January 23, 2023

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

Re: 2022 Proposed Foreign Tax Credit Regulations

Dear Secretary Yellen:

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.

Attached are ACT's comments on proposed regulations providing guidance related to the foreign tax credit.[1] We appreciate your consideration of these comments. ACT representatives welcome future discussion of these comments with your staff.

Yours sincerely,

Alliance for Competitive Taxation

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

[1] NPRM REG-112096-22.

ALLIANCE FOR COMPETITIVE TAXATION RECOMMENDATIONS REGARDING 2022 PROPOSED FOREIGN TAX CREDIT REGULATIONS

I. INTRODUCTION

The proposed foreign tax credit regulations (the "Proposed Regulations") provide important guidance that will help prevent the foreign income of U.S. companies from being subject to double taxation in certain circumstances. ACT appreciates Treasury's reconsideration of certain aspects of its recent guidance and looks forward to continuing the discussion with Treasury and the Internal Revenue Service ("IRS") to further circumscribe the double taxation of globally engaged U.S. companies so they can compete on a level playing field with their foreign-headquartered competitors.

Notwithstanding the recent changes, income earned abroad by U.S. companies will still be subject to double taxation in many cases unless the Proposed Regulations are further modified. This double taxation inevitably will result in a loss of U.S. jobs, as U.S. companies will be forced to reduce their U.S. footprint or restructure their operations to avoid losing market share. For example, the Proposed Regulations would encourage U.S. companies to move their U.S. operations that provide services to foreign customers from the United States to foreign countries to avoid double taxation.

The Proposed Regulations would also make U.S. companies uncompetitive in large and growing foreign markets. For example, because the Brazilian corporate income tax law does not follow arm's length principles with respect to transfer pricing, the cost of operating in Brazil under the 2021 regulations is now much greater for U.S.-headquartered companies than for their foreign competitors because the 2021 regulations prevent U.S. companies from claiming a foreign tax credit for their Brazilian corporate income taxes.[2]

The original impetus for the 2021 final foreign tax credit regulations[3] ("Final Regulations") was to deny a foreign tax credit for digital services taxes and similar novel extraterritorial taxes that certain foreign jurisdictions have adopted that are fundamentally inconsistent with international norms.

ACT agrees that Treasury, the IRS, and Congress should take action to respond to foreign jurisdictions that adopt unilateral tax measures that discriminate against U.S. companies. However, ACT also believes that the Final Regulations are overly broad and without Congressional authorization overturn tax principles that have been relied upon by taxpayers,

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[2] ACT notes that subsequent to the promulgation of the Proposed Regulations, the outgoing president of Brazil issued a provisional measure that would bring Brazilian transfer pricing guidelines in line with OECD guidelines (thus removing the largest impediment to the Brazilian corporate income tax being a creditable tax for U.S. federal income tax purposes). If passed by the Brazilian Congress, such measure would be optional for 2023 and mandatory beginning in 2024. Taxpayers and the IRS will have to consider whether opting into the regime in 2023 is sufficient to satisfy the attribution requirement in Treas. Reg. § 1.901-2(b)(5)(ii); however, assuming the attribution requirement is met for 2023, taxpayers would still suffer double taxation related to any Brazilian foreign income taxes that accrued in the tax year beginning in 2022.

[3] TD 9959.

the IRS, and courts for many decades.[4] ACT strongly maintains that there is a better way forward.

ACT noted in its previous submissions that the Final Regulations deny credits for many conventional taxes that have been treated as creditable taxes by the U.S. Government for more than a century (e.g., the Brazilian corporate income tax).[5] With respect to some of these taxes, in certain fact patterns, the Proposed Regulations provide welcome changes. However, as detailed below, further modifications to the Proposed Regulations are urgently needed in several key areas.

A jurisdiction's tax policy is one of a number of factors considered by companies when deciding where to locate. While a jurisdiction's infrastructure, natural resources, workforce, customer base, and geopolitical posture are generally viewed as the major determinants of where companies invest, tax considerations also play a role in locational decisions, particularly when taxes result in one company facing significant added costs compared to a similarly situated competitor. Further, tax policy not only can influence the location of an investment, but also the magnitude of that investment. ACT believes that for U.S. businesses to be globally competitive it is vitally important that their foreign earnings not be subject to double taxation.

The Final Regulations, even as modified by the Proposed Regulations, are far more restrictive in allowing foreign tax credits to mitigate double taxation than international norms and, as a result, U.S. companies are at a competitive disadvantage relative to their foreign competitors, particularly with respect to operations in less developed countries with whom the United States (unlike many other countries that are home to large, globally engaged companies) does not have tax treaties to prevent double taxation. These policy decisions adversely affect numerous U.S. headquartered companies that have for many decades developed their business models to remain competitive in the global economy, especially those with centralized service models (discussed in detail below).[6]

While the Proposed Regulations address double taxation in certain circumstances (specifically with respect to withholding taxes on certain royalties and the cost recovery requirement), the guidance continues to create tax incentives for U.S. companies to shift activities and jobs from the United States to foreign locations.

Importantly, as noted above, the inability to claim a credit for withholding taxes on many service payments and royalties under the Proposed Regulations creates an incentive for U.S. companies to provide services and develop and invest in (or acquire) patents, copyrights, and other intellectual property in foreign countries that have more robust tax treaty networks than the United States. Over time, this will result in the loss of U.S. jobs and tax revenues, harming U.S. workers and their communities, because U.S. companies will face the unpalatable choice of

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[4] *See* Letter from Ways and Means Republican Members to Treasury Secretary Janet Yellen, June 16, 2022, https://gop-waysandmeans.house.gov/wp-content/uploads/2022/06/Letter-to-Sec.-Yellen-on-FTC-Regs-2022.06.1635.pdf.

[5] *See* ACT Comment Letter to Secretary Yellen on 2021 Final Foreign Tax Credit Regulations, July 1, 2022, https://actontaxreform.com/media/pwpjbnwx/act-ftc-comment-letter_20220701.pdf. *See also* Comment Letter on 2021 Final Foreign Tax Credit Regulations, February 24, 2022, https://actontaxreform.com/media/gpuh55nj/act-letter-to-treasury-2021-final-ftc-regs_20220224-final.pdf.

