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Applying the New Foreign Tax Credit Regulations

SIMULIVE UPDATE

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Introduction: Foreign Tax Credit Regulations

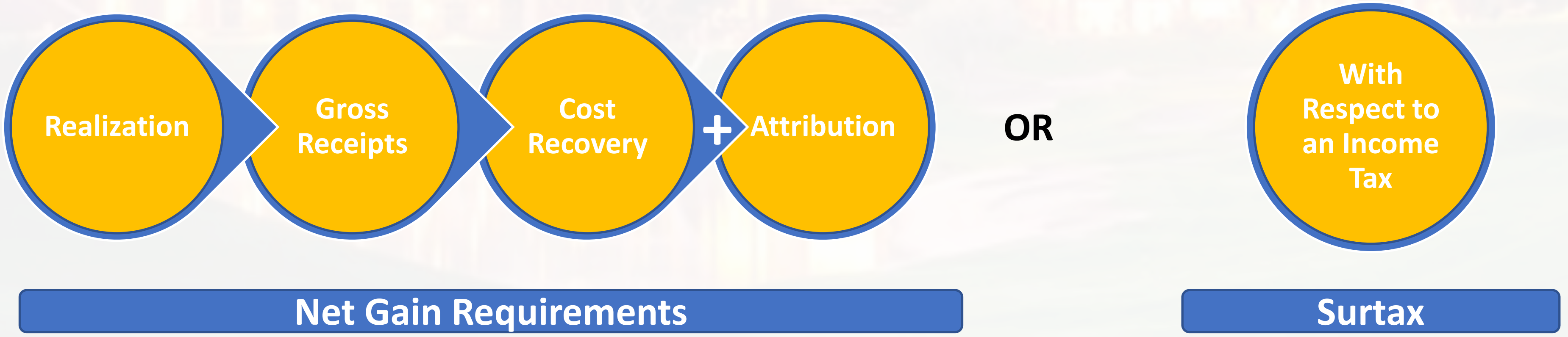
- On Jan. 4, 2022, Treasury published in the Federal Register new final regulations
- Final Regs were released on Dec. 28, 2021, largely adopting the Proposed Regs
  - Imposed new “attribution” requirement and more stringent “cost recovery” requirement
  - Shifts definition of creditable tax from an “income tax” to “tax sufficiently similar to the IRC”
  - Significantly narrowed Sec. 903’s “in lieu of income tax”
  - Generally applicable for TYs beginning after Dec. 28, 2021, though some govern TY 2020
- Treasury released technical corrections to Final Regs on July 27, 2022
  - Softened the “cost recovery” requirement
  - Clarified “eligible current year taxes” for calculation of the GILTI high-tax exclusion
- Treasury released proposed regulations on November 18, 2022
  - The proposed regulations address the reattribution asset rule for purposes of allocating and apportioning foreign taxes, the cost recovery requirement, and the attribution rule for withholding tax on royalty payments
  - See slide at the end of the deck for applicability of the proposed regulations
- Topics for today:
  - Attribution Requirement
  - Cost Recovery Requirement
  - Disregarded Payment Rules

Attribution Requirement

Roads to Creditability

Section 901 Net Income Taxes

- Must analyze with each separate levy
- Income tax must either
  - Satisfy the net gain requirement; or
  - Be a surtax with respect to an amount qualifying as an income tax
- Now a much more objective comparison of US and foreign law



Sections 901 & 903
Attribution Requirement

- Generally retain the approach of the 2020 Proposed Regulations
  - Renamed from the "jurisdictional nexus requirement"
  - No longer a separate requirement – now part of net gain requirement
- Separate rules for taxes imposed on nonresidents vs. residents
- Intended to deny FTCs for digital services taxes and soak-up taxes

Tax on Residents

Arm's Length Principles
(no destination-based criteria)

Tax on Nonresidents

Activities

OR

Source

OR

Situs

Sections 901 & 903
Attribution – Impacted Taxes

- Withholding and other taxes on royalties / services performed outside the country where sourcing rules are not similar to the US
- Digital services taxes and other market-based taxes
  - UK DPT
  - Australian MAAL
- Nonresident capital gains taxes (exception for taxes similar to FIRPTA)
- Taxes that depart from the arm's length standard or use destination-based principles
- Treaty Exception:
  - Tax generally will not need to satisfy the attribution test if the US has a tax treaty with the foreign country and certain facts are present.
  - Treaty may alter the sourcing treatment for third-country taxes paid by CFCs.

