax A and Tax C will only have a credit available for Tax A.

ACT does not believe there is any policy reason why a taxpayer who pays an "in lieu of" tax in substitution for, and not in addition to, an income tax which would be creditable under section 901 should be disallowed a foreign tax credit as a result of also being subject to a separate generally imposed net income tax. Indeed, the text of section 903 only requires that a tax be imposed "in lieu of a tax on income," not in lieu of all taxes on net income. Accordingly, ACT recommends that the non-duplication requirement be revised to apply only to the presumed target of the provision: to disallow tax credits for an "in lieu of" tax which is imposed in addition to and not in substitution for a generally imposed net income tax.

7. Allocation and Apportionment of Foreign Tax with Respect to Remittances (Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii))

Final Regulations

The Final Regulations assign to foreign tax credit limitation categories foreign gross income arising from a remittance by reference to the statutory and residual groupings to which the assets of the payor taxable unit are assigned for purposes of apportioning interest expense (i.e., the tax book value method). These regulations were finalized to apply retroactively to tax years beginning after December 31, 2019.

ACT Recommendations

1) When determining asset value for purposes of assigning foreign gross income arising from a remittance, a working capital exception should be provided to taxable units that

hold cash for the express purpose of funding operations; and

2) Provide taxpayers with a binding election to assign foreign gross income arising from a remittance by reference to (i) the statutory and residual groupings to which the assets of the payor taxable units are assigned for purposes of apportioning interest expense (i.e., the tax book value method), (ii) the statutory and residual groupings to which the assets of the payor taxable units would have been assigned under the fair market value method of Treas. Reg. § 1.861-9T(h), or (iii) tracing foreign gross income to current and accumulated earnings of the taxable unit. Such election should be made on a taxable unit basis and be binding for a period of no more than five years.

Reasons for ACT Recommendations

In most fact patterns, utilizing the tax book value method in assigning foreign gross income to statutory and residual groupings will produce results that are not consistent with the underlying economics. While ACT understands that the tax book value method is meant to act as a surrogate for the accumulated earnings of a taxable unit distributing a remittance, in many cases the tax book value method assigns value to assets that are not producing the earnings subject to distribution, or assigns no value to assets that give rise to the majority of the taxable units' income.

Working Capital Exception

If a payor taxable unit has a large amount of cash or cash equivalents[23] on its balance sheet, in the absence of an exception, the cash could be viewed as a passive asset (because the cash could be generating interest income through a third party bank) for purposes of assigning foreign gross income upon a remittance, despite the fact that the cash is giving rise to only an incidental amount of the accumulated earnings of the taxable unit. For some taxable units, cash balances can be material as the taxable unit may hold the cash to fund general operations (overhead costs, payroll, etc.).

To address this potential distortion, taxpayers should be provided with a working capital exception for cash and cash equivalents held to fund operations. Assigning a significant portion of a taxable unit's assets to the passive category will result in a mismatch between the assignment of income and the economic activity of the taxable unit. ACT believes if a taxpayer can prove to the satisfaction of the Secretary that its cash and cash equivalents fund general business operations, the cash and cash equivalents should be disregarded in assigning income under Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii). Such a rule may be similar to a rule provided in recently proposed passive foreign investment company ("PFIC") regulations.[24] These regulations provide an exception to the general approach of treating cash as a passive asset, pursuant to which a limited amount of working capital held in a non-interest bearing account may be treated as a non-passive asset.

While the rule in the proposed PFIC regulations limits the exception to working capital held in a non-interest-bearing account, ACT believes that whether or not an account is interest bearing

[23] For example, in many cases because of cash sweeps and other inter-company financing arrangements cash may be converted to short-term receivables for a short duration before being used to fund operations.
[24] See Prop. Reg. § 1.1297-1(d)(2).

should not govern whether such an exception applies.[25] In most cases working capital is held in interest-bearing accounts until the money is needed to either pay overhead costs or payroll and the interest earned on the cash balances is likely immaterial. Further, nearly all multinational companies have a goal of minimizing working capital to reduce foreign currency exposure and provide for repatriation of cash. In addition, the information needed to prove, to the satisfaction of the Secretary, that such cash is held to fund business operations is readily available to both the taxpayer and the IRS.