[6] These models may include (i) regional entrepreneur structures to help drive sales within a select geographical region, or (ii) regional/global service centers that minimize the duplication of work, maximize benefits of scale, and ensure that all affiliates within a global group of affiliated companies receive the same high-quality services in a cost-effective way.

either restructuring their operations to reduce double taxation or losing market share to foreign-headquartered companies. In either scenario, the result will be fewer U.S. jobs and lower economic growth – harmful results that can be avoided by modifying the Proposed Regulations.

ACT appreciates the Treasury Department's and the IRS's acknowledgement of some of the issues raised in ACT's previous submissions, but believes additional changes are needed to ensure U.S. multinational organizations are not at a competitive disadvantage in global markets by reason of the United States' foreign tax credit policy.

Accordingly, this letter sets forth specific recommendations for modifying the Final and Proposed 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 on both taxpayers and the IRS.

The following section of the letter sets forth ACT's specific recommendations including the rationale for modifying portions of the Final and Proposed Regulations with respect to the following issues:

1. Single-Country Exception (Prop. Reg. § 1.903-1(c)(2)(iii)(B))
2. Services Withholding Taxes (Treas. § 1.901-2(b)(5)(i)(B)(1))
3. Mexican Corporate Income Tax
4. Allocation and Apportionment of Foreign Tax with Respect to Remittances (Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii))
5. Application of Income Tax Treaties (Treas. Reg. § 1.901-2(a)(1)(iii))
6. Attribution Requirement – Tax on Residents (Treas. Reg. § 1.901-2(b)(5)(ii))

II. COMMENTS RELATING TO CERTAIN ASPECTS OF THE PROPOSED REGULATIONS

1. Single-Country Exception (Prop. Reg. § 1.903-1(c)(2)(iii)(B))

<u>Proposed Regulations</u>

The Proposed Regulations provide a limited exception to the source-based attribution requirement of the Final Regulations when qualifying a foreign tax as a covered withholding tax under section 903 if the taxpayer can substantiate that a withholding tax is imposed on royalties received in exchange for the right to use intangible property ("IP") solely within the country imposing the withholding tax. This limited exception applies only if the taxpayer has a written license agreement that provides for the payment of the royalty and that limits the use of the IP giving rise to the royalty payment to the foreign country imposing the tax, or otherwise specifies the portion of the payment attributable to such foreign country ("single-country exception").

If the agreement misstates the country in which the IP is used or overstates the amount of the royalty with respect to the part of the territory of the license that is solely within the foreign country imposing the tax, the single-country exception does not apply.

<u>ACT Recommendations</u>

ACT recommends:

(1) In determining place of use of IP, if the taxpayer can substantiate a significant level of activity by the licensee within the licensee's jurisdiction, such IP should be deemed to "be used" within such jurisdiction and thus qualify for the single-country exception.

(2) Treasury and IRS should modify the validity requirement (defined below) to:
   a. Remove the cliff-effect by allowing taxpayers to retain a portion of the creditable foreign income tax should a misstatement or overstatement exist; and
   b. Allow taxpayers to substantiate the application of the single-country exception through reliable documentation standards other than the relevant license agreement.

<u>Reasons for ACT Recommendations</u>

Presumption of Use in a Single Country

ACT welcomes Treasury's and IRS' promulgation of the single-country exception. In ACT's experience, very few jurisdictions source royalties based on the place of use of, or the right to use, IP.[7] Accordingly, many withholding taxes on royalty payments made to the United States for use of U.S.-owned IP are not creditable under the Final Regulations. ACT notes that the "place of use" determination under the single-country exception is based on the principles of section 861, while the attribution requirement of Treas. Reg. § 1.901-2(b)(5)(i)(B)(1) and (2) (regarding services and royalties) appears to base the place of performance and place of use determination on foreign law concepts.[8] Accordingly, because of the nebulous place of use standard under section 861 (which has mainly been articulated via case law and informal administrative guidance), the single-country exception is likely to prove challenging to satisfy in many common fact patterns.

ACT believes that the single-country exception is a helpful step in ensuring that double taxation does not result with respect to withholding taxes on royalties associated with U.S.-owned IP. However, ACT believes that the single-country exception is not fit for purpose for many U.S.-based multinationals that provide regional headquarters services from a central location. Accordingly, taxpayers should be given additional alternatives to substantiate, solely for purposes of the single-country exception, that IP is "used" in a particular country based on the taxpayer having a significant level of activity in that country. ACT's recommendation is consistent with the policy rationale for introducing both the attribution requirement and the single-country exception.

As described above, the single-country exception does not apply unless the taxpayer can (1) prove (via the license agreement) that the IP is used solely within a single country, and (2) substantiate the amount of royalty that is attributable to single-country use. The substantiation of "use" is based on U.S. transfer pricing rules (with respect to the amount) and U.S. sourcing rules (with respect to location). However, as noted in the preamble to the Proposed Regulations, substantiating "use" can be burdensome on both taxpayers and the IRS and is subject to a variety of authorities, which can be confusing to apply in practice and thus can lead to uncertainty for both taxpayers and the IRS.

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[7] In fact, in many jurisdictions local law and legislative history do not provide the information necessary to determine whether the place of use standard can be satisfied.

[8] ACT would support further clarification that the "place of use" and "place of performance" standards under Treas. Reg. 1.901-2(b)(5)(i)(B)(1) and (2) are based on foreign law concepts. As many jurisdictions do not specifically reference either of these concepts in their legislative text or legislative history, ACT recommends adding examples to the regulations highlighting instances where a jurisdiction's law is sufficiently similar to the U.S. to render a withholding tax on royalties or services creditable. ACT stands ready to provide these examples.