Sections 901 & 903
Attribution – Residents

- Foreign resident tax base may include the resident's worldwide gross receipts
- However, foreign tax/transfer pricing allocations must be made using arm's length standard
- Arm's length principles cannot take into account as a significant factor the location of customers, users, or any other similar destination-based criteria

Sections 901 & 903

Attribution – Nonresidents (e.g. US Co doing business directly in Foreign Country)

- Foreign tax base must be limited to gross receipts and costs that are attributable, under reasonable principles, to the nonresident's activities located in the foreign country
  - Nonresident activities include the nonresident's functions, assets, and risks
  - Reasonable principles "include" rules similar to those for determining ECI under section 864(c)
- Without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion, or the mere location of persons from whom the nonresident makes purchases in the foreign country
- Attribution of activities is limited to agents and attribution from the owner of a pass-through entity with respect to that entity's activities

Sections 901 & 903

Attribution – Nonresidents (e.g. US Co generating income without doing business directly in Foreign Country)

- Foreign tax base must be limited to gross income or receipts (other than from sales or dispositions of property) arising from sources within taxing country
- Foreign sourcing rules must be “reasonably similar” to those under the Code but “need not conform in all respects” to the U.S. sourcing rules
- Character is generally determined under foreign tax law (other than sales of copyrighted articles)

Sections 901 & 903
Attribution – Nonresidents: Royalties

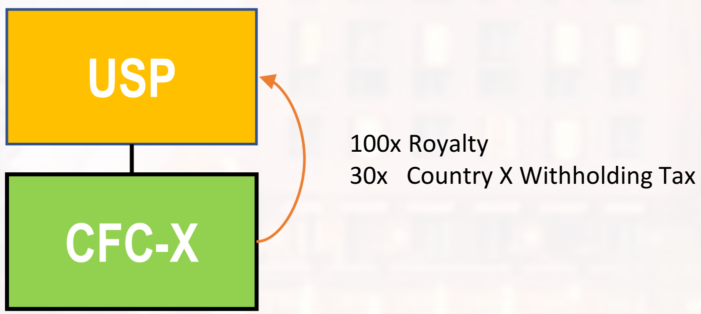
- Royalties must be sourced based on the place of use of, or the right to use, the intangible property
- Proposed Regs – single-country exception where a taxpayer can substantiate that a withholding tax is imposed on royalties received for the right to use IP solely within the territory of the taxing jurisdiction
  - Exception also applies if the agreement separately states a portion of the royalty that is attributable to the part of the said territory, even if the license is used in multiple territories/countries
  - To qualify for this limited exception, a taxpayer must have proper documentation in place in the form of a written license agreement no later than the date on which the royalty is paid
  - There is a special transitory rule in place for royalties paid on or before **May 17, 2023**
  - A payment will not be treated as made pursuant to the single-country license if the taxpayer knows, or has reason to know, that the required agreement misstates the territory in which the IP is used or overstates the amount of the royalty associated with the license that is solely within the said country.
  - Of importance, the single-country exception does not apply to services, sales of copyrighted articles, or instances in which the IP is licensed outside the foreign country imposing tax.

Sections 901 & 903

Attribution – Nonresidents: Services & Other Dispositions

- Services must be sourced based on where the services are performed, "as determined under reasonable principles," which does not include determining place of performance based on location of the service recipient
- Gross income arising from gross receipts from sales or other dispositions must be included in the foreign tax base on the basis of activities or situs of property
  - Special rules apply for a sale of a copyrighted article; specifically, the transaction must be treated as a sale of tangible property