Assignment of Income

As described below, ACT recommends providing taxpayers with the ability to assign foreign gross income arising from a remittance based on the (i) tax book value of assets, (ii) fair market value of assets, or (iii) a tracing of foreign gross income to current and accumulated earnings of a taxable unit.

Tax Book Value Method

The tax book value of assets method is identical to the current rule in Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(i) and thus is not discussed in detail.

Fair Market Value Method

The fair market value method of valuing assets for purposes of apportioning interest expense was repealed as part of the Tax Cuts and Jobs Act. However, this repeal was mandated solely for the purposes of apportioning interest expense and ACT believes the method has continued relevance in other areas of tax law (i.e., assigning foreign gross income for purposes of Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(i)).

The fair market value method in many cases take into account assets that otherwise would not be contemplated by the tax book value method. This is the case most often when valuing intangible property. Under the tax book value method, in ACT's experience, intangible property has little to no tax basis and thus does not contribute to assigning the foreign gross income to the appropriate statutory and residual groupings. However, intangible property in many fact patterns is the principal contributor to the gross income earned by a taxable unit. Accordingly, intangible property can have fair market value that is in excess of nearly all other assets on a taxable unit's balance sheet. In such cases ACT believes taxpayers should be provided the opportunity to align asset value with the taxable unit's economic reality.

[25] Treas. Reg. § 1.148-6(d)(3)(iii)(B) provides for a working capital reserve that does not take into account whether such funds are invested in an interest bearing account: "…Any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amounts is made…"

Tracing of Accumulated Earnings

While the use of the tax book value method or fair market value method can be acceptable surrogates for the accumulated earnings of a taxable unit in some cases, economic precision can be achieved if taxpayers are able to trace the accumulated earnings of a taxable unit to a specific statutory and residual grouping. While ACT understands Treasury and the IRS have concerns that such a tracing mechanism is complex, we believe such concerns are overstated as compliance and administrative costs for both taxpayers and the IRS would not be materially different than under the tax book value method. More importantly, ACT believes such a mechanism should be provided to taxpayers to address cases where neither the tax book value nor the fair market value method aligns with the economics of the business.

These situations are more pronounced for taxpayers with a high concentration of jobs and capital investment in the United States and a limited footprint outside the U.S. For example, a U.S. manufacturer with limited sales and distribution activities in a foreign branch might have a balance sheet dominated by cash and receivables. Requiring a balance sheet-based methodology for characterizing income will clearly create a distortive result. Preserving this result will also incentivize capital investment in the foreign entity rather than in the United States.

As another example, assume a CFC owns two disregarded entities ("DRE1" and "DRE2", respectively). The CFC is a full inclusion entity as defined under Treas. Reg. § 1.954-1(b)(1)(ii). DRE1 earns solely subpart F income and DRE2 earns solely tested income. DRE2 makes a remittance as defined in Treas. Reg. § 1.861-20(d)(3)(v)(C) and incurs a local country withholding tax. Under either the tax book value method or the fair market value method, a portion of the gross income could be assigned to the tested income category as DRE2 owns assets that produce solely tested income. However, in this fact pattern, because the CFC is a full inclusion entity, if the taxes are assigned to the tested income grouping, CFC has no income within the tested income grouping for which to credit the taxes, thus rendering the foreign taxes non-creditable. Essentially the income and taxes would be separated from one another and the CFC would suffer double taxation.