The place of use of IP (*e.g.,* trademarks, know-how) for sourcing purposes has been considered in judicial and administrative guidance, which generally looks to, among other factors, the place where the IP is legally protected and, alternatively, the location where the exploitation of the IP occurs. These factors can also vary significantly based on the type of IP being licensed (i.e., place of use may be determined very differently, respectively, for patents, copyrights, trademarks, and other types of IP such as know-how). The available guidance lacks consistency with respect to sourcing methodology and can create a large substantiation burden for taxpayers and enforcement challenges for the IRS.[9] Because the existing authorities rely on different factors for determining source, the place of use standard invites controversy between taxpayers and the IRS with respect to the appropriate standard to apply to particular facts.

Further, ACT does not believe that the single-country exception, as currently proposed, will be available to many U.S.-based multinationals who operate in a centralized business model. The Proposed Regulations will be meaningful for those taxpayers that operate a decentralized business model in which each foreign subsidiary, individually, has its own senior leadership vested with decision making responsibility for the business within its respective jurisdiction (e.g., the use of IP, distribution of products, and management of the overall brand) . Such a business model gained popularity decades ago as local senior leaders were thought to have the best understanding as to what local stakeholders expected from the company and its products (e.g., the expectations of a customer located in Australia may be different than a customer located in South Korea).

Many companies have now adopted centralized business models in response to the availability of digital technologies that allow real-time access to information on a global basis and the decline in trade barriers. Under this model, regional brand management, manufacturing, and distribution are centralized in a single jurisdiction (i.e., a "hub" structure). Doing so allows the company to gain the needed scale efficiencies to compete in foreign markets, and allows quality assurance on a regional basis. Each hub generally operates with a high degree of autonomy, is responsible for financial performance, quality, and brand management within its region, and pays a royalty back to the U.S. based on a metric of economic performance. As the U.S. is the largest global economy, the U.S. market is generally served through a separate, U.S. hub. While in the past a license of IP from the U.S. to a foreign jurisdiction may have been isolated to a customer base within one country, in the centralized business model the IP rights are licensed to hubs for use on a regional basis (e.g., a single European subsidiary of a U.S. company holding the rights to exploit IP throughout Europe).

As these hubs bear the responsibility of the entire organization within a particular region, such hubs generally have substantial business activity within their jurisdiction of residence (e.g., employee headcount, buildings, manufacturing facilities, etc.). The single-country exception will disfavor this business model if only a portion of the withholding tax imposed on a royalty is creditable (e.g., if only the portion of the royalty that is isolated to the hub jurisdiction's customer base is treated as arising from sources within that jurisdiction). ACT does not believe

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[9] *See, e.g.,* Field Serv. Advisory 200139022 (Sept. 28, 2001); *Sabatini v. Comm'r*, 98 F.2d 753, 755 (2nd Cir. 1938), aff'g in part 32 B.T.A. 705 (1935), Rev. Rul. 68-443, 1968-2 C.B. 304 (1968); Rev. Rul. 72-232, 1972-1 C.B. 276 (1972); Rev. Rul. 84-78, 1984-1 C.B. 173 (1984); Rev. Rul. 80-362, 1980-2 C.B. 208 (1980); Field Serv. Advisory 1994 WL 1866328 (May 9, 1994); *Rohmer v. Comm'r*, 14 T.C. 1467, 1467 (1950); Field Serv. Advisory 200222011 (May 31, 2002); *Estate of Marton v. Comm'r,* 47 B.T.A. 184, 186 (1942); *SDI Netherlands B.V. v. Comm'r*, 107 T.C. 161, 161 (1996); and *Ferenc (Franz) Molnar*; T.C.M. (P-H) P 45317 (T.C. 1945).

that taxpayers should be penalized for employing a centralized model that achieves the operational advantages discussed above which are needed to compete in foreign markets.[10]

Taking the above into account, ACT believes that, solely for purposes of the single-country exception, Treasury and the IRS should include objective standards for determining "use" that better accommodate the modern business reality. Failing to do so will force U.S. companies, unlike their foreign counterparts, to face double tax associated with their foreign operations or revert to less efficient business models solely to mitigate such double tax. It is particularly unfortunate that the impact of this double taxation will be felt most acutely by those U.S. companies that have put modern business models into place while continuing to develop and own much of their highly valuable IP in the U.S.

Under ACT's suggested approach, Treasury and the IRS could provide that the single-country exception allows taxpayers to demonstrate that a license agreement applies with respect to use in a single country if the taxpayer can substantiate that its activities in that country are sufficient to provide such country with taxing nexus with respect to the income generated by the exploitation of the particular IP. Specifically, for manufacturing related IP, this standard would be satisfied if the taxpayer meets the CFC manufacturing exception under Treas. Reg. § 1.954-3(a)(4) (i.e., for taxpayers that satisfy the CFC manufacturing exception, IP licensed with respect to such operations should be deemed to be used within the relevant jurisdiction for purposes of the single-country exception). For fact patterns where IP is licensed on a regional basis and then further sub-licensed, ACT recommends applying a standard similar to the "active royalties" exception in subpart F, as described in Treas. Reg. § 1.954-2(b)(6).

These concepts could readily be applied in many common fact patterns for both centralized and decentralized business models. For example, if a taxpayer licenses the use of IP from the U.S. to Country X and has the necessary business activities in Country X to meet the CFC manufacturing exception under Treas. Reg. § 1.954-3(a)(4), the use of the IP would be deemed to take place solely in Country X for purposes of the single-country exception. As discussed above, in many cases U.S. multinational organizations will have local country entrepreneurs that are the licensees of IP held in the United States. The local country entrepreneur, through its employees and manufacturing processes, develops a product utilizing the licensed IP and distributes the product regionally. This common fact pattern is consistent with the statement in the preamble to the Proposed Regulations that the purpose of the attribution requirement is to allow a credit for foreign tax only if the country imposing the tax has sufficient nexus to the taxpayer's activities or investment of capital that generates the income included in the tax base. Further, in the example above, ACT's recommendation is not dependent on the type of IP being licensed (e.g., know-how vs. trademarks), so long as the taxpayer has sufficient activities in the country to meet the CFC manufacturing exception.