Sections 901 & 903
Withholding Taxes on Royalties



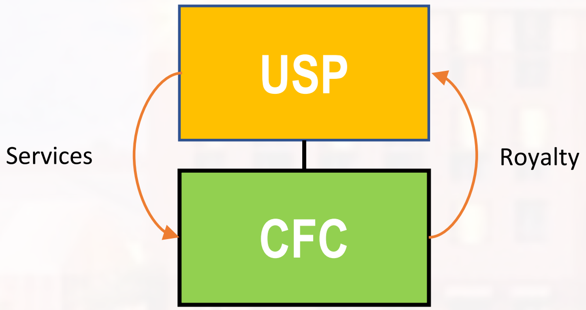
Facts

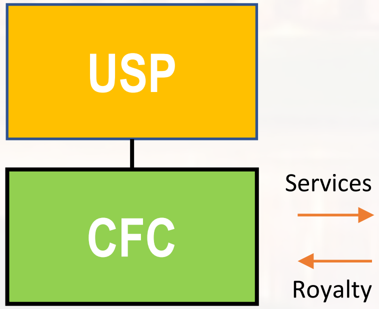
- CFC-X pays a 100x royalty to USP, which is subject to a 30% Country X withholding tax that is payable regardless of USP's presence in Country X
- 50% of the royalty is attributable to use of the IP in Country X and 50% is not
- No US-Country X treaty exists

Analysis

- Country X's withholding is a separate levy with source rules for royalties based on the payor's residence, thus source-based attribution standard is not satisfied
- Under the final regulations:
  - None of the 30x Country X withholding tax is creditable
  - Even if 100x of the royalty was attributable to the use of IP in Country Y, none of the withholding tax would be creditable
- However, if USP qualifies for the "single-country exception":
  - 50x of the royalty is treated as used in Country X
  - 15x of the 30x Country X withholding tax is creditable

Sections 901 & 903
Cross-Border Services





Scenario 1: Withholding imposed on US taxpayer (Non-Resident Tax)

- USP performs services (e.g., SAAS) for CFC (or other foreign corp) in the US in exchange for a payment characterized under foreign law as a “royalty” and subject to local withholding tax (e.g., Brazil or India) that is based on the residence of the payor
- Final regulations would disallow a Section 901 FTC for the withholding taxes because the local source rule for royalties does not apply a “place of use or right to use” standard absent override from an applicable US tax treaty (e.g., the US-India treaty)

Scenario 2: Withholding imposed on a CFC (Resident Tax)

- CFC performs services (e.g., SAAS) for an unrelated party in the CFC’s country of incorporation in exchange for a payment characterized under the payor’s law as a “royalty” and subject to local withholding tax
- Final regulations would disallow a Section 960 deemed paid FTC for the withholding taxes unless the local source rule for royalties applies a “place of use or right to use”
- Consider the application of the relevant underlying treaty, if applicable

Cost Recovery Requirement

Final FTC Regulations

Cost Recovery

- Certain taxes that previously were creditable may not be creditable based on the cost recovery requirement of the final regulations.

- The general rule is that a foreign tax satisfies the cost recovery requirement if the base of the tax is computed by reducing gross receipts to permit recovery of the significant costs and expenses (including capital expenditures) described Reg.1.901-2(b)(4)(i)(C) attributable, under reasonable principles, to such gross receipts.

- 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 Reg. 1.901-2(b)(4)(i)(C)(1).

- Subject to a small business exception in Reg. 1.901-2(b)(4)(i)(B)(2), if foreign tax law does not permit recovery of one or more significant costs and expenses in computing the base of the foreign tax but provides an alternative cost allowance, the foreign tax satisfies the cost recovery requirement only if the alternative allowance permits recovery of an amount that by its terms may be greater, but can never be less, than the actual amounts of such significant costs and expenses

Final FTC Regulations

Cost Recovery

- If foreign tax law provides an optional alternative cost allowance or an election to recover costs and expenses under an alternative method, the foreign tax satisfies the cost recovery requirement if the foreign tax law also expressly provides an option to recover actual costs and expenses.
  - However, if foreign tax law provides an alternative cost allowance that does not by its terms permit recovery of an amount equal to or greater than the actual amounts of significant costs and expenses, the foreign tax does not satisfy the cost recovery requirement, even if, in practice, the amounts recovered under the alternative allowance equal or exceed the amount of actual costs and expenses.
- Certain amounts must be recovered
  - Whether a cost or expense is significant for purposes of Reg. 1.901-2(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.

Final FTC Regulations

Cost Recovery

- Certain amounts must be recovered
  - 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 Reg. 1.901-2(b)(4)(i).
  - Significant costs and expenses (such as interest expense) are not considered to be recovered by reason of the time value of money attributable to the acceleration of a tax benefit or other economic benefit attributable to the timing of the recovery of other costs and expenses (such as the current expensing of debt-financed capital expenditures).