Instead, if taxpayers are allowed to match the foreign gross income to the accumulated earnings of DRE2 (the taxable unit) no such separation would occur as the income and taxes would be assigned to the same statutory and residual groupings (i.e., the income earned by DRE2 is full inclusion income at the CFC level). While the taxpayer would incur additional complexity and administrative costs, in ACT's experience such costs would be warranted in order to achieve a more precise economic answer.

In conclusion, ACT does not believe it is possible for Treasury to promulgate a single specific rule to economically align the basketing of foreign taxes incurred upon a remittance with the gross income of the payor taxable unit. Rules that do not align tax treatment with economic reality are prone to, and will often guarantee, irrational results. Providing taxpayers with an election to choose a method that works best in their fact patterns, and binding the taxpayer for a period of 5 years after initially selecting the method for each DRE, strikes a balance between complex and evolving fact patterns and the potential for abuse.

8. Separate Levies (Treas. Reg. § 1.901-2(d)(2))

Final Regulations

The Final Regulations provide that if foreign tax law imposing a levy is modified for one or more persons subject to the levy by a contract entered into by such person or persons and the foreign country, then the foreign tax law is considered for purposes of sections 901 and 903 to impose a separate levy for all persons to whom such contractual modification of the levy applies, as contrasted to the levy as applied to all persons to whom such contractual modification does not apply.

<u>ACT Recommendation</u>

ACT recommends clarifying that agreements between taxpayers and a foreign taxing jurisdiction are (i) separate levies as defined under Treas. Reg. § 1.901-2(d)(2), and (ii) merely entering into an agreement with a foreign taxing jurisdiction does not render the corresponding taxes noncompulsory taxes nor soak-up taxes.

<u>Reasons for ACT Recommendation</u>

Since 1983 it has been clear under Treas. Reg. § 1.901-2(a) that whether a foreign levy is creditable as an income tax is determined by considering each separate levy, and that under Treas. Reg. § 1.901-2(d)(2) if a foreign levy is modified for one or more persons by a contract entered into between such person(s) and the foreign country, the foreign tax law is considered to impose a separate levy for all persons to whom the contractual modification applies. These provisions have now become much more relevant as taxpayers must consider "self-help" measures to mitigate potential double taxation in numerous foreign countries whose laws do not comply (or at least do not clearly comply) with certain provisions in the Final Regulations (as discussed in detail above). The Final Regulations, whose general aim is to decrease the administrative burden on taxpayers and the IRS and provide clear standards as to creditable taxes for purposes of section 901 and section 903, may increase such burdens as taxpayers now seek out private agreements with foreign countries.

It is important for the fair and efficient administration of the Final Regulations that taxpayers and the IRS have clarity as to application of Treas. Reg. § 1.901-2(d)(2) and the impact of any private agreements entered into with a foreign country. While this is not the only issue raised in this context, we specifically believe that additional clarity is needed in describing the interaction of Treas. Reg. § 1.901-2(d)(2) and Treas. Reg. § 1.901-2(a)(2)(i), which generally provides that for a foreign levy to be a "tax," the levy must be a compulsory payment that is imposed pursuant to a foreign country's authority to levy taxes.

For example, taxpayers may choose to enter into legal agreements with foreign taxing jurisdictions under terms that align the sourcing of royalty income consistent with U.S. tax principles in order for withholding taxes on royalty payments to be creditable. ACT recommends that Treasury and IRS clarify that such an agreement would be a separate levy under Treas. Reg. § 1.901-2(d)(2), any taxes imposed under the agreement are neither non-compulsory payments as defined in Treas. Reg. § 1.901-2(a)(2)(i) nor soak-up taxes described in Treas. Reg. § 1.901-2(e)(6) merely because they are imposed by reason of the agreement.

III. CONCLUSION

We understand that a number of technical issues would need to be addressed if Treasury and the IRS accept the recommendations set forth above. ACT member companies have identified a number of these detailed drafting issues and have given some thought as to how they might be addressed. ACT representatives would welcome the opportunity to meet with Treasury and the IRS to discuss the above recommendations.