ACT understands that the CFC manufacturing exception of Treas. Reg. § 1.954-3(a)(4) can only be analyzed on a factual analysis. Further, the CFC manufacturing exception may not be the appropriate proxy for companies that are not in the manufacturing business. In other fact patterns, ACT believes that the single-country exception should also be satisfied based on the

[10] ACT acknowledges Treasury's concern with digital services taxes, which we address below. ACT's recommendations to place varying business models (centralized or decentralized) on an equal footing recognize that payments within these disparate business models will have a connection to activities and substance within a particular country. By contrast, a digital services tax may be imposed on payments from a jurisdiction where there are no substantive business activities.

taxpayer having the requisite amount of business activities to accord the licensee country primary taxing rights over the income earned through exploitation of the IP.[11] Accordingly, in the case of IP that is licensed from the U.S. to a foreign affiliate and then sublicensed by that affiliate to related or unrelated persons, ACT recommends requiring the taxpayer to meet a standard similar to the "active royalties" exception to subpart F described in Treas. Reg. § 1.954-2(b)(6),[12] which would provide assurance that the foreign country that is the primary licensee/sublicensor is asserting jurisdiction to tax the income appropriately.[13]

ACT recognizes that neither of these approaches will cover every potential fact pattern where a taxpayer could argue that its activities in a jurisdiction are sufficiently active to satisfy this approach to the single-country exception. However, these proposed additions to the single-country exception would provide meaningful relief in common fact patterns in which a foreign country's assertion of taxing rights over the relevant royalty stream would clearly not run afoul of international norms. Further, because these exceptions would rely on long-standing U.S. law principles that can readily be applied by taxpayers and the IRS and were devised for a similar purpose (i.e., ensuring that a taxpayer's activities in a foreign jurisdiction are substantial enough for the U.S. to relinquish immediate taxing rights over the income), adapting these rules to apply for purposes of the single-country exception would not result in the United States inappropriately ceding taxing jurisdiction to foreign governments.

Validity Requirement

As discussed above, the single-country exception is validated via the language of the license agreement. The single-country exception does not apply if the taxpayer knows, or has reason to know that the terms of the agreement misstate the territory in which the IP is used or overstate the amount of the royalty[14] that is attributable to the jurisdiction imposing the tax (the "validity requirement").[15] Whether a taxpayer knows of a misstatement or overstatement is based on whether "a reasonably prudent person in the position of the taxpayer would question whether the terms of the agreement misstate the territory in which the relevant [IP] is used or overstate the amount of a royalty."

ACT submits that a reasonably prudent person will often *question* whether the agreement misstates the location where the IP is used or overstates the amount of royalty with respect to

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[11] ACT understands that there are mechanisms in the Internal Revenue Code and regulations that could be utilized to substantiate a requisite level of business operations other than those described in ACT's recommendation. ACT representatives would welcome the opportunity to discuss other potential approaches with Treasury and the IRS.
[12] ACT notes that the active royalties exception in Treas. Reg. § 1.954-2(b)(6) is premised on the controlled foreign corporation deriving the income "in the active conduct of a trade or business". Expanding this standard to the single-country exception would not be novel as the active conduct of a trade or business is a key characteristic in determining other U.S. federal income tax consequences (e.g., in qualifying for the Limitation on Benefits article in many tax treaties).
[13] While the active royalty exception of Treas. Reg. § 1.954-2(b)(6) only applies to royalties received from a person that is unrelated, ACT does not believe the distinction between related and unrelated is necessary in this context. This treatment would be consistent with Treas. Reg. § 1.904-4(b)(2)(iii)(A) which provides that passive income does not include royalties derived in the active conduct of a trade or business regardless of whether the royalty was received from a related or unrelated party.
[14] ACT notes that the single-country exception relates to a "payment as a royalty", however in certain cases foreign jurisdictions will define a payment related to the exploitation of IP in a manner other than a "royalty". ACT does not believe that such a difference in nomenclature should prevent a taxpayer from qualifying for the single-country exception.
[15] ACT understands and agrees with the assumed purpose of this rule, which seems to be to ensure that taxpayers appropriately update agreements in order to qualify for the single-country exception.

the jurisdiction imposing the tax. As discussed above, the law regarding "place of use" is imprecise and inconsistent. Accordingly, taxpayers will exercise caution (i.e., prudence) when analyzing the source of use of IP, continually questioning whether its source determination is consistent with the applicable case law and administrative guidance. Further, because section 482 is a fact-intensive, evolving area of law, implicating sometimes hundreds of different datapoints, taxpayers will question whether the datapoints that factor into a transfer price are accurate in all material respects.

Because taxpayers will question whether the agreement misstates the territory in which the IP is used or overstates the amount of the royalty with respect to the jurisdiction imposing the tax, the validity requirement is essentially a *per se* rule. The validity requirement will always apply if there is a misstatement or overstatement, as prudent taxpayers will always question the validity of the source and amount of the royalty. Accordingly, the salient datapoint for purposes of the validity requirement is whether there is or is not a misstatement or overstatement. If such a misstatement or overstatement exists, the taxpayer is left with the cliff effect of losing the creditability of all withholding taxes subject to the agreement.

If the IRS determines that the source of use of IP is incorrect, or the amount of royalty with respect to such jurisdiction is overstated by $1, the taxpayer loses all creditability of the withholding tax subject to the agreement. ACT believes such a result is inconsistent with Treasury's and IRS's intent behind the validity requirement and would lead to harsh results in practice. To prevent these results, a mechanism should be provided that limits the disallowance to a portion of the withholding tax subject to the single-country exception, rather than the entirety of the withholding tax.