Final FTC Regulations

Cost Recovery

- Certain amounts must be recovered
  - 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 such disallowance is consistent with **any principle** underlying the disallowances required under the Internal Revenue Code**, including the principles of** limiting base erosion or profit shifting **and public policy concerns**. 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** measure of taxable income (determined either before or after depreciation and amortization), disallows deductions in connection with hybrid transactions, disallows deductions attributable to gross receipts that in whole or in part are excluded, exempt or eliminated from taxable income, or disallows certain deductions based on public policy considerations similar to those **underlying** the disallowances contained in section 162.

Cost Recovery

- Certain amounts must be recovered

    - Note-The prior paragraph reflects certain technical corrections to the regulations to make the rules more principle based and removed references to certain code sections in certain places in what appears to be an attempt to make it a more flexible standard.
        - For example, the prior language provided that “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 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.
            - New language has “any principle” underlying the disallowances required under the Internal Revenue Code and adds “public policy”
        - For example, prior to the technical correction, the following language was included in the above paragraph
            - “For example, a foreign tax is considered to permit recovery of significant costs and expenses if the foreign tax law limits interest deductions 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,… “

Cost Recovery

- Timing of Recovery
  - A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered earlier or later than they are recovered under the Internal Revenue Code unless the time of recovery is so much later as effectively to constitute a denial of such recovery.
  - The amount of costs and expenses that is recovered under the foreign tax law is neither discounted nor augmented by taking into account the time value of money attributable to any acceleration or deferral of a tax benefit resulting from the foreign law cost recovery method compared to when tax would be paid under the Internal Revenue Code.
    - Therefore, a foreign tax satisfies the cost recovery requirement if items deductible under the Internal Revenue Code are capitalized under the foreign tax law and recovered either immediately, on a recurring basis over time, or upon the occurrence of some future event (**for example, upon the property becoming worthless or being disposed of**), or if the recovery of items capitalized under the Internal Revenue Code occurs more or less rapidly than under the foreign tax law.
    - Note-The above language reflects certain technical corrections to the regulation.
- For additional rules on cost recovery, see Reg. 1.901-2 (b)(4).

Cost Recovery

- The 2022 Proposed FTC regulations provide the following:
  - The proposed regulations retain the general cost recovery requirement under the 2022 FTC final regulations, but provide that the relevant foreign tax law need only permit recovery of substantially all of each item of significant cost or expense.
  - Consistent with the final FTC regulations, whether a foreign tax permits recovery of substantially all of each item of significant cost or expense is determined based solely on the terms of the foreign tax law.
  - A safe harbor for satisfying the cost recovery requirement

Cost Recovery

- The 2022 Proposed FTC regulations provide the following:
  - Safe Harbor
    - A disallowance of a stated portion of an item (or multiple items) of significant cost or expense does not prevent a foreign tax from satisfying the cost recovery requirement if the portion of the item (or items) that is disallowed does not exceed 25 percent.
    - This safe harbor also permits the foreign tax law to cap deductions of a single item of significant cost or expense or multiple items that relate to a single category of per se significant costs and expenses described in proposed §1.901-2(b)(4)(i)(B)(2) so long as the cap, based solely on the terms of the foreign tax law, is not less than 15 percent of gross receipts, gross income, or a similar measure, or in the case of a cap based on a percentage of taxable income, or a similar measure, the cap is not less than 30 percent.

2022 Proposed FTC Regs

Cost Recovery

- The 2022 Proposed FTC regulations provide the following:
  - Safe Harbor
    - A foreign law limitation that caps deductions of multiple items that relate to different categories of per se significant costs and expenses at a stated percentage (for example, a cap on the deduction of all interest and royalties, combined, at 15 percent of gross receipts), or that caps deductions of multiple items of significant costs or expense that are significant under proposed §1.901-2(b)(4)(i)(B)(1) at a stated percentage, would not meet the safe harbor.
    - Importantly, if the foreign law disallowance does not meet the safe harbor or otherwise permit recovery of substantially all of each item of significant cost or expense, the principles-based exception in the regulations would be relevant for determining whether the foreign tax could satisfy the cost recovery requirement.

2022 Proposed FTC Regs

Cost Recovery

- The 2022 Proposed FTC regulations provide the following:

  - The proposed regulations make additional clarifications to the principle-based exception to provide that the principle must be reflected in a disallowance within the income tax provisions of the Code, and if the disallowance addresses a non-tax public policy concern, then such concern must be similar to the non-tax public policy concerns reflected in the Code.