Further, ACT believes that requiring the license to have explicit terms related to amount and location of use of IP to qualify for the single-country exception needlessly places an administrative burden on taxpayers as many current license agreements do not contain the needed terms to qualify for the single-country exception. Taxpayers will be forced to update intercompany license agreements and third-party license agreements to qualify for the single-country exception. For some taxpayers amending these agreements may be impractical and sometimes impossible. ACT believes the single-country exception should be substantiated with other forms of reliable documentation (e.g., a separate binding agreement or memorandum of understanding between the licensee and licensor that demonstrates the agreement is limited to the use of IP within the licensee's jurisdiction). Relying on "reliable documentation" to substantiate "in-country" use would align the single-country exception with rules for substantiating sourcing[16] in general and with the FDII documentation rules applicable to "foreign use" of intangible property without requiring taxpayers to renegotiate existing licenses.[17]

ACT believes, without amendment, the validity requirement will lead to increased tax controversy. ACT's recommendations would allow the IRS to police the potential abuse of the single-country exception without placing an undue burden on the taxpayer.

[16] Section 6001 and Treas. Reg. 1.6001-1(a).
[17] Treas. Reg. 1.250(b)-(4)(d)(3)(iv).

2. **Services Withholding Taxes (Treas. Reg. § 1.901-2(b)(5)(i)(B)(1))**

<u>Proposed Regulations</u>

The Proposed Regulations do not modify the standard for determining whether a foreign jurisdiction's sourcing rule is similar to that of the United States with respect to services income, i.e., the income 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)."

<u>ACT Recommendation</u>

ACT recommends modifying the language in the Treas. § 1.901-2(b)(5)(i)(B)(1) related to the attribution requirement with respect to services to disallow a foreign tax credit with respect to digital services taxes and other novel extraterritorial taxes without disallowing a credit for other services withholding taxes that have been creditable for decades.

If ACT's primary recommendation is not adopted, ACT recommends adding an alternative to the source-based attribution requirement for general business strategy, management, and administration services (collectively "general business services"), and, in addition, for certain research and experimentation ("R&E") services.

<u>Reasons for ACT Recommendation</u>

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 some of 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 primary 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.

If ACT's primary recommendation is not adopted, ACT believes that certain services with respect to general business activities and R&E should be provided an alternative to the source based attribution requirement. As described further below, such an approach is conceptually similar to the single-country exception with respect to royalties.

General business services

Similar to the business model discussion above (related to the single-country exception and "hub" model), many U.S. multinational organizations provide global business support (i.e., services) to their organization in a centralized manner. These services functions (and associated jobs) are most often centralized in the United States. Centralizing these services minimizes the duplication of work, maximizes benefits of scale, and ensures that all jurisdictions receive the same high-quality services in a cost-effective manner. In ACT's experience these services primarily relate to business strategy, legal, accounting, and marketing activities (in the majority of cases these services are described in the services cost method of Treas. § 1.482-9(b)).[18] As noted, this cost pool is typically aggregated at the U.S. parent level where the services are performed and charged out to affiliates based on the proportionate value of the benefits received. To the extent that payments for these services are subject to foreign withholding taxes, such taxes are generally not creditable under the Final Regulations.

However, withholding taxes on general business services have been creditable for decades and do not present the same policy concerns as those related to novel extraterritorial taxes. Disallowing a foreign tax credit for these types of services subjects U.S. multinationals to double taxation and places foreign multinationals, who don't face this detriment, at a competitive advantage when compared to their U.S. counterparts. Accordingly, ACT believes these general business services should be provided an alternative to Treas. Reg. § 1.901-2(b)(5)(i)((B)(1) to meet the requirements of a creditable tax, provided the services that are the subject of the withholding tax directly benefit the services recipient in the jurisdiction that is imposing the withholding tax (similar to the "single country" exception for royalties).

Research and Experimentation

ACT believes that withholding taxes on payments that relate to R&E services performed in the United States should also be creditable for U.S. federal income tax purposes in certain circumstances. R&E services provided in the United States generate valuable jobs and have spillover effects that increase U.S. productivity and competitiveness.[19] To the extent such

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[18] ACT believes all services eligible for the services cost method of Treas. Reg. § 1.482-9(b) (without regard to the exclusion for services that contribute significantly to fundament risks of business success or failure under Treas. Reg. § 1.482-9(b)(5)) should be eligible for the alternative to Treas. Reg. § 1.901-2(b)(5)(i)(B)(1). Such a rule is substantially similar to the rule provided in Treas. Reg. § 1.59A-3(b)(3)(i)(B).

[19] *See*, U.S. Department of the Treasury, Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit, March 25, 2011.

withholding taxes are not creditable, an incentive exists to move these valuable jobs offshore to avoid double taxation. ACT does not believe this was the intent of the Final Regulations, nor is it consistent with Congressional intent in enacting the provisions of section 901.

ACT recommends providing that withholding taxes relating to R&E service payments be provided an alternative from the source-based attribution requirement of Treas. Reg. § 1.901-2(b)(5)(i)(B)(1) if a withholding tax on a royalty from such jurisdiction would be creditable under the single-country exception of the Final Regulations, as revised by ACT's recommendations above. Specifically, under this approach, if R&E service payments from a foreign services recipient to a U.S. services provider are subject to a foreign withholding tax, such withholding tax will be creditable if the services recipient owns the IP and: (i) uses it exclusively within that foreign jurisdiction, (ii) satisfies the CFC manufacturing exception of Treas. Reg. § 1.954-3(a)(4) with respect to its activities within that foreign jurisdiction relating to the ownership and use of that IP, or (iii) licenses the IP to others and satisfies the active royalties exception described above.

The single-country exception for royalties (as revised by ACT's recommendations above) provides an exception from the attribution rule in Treas. Reg. § 1.901-2(b)(5)(i)(B)(2) in certain limited fact patterns in which legal title to the IP is held in the United States and the IP is licensed out to a single-country. ACT's recommendation with respect to R&E services payments addresses the mirror image fact pattern in which services related to the development of IP are performed in the United States and charged out to foreign affiliates. ACT believes that in both cases, the withholding tax on either the royalty or services payment should be creditable for U.S. federal income tax purposes.

ACT's recommendations would protect valuable U.S. jobs and prevent U.S. multinational corporations from being placed at a competitive disadvantage with respect to the supply of many cross-border services while simultaneously ensuring that foreign tax credits are not granted for novel extraterritorial taxes.

3. Mexican Corporate Income Tax

<u>Proposed Regulations</u>

The Proposed Regulations retain the general cost recovery requirement[20] of the Final Regulations but provide that foreign tax law need only permit recovery of "substantially all" of each item of significant cost or expense. Whether a cost or expense is significant 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 taxpayer's total costs and expenses.

Costs or expenses 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. The Proposed Regulations provide a safe harbor for certain disallowances. Under the safe harbor, the disallowance of a stated portion of an item of significant cost or expense would not prevent a foreign tax from satisfying the cost recovery requirement if the disallowance or add-back does not exceed 25 percent of such cost or expense. The safe harbor also would

[20] *See* Treas. Reg. § 1.901-2(b)(4). The cost recovery requirement generally provides that the tax base must be computed by reducing gross receipts to permit recovery of the significant costs and expenses (including capital expenditures) under reasonable principles (similar to U.S. tax rules).

permit deduction limitations based on a percentage of revenues or gross income (no more than 15%) or an amount similar to taxable income (no more than 30%).

The Proposed Regulations retain the realization requirement of the Final Regulations.[21]

ACT Recommendation

ACT recommends Treasury issue guidance clarifying that the Mexican corporate income tax ("Mexican CIT") satisfies the cost recovery and realization requirements.

Reasons for ACT Recommendation

ACT does not believe it was Treasury's and the IRS's intent to disallow a credit for the Mexican CIT. However, as currently constructed there is a question whether the Mexican CIT satisfies the cost recovery and realization requirements in the regulations.

Under Mexican CIT law, purchased goodwill (i.e., the excess paid for an asset over its fair market value) is a nondeductible item. Further, upon the disposition of the asset, any amount related to purchased goodwill does not factor into basis recovery (the goodwill is subject to full taxation upon disposition). Accordingly, this amount is never recovered by the taxpayer, thus calling into question whether the Mexican CIT can satisfy the cost recovery requirement.

The Mexican CIT also includes certain anti-abuse rules, that may disallow interest expense for, among other factors, certain debt financing structures that utilize back-to-back loans. For example, interest arising due to back-to-back loans may be recharacterized as dividends rather than interest expense, resulting in a disallowance of the deduction.

Further, the Mexican CIT contains an inflation adjustment which seeks to recognize the effects of inflation for tax purposes in the areas of monetary assets and liabilities and depreciable property. As the United States has no similar concept, Mexico's inflationary adjustment calls into question whether the Mexican CIT can satisfy the realization requirement.

Mexico is the largest trading partner of the United States.[22] The importance of the U.S.-Mexico relationship was formalized in December 1993 with the signing of the North America Free Trade Agreement ("NAFTA") and was reaffirmed in July 2020 with the United States-Mexico-Canada Agreement ("USMCA"). USMCA serves to strengthen the longstanding friendship between the three countries, including the strong economic cooperation that has developed through trade and investment.[23] Should the Mexican CIT not be creditable in the United States, such strong economic cooperation would be placed in jeopardy.

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[21] *See* Treas. Reg. § 1.901-2(b)(2). The realization requirement generally provides that a tax must be imposed on or after either an event that results in the realization of income under the Internal Revenue Code or one of an exclusive list of pre-realization events.

[22] *See* "U.S. Trade with Mexico, 2021," Department of Commerce, https://www.bis.doc.gov/index.php/documents/technology-evaluation/ote-data-portal/country-analysis/3028-2021-statistical-analysis-of-u-s-trade-with-mexico/file.

[23] *See* Agreement Between the United States of America, the United Mexican States, and Canada Preamble, https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Text/00_Preamble.pdf.

Further, the Mexican CIT does not present the concerns Treasury and IRS have stated were the primary reason for promulgating the Final Regulations.[24] The Mexican CIT is neither novel nor does it diverge in significant respects from U.S. tax rules and the traditional norms of international taxation. Accordingly, ACT believes there are no policy considerations that support disallowing a foreign tax credit with respect to the Mexican CIT.

ACT recommends Treasury and the IRS provide a regulatory example that satisfies the cost recovery of a foreign taxing jurisdiction disallowing amortization of goodwill and subjecting the goodwill to tax upon disposition. The example may deem such disallowance to be consistent with the principles underlying the disallowance provisions of the IRC with respect to indefinitely lived nonwasting assets.[25] Alternatively, guidance could provide that an item not treated as a cost or expense under foreign law principles need not be recovered for the cost recovery requirement to be satisfied. ACT also recommends that Treasury address the anti-abuse rules of the Mexican CIT (described above) in the preamble to the final version of the Proposed Regulations, noting that such disallowance is not inconsistent with IRC principles (similar to the equity-based compensation example in Prop. Reg. § 1.901-2(b)(4)(iv)(J)).

Further, ACT recommends, as depicted below in red text, adding inflationary adjustments as an example of a pre-realization timing difference event under Treas. Reg. § 1.901-2(b)(2)(i)(C)(1) (thus inflationary adjustments would not run afoul of the realization requirement):

> "(C) Pre-realization timing difference events. The foreign tax is imposed upon the occurrence of a pre-realization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event, impose tax under the same or a separate levy (a "second tax") on the same taxpayer (for purposes of this paragraph (b)(2)(i)(C), treating a disregarded entity as defined in §301.7701-3(b)(2)(i)(C) of this chapter as a taxpayer separate from its owner), with respect to the income on which tax is imposed by reason of such pre-realization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the pre-realization event) and--
>
> (1) The imposition of the tax upon such pre-realization event is based on the difference in the fair market value of property at the beginning and end of a period (for example, including possible adjustments to take into account the effects of inflation);"

[24] *See* TD 9959, "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."

[25] ACT recognizes that other technical arguments could also be used to support the conclusion that the Mexican CIT treatment of goodwill does not cause the Mexican CIT to be non-creditable.

If adopted, ACT believes its recommendation will lead to certainty for both taxpayers and the Mexican government as to the credibility of the Mexican CIT.