Cost Recovery

- The 2022 Proposed FTC regulations provide the following:
  - Examples in proposed regulations provide guidance on application of safe harbor and the principle-based exception.
  - Safe harbor satisfied in the following scenarios:
    - E Country X imposes a tax (“Country X tax”) on the income of corporations that are resident in Country X. Under Country X tax law, full deductions are allowed for each item of significant cost or expense attributable under reasonable principles to the gross receipts included in the Country X tax base, ***except that Country X tax law disallows a deduction for 25 percent of a taxpayer’s costs and expenses for royalties related to patents.*** (Ex. 6)
    - Country X imposes a tax (“Country X tax”) on the income of corporations that are resident in Country X. Under Country X tax law, full deductions are allowed for each item of significant cost or expense attributable under reasonable principles to the gross receipts included in the Country X tax base, ***except that Country X tax law disallows a deduction for 15 percent of a taxpayer’s costs and expenses for rents and 25 percent of a taxpayer’s costs and expenses for interest.*** (Ex. 7)
    - Country X imposes a tax (“Country X tax”) on the income of corporations that are resident in Country X. Under Country X tax law, full deductions are allowed for each item of significant cost or expense attributable under reasonable principles to the gross receipts included in the Country X tax base, ***except that Country X tax law caps the recovery of the deduction of interest at 30 percent of the taxpayer’s taxable income determined without regard to interest expense.*** (Ex. 8)

Cost Recovery

- The 2022 Proposed FTC regulations provide the following:
  - Two examples illustrate scenarios where the safe harbor does not apply but the taxpayer is able to satisfy the principle-based exception to cost recovery.
    - Ex. 9 (Country X's disallowance of a deduction for any payment, including interest, royalties, rents, or payments for services, made by a Country X resident to a related entity located outside of Country X if the payment is not included in gross income by the payee or the payee is not subject to tax satisfies principle-based exception; disallowance consistent with section 267A and reflects the principle of limiting base erosion or profit shifting)
    - Ex. 10 (Country X's tax law preventing deduction for any stock-based payments for services satisfies principle-based exception; Country X tax law's disallowance is consistent with a principle underlying the disallowances required under the income tax provisions of the Internal Revenue Code).
  - See Prop. Reg. 1.901-2(b)(4) for further details on cost recovery requirement, along with corresponding examples illustrating the application of the cost recovery requirement.

Disregarded Payment Rules

Disregarded Payment Rules
Overview of § 1.861-20(d)(3)(v)

- § 1.861-20 allocates and apportions foreign income taxes, including to separate categories for purposes of the foreign tax credit
- Framework of § 1.861-20
  - **Assign foreign gross income to groupings**
  - Allocate and apportion deductions under foreign law
  - Allocate and apportion foreign income tax to foreign taxable income
- Disregarded payment rules apply to both:
  - Disregarded payments among a US corporation and its foreign branches to apply sections 901 and 904
  - Disregarded payments among a CFC and its foreign DREs to apply section 960

Disregarded Payment Rules
Overview of § 1.861-20(d)(3)(v)

- Identify Taxable Units / Disregarded Payments
- Characterize Each Disregarded Payment
  - Reattribution Payment
  - Remittance
  - Contribution
  - Disregarded Payment in Exchange for Property
- Apply Operative Rule to Assign Foreign Gross Income / Taxes
- Multiple Payment Rules

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Reattribution Payments

Allocation of Tax on Reattribution Payments

- A “reattribution payment" arises when a disregarded payment is allocable to the U.S. gross income or reattributed income of the payor taxable unit. That income is then reattributed to the payee taxable unit.

- The income tax (and withholding tax, if any) from the reattribution payment is allocated to the same income group as the reattributed income.

- The recent Technical Corrections clarify that a disregarded payment in exchange for property can be a reattribution payment, at least in part.