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

Proposed Regulations

The Proposed Regulations modify the application of Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii) dealing with the reattribution of income from one taxable unit to another taxable unit. While ACT welcomes Treasury's and IRS's willingness to reconsider the harsh results of this rule, the relief provided in the Proposed Regulations will be helpful in only very narrow circumstances and will not help the broad set of taxpayers for whom the existing rule produces punitive results. ACT appreciates that Treasury and the IRS specifically requested comments on other issues related to the allocation and apportionment of foreign income taxes to disregarded payments.

ACT Recommendations

1) ACT recommends either:
    a. Assigning foreign gross income arising from a remittance by reference to a 3-year rolling average of the payor taxable unit's earnings (after taking into account reattribution payments); or
    b. Providing 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.
2) If ACT's primary recommendation is not adopted, when determining asset value for purposes of assigning foreign gross income arising from a remittance, provide a working capital exception in the case of taxable units that hold cash for the express purpose of funding operations; any remaining cash that does not meet this exception should be characterized based on the payor taxable unit's current year earnings (after taking into account reattribution payments).

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 unit's income.

Assignment of Income

ACT recommends that for purposes of Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii), foreign gross income from a remittance be assigned to the statutory and residual groupings based on the 3-year rolling average of the payor taxable unit's earnings. ACT understands that the purpose of the tax book value method is to serve as a proxy for the accumulated earnings of the payor taxable unit. However, as discussed above, the tax book value method creates distortive results in many fact patterns. Accordingly, ACT recommends assigning foreign gross income based on a rolling 3-year average of the payor taxable unit's earnings (after taking into account activity of disregarded subsidiaries and any reattribution payments).

Taxpayers, in response to request for comments on Prop. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii), recommended characterizing foreign gross income, included by reason of a remittance, based on the current year earnings of the payor taxable unit.[26] While acknowledging that the tax book value method is not a perfect surrogate for the accumulated earnings of the payor taxable unit, Treasury and IRS declined to adopt this comment on the basis that current year earnings: (i) may have already been accounted for through reattribution payments, (ii) may not reflect all of a taxable unit's assets, and (iii) could be subject to manipulation through the timing of disregarded payments in any particular year.[27]

ACT's recommendation addresses Treasury's concerns. First, the 3-year rolling average would take place *after* any reattribution payment within the 3-year period (thus the average would not include any earnings that were characterized under Treas. Reg. § 1.861-20(d)(3)(v)(B)(1)). Second, because the characterization is made on a rolling 3-year average, taxpayer's ability to manipulate the average will be substantially diminished (as taxpayers would not be able to take advantage of potential volatility in the character of the payor taxable unit's earnings in any particular year). Finally, regarding Treasury's and IRS's concern that a particular method may not reflect all of a taxable unit's assets, ACT submits that using a 3-year average as proxy for total accumulated earnings should significantly reduce any potential distortions compared to either an asset-based tax book value method or a single-year of earnings approach.

ACT believes its recommendation provides for a more accurate matching of foreign gross income to the accumulated earnings of a payor taxable unit for Federal income tax purposes, and does so without adding a material administrative burden to either taxpayers or the IRS or providing taxpayers with the ability to manipulate results.

In lieu of the 3-year rolling average approach, ACT believes that Treasury could consider providing taxpayers with an election to assign foreign gross income arising from a remittance based on: (i) the tax book value of assets, (ii) the 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.

[26] TD 9959, at 281.
[27] *Id.*

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 takes into account assets that otherwise would not be recognized by the tax book value method. This is the case most often when valuing IP. In ACT's experience, IP often has little to no tax basis and thus does not contribute to assigning the foreign gross income to the appropriate statutory and residual groupings under the tax book value method. However, IP in many fact patterns is the principal contributor to the gross income earned by a taxable unit. Accordingly, IP 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 could be provided the opportunity to align asset value with the taxable unit's economic reality.

Tracing of Accumulated Earnings

While the use of the tax book value method or fair market value method in some cases can be acceptable surrogates for the accumulated earnings of a taxable unit, greater 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. ACT understands Treasury and the IRS have concerns that such a tracing mechanism is complex, however, we believe such concerns are overstated in many common fact patterns. More importantly, if Treasury does not adopt the 3-year rolling average approach described above, ACT believes a tracing mechanism should be provided to taxpayers on an elective basis to address cases where neither the tax book value nor the fair market value method aligns with the economics of the business.

For 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, the CFC has no income within the tested income grouping to support creditability. 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 to achieve a more precise economic answer. For administrative ease, because the rule related to the allocation and apportionment of foreign taxes with respect to remittances is effective for tax years beginning after December 31, 2019, ACT recommends limiting the tracing of earnings to the earnings accumulated in such years.

Working Capital Exception – Characterizing Cash

If the tax book value method is retained, and a payor taxable unit has a large amount of cash or cash equivalents[28] 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 a taxable unit, 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, Treasury could provide taxpayers 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.[29] 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 nonpassive 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 an account is interest bearing should not govern whether such an exception applies.[30] 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. 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.

ACT recommends any remaining cash, after taking into account any reattribution payments and the working capital exception, should be characterized based on the current year earnings of the payor taxable unit (alternatively, if no working capital exception is provided, *all* cash of a payor taxable unit could be characterized based on current year earnings). Cash on the balance sheet (that is not being used to fund operations) is largely a byproduct of an entity's operations and ACT believes any such cash should be categorized consistent with the operations of the entity.

In conclusion, ACT believes that the current tax book value method is a poor surrogate for matching the foreign taxes of a payor taxable unit to the earnings to which those taxes economically relate. The alternative approaches described above provide a significant improvement in the matching of foreign taxes with related income without imposing undue administrative burdens on taxpayers or the IRS.

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[28] 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.
[29] *See* Prop. Reg. § 1.1297-1(d)(2).
[30] 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…"

5. Application of Income Tax Treaties - (Treas. Reg. § 1.901-2(a)(1)(iii))

Final Regulations

The Final Regulations, before correction, originally provided 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.[31] 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 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 to qualify as a creditable foreign income tax.