- Reattribution assets

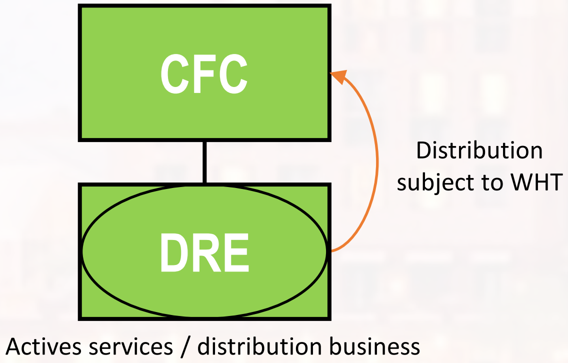
Reattribution Payments
Examples

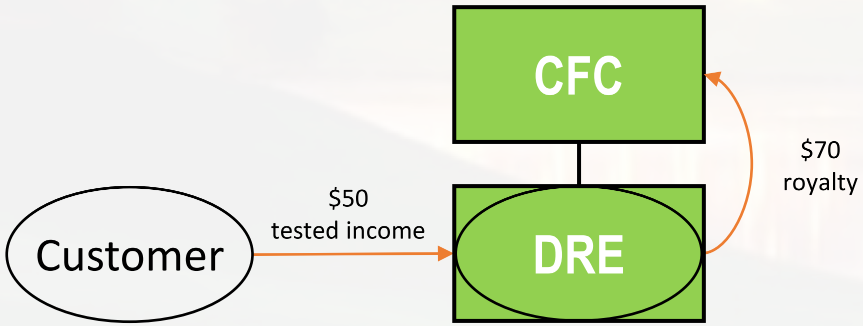
Remittances

Allocation of Tax on Remittances

- A "remittance" is a disregarded payment that is not a reattribution payment, a payment for property, nor a contribution, *e.g.*, a distribution from DRE to CFC.
- Foreign tax on a remittance is allocated to the income out of which the payor makes the remittance, which is deemed to be in proportion to the tax book value of the payor's assets.
  - Assets are determined in accordance with Treas. Reg. § 1.987-6(b), but include stock held by the taxable unit, reattribution assets assigned to the taxable unit, and the taxable unit's pro rata share of the assets of another taxable unit.
- This may result in a material distortive effect, especially for taxpayers that generate cash from the collection of receivables for services or goods in the active conduct of a trade of business.

Remittances
Consequences of Allocation Rule





Scenario 1: Distribution from active business

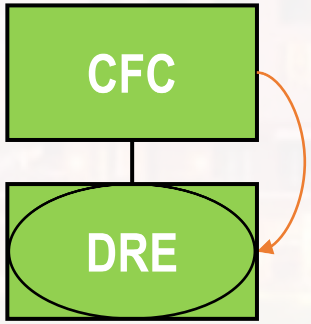
- Potentially causes a significant allocation to the subpart F passive income grouping even though cash arises from active business operations.
- May make it more difficult to credit WHT on disregarded dividends because of § 904 limitation, for lack of income in the passive basket.

Scenario 2: Deductible payment exceeding regarded income

- Causes a portion of a payment to be treated as a remittance

Contributions

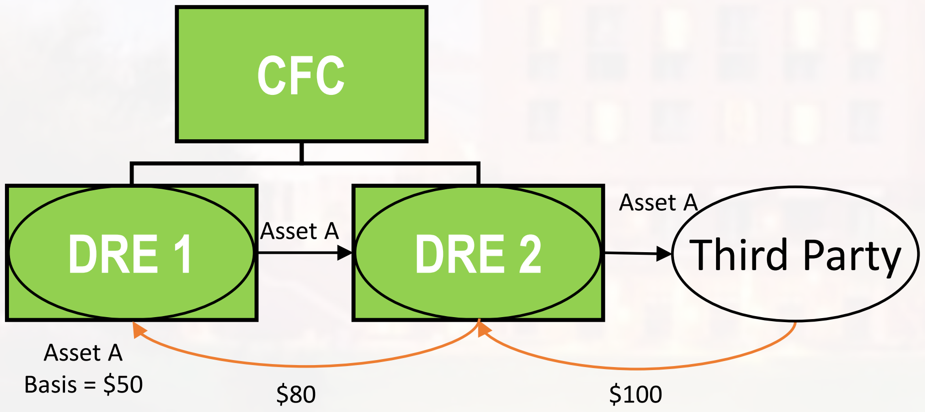
Allocation of Tax on Contributions



- A "contribution" is a disregarded payment from a parent to its subsidiary that is not a reattribution payment or a payment in exchange for property.
- Foreign tax on a contribution is allocated to the "residual grouping."
  - When allocating and apportioning foreign tax to section 960 income groups, the residual grouping is the "residual income group" for which no deemed FTC is permitted.

Payments in Exchange for Property