Treasury and the IRS made certain technical corrections (released July 27, 2022) to the Final Regulations.[32] The corrections revise Treas. Reg. § 1.901-2(a)(1)(iii) to clarify that an income tax treaty determines both the payor of a levy and whether the payor is a resident of the United States for purposes of the income tax treaty. The corrections also modify the coordination rule's separate levy provision to make clear that it applies to any foreign tax that is modified by an income tax treaty, not just those taxes paid by CFCs.

ACT Recommendation

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

Reasons for ACT Recommendation

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.[33]

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[31] *See* Federal Register, Vol. 87, No. 2, January 4, 2022, U.S. Government Printing Office, p. 292.
[32] *See* 87 FR 45018.
[33] *See* Ege Berber, Wade Sutton, Aaron Junge, and Kellen Yent, "Tax Treaties and Indirect Foreign Tax Credits," Tax Notes International, Volume 108, October 10, 2022.

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 not 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 with whom the United States has an income tax treaty.[34]

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.[35] ACT does not believe that novel extraterritorial foreign taxes, including digital services taxes, would be covered taxes under any U.S. income tax treaty, thus ACT's recommendation would not render digital services taxes creditable.[36]

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

<u>Proposed Regulations</u>

The Final Regulations introduced an 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."

The Proposed Regulations retain this general rule.

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[34] Article 23 of the 2016 Model Tax Treaty provides that the United States: "shall allow to a resident or citizen of the United States as a credit against the United States tax on income a) the income tax paid or accrued to [the other Contracting State] by or on behalf of such citizen or resident; and b) in the case of a United States company owning at least 10 percent of the voting stock of a company that is a resident of [the other Contracting State] and from which the United States company receives dividends, the income tax paid or accrued to [the other Contracting State] by or on behalf of the payor with respect to the profits out of which the dividends are paid." Thus, the U.S. model treaty, which represents the United States' starting position for negotiating a tax treaty provides a credit for both direct and indirect taxes. *See id.*

[35] *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."

[36] 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.

ACT Recommendations

ACT recommends:

(1) A country's entire income tax imposed on resident companies is not rendered noncreditable because the country requires transfer pricing that deviates from arm's length principles in certain circumstances, provided that the company in fact uses arm's length principles for transfer pricing (or has no controlled transactions); and
(2) An example be added to the regulations clarifying that a country with transfer pricing policies that use a formulaic approach and/or safe harbors (in lieu of an economic analysis) will not automatically be deemed as failing to satisfy the attribution requirement.

Reasons for ACT Recommendations

Use of Arm's Length Principle

The Proposed Regulations provide an exception to the source-based attribution requirement of the Final Regulations where the taxpayer can substantiate that a withholding tax is imposed on royalties received in exchange for the right to use IP solely within the territory of the taxing jurisdiction. Such an exception is an acknowledgement by Treasury and the IRS that the sourced-based attribution requirement in the Final Regulations is imperfect, and there are fact patterns that should be excluded from its rigid application. As noted above, ACT agrees with this acknowledgement and welcomes this limited exception.

ACT further believes that other limited exceptions should be provided when the economic realities of taxpayers' fact patterns cause the regulations to reach inappropriate and illogical results. For example, under the Final Regulations, if a country's transfer pricing principles permit a methodology other than an arm's length methodology, it appears the country's entire income tax imposed on resident companies is rendered noncreditable. This loss of credits for U.S. tax purposes would result even if a company had no controlled 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). 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 has no effect on the resident company's tax liability.

Denying foreign tax credits is an unduly harsh result because the technical deviation in the foreign country's law from the requirements in the Final Regulations does not result in an increase in the amount of foreign tax paid by the taxpayer. ACT's recommendation is similar to the approach taken by the Treasury and the IRS in the Proposed Regulations under the single-country exception for royalties to prevent taxpayers being subjected to double tax because of a technical "foot fault" in the details of a foreign country's law that has no effect on the taxpayer's foreign tax liability.

Accordingly, ACT recommends that the attribution requirement for resident companies under Treas. Reg. § 1.901-2(b)(5)(ii) be revised to allow the attribution requirement to be met if the taxpayer can substantiate that the arm's length principles are in fact utilized in calculating its local tax liabilities (or if the taxpayer has no controlled transactions).

This exception does not add a material administrative burden for either the IRS or the taxpayer. It does not require the IRS separately to determine whether varying foreign jurisdictions follow the arms-length principle, nor does it require the IRS continually to analyze changes made to foreign jurisdiction transfer pricing policies. The taxpayer must substantiate that the arm's length principle is being followed (or that there were no controlled transactions), a documentation exercise that is already within the purview of IRS examination (due to the calculation of tested income at the CFC level).

ACT's recommendation, if adopted, would prevent double taxation while ensuring that foreign tax credits are only available for foreign income taxes due that are calculated in accordance with U.S. tax principles.

Regulatory Example

To satisfy the attribution requirement of Treas. Reg. § 1.901-2(b)(5)(ii), the Final Regulations require a taxing jurisdiction's transfer pricing policies be 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 understands the purpose of this rule is to ensure that jurisdictions are allocating a taxpayer's taxable base under reasonable principles and not inappropriately expanding their taxable base. However, ACT has found that many countries, while not following the economic analysis required under the arm's length principles, have mechanical rules and safe harbors that arrive at similar results (i.e., preventing an overinclusion of a taxpayer's base in a single jurisdiction).

Accordingly, ACT recommends adding a regulatory example that a country can be deemed to follow the arm's length principle if the taxpayer can prove that the country's transfer pricing policies do not create a material distortion to income or expense when compared to the arm's length standard.

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 representatives welcome the opportunity to meet with Treasury and the IRS to discuss our recommendations and the manner in which they could be implemented to address any technical issues or other concerns. We thank you in advance for your consideration of our recommendations and look forward to continuing our discussions on how the foreign tax credit regulations can be further refined to avoid double taxation and, by so doing, advance the economic welfare of the United States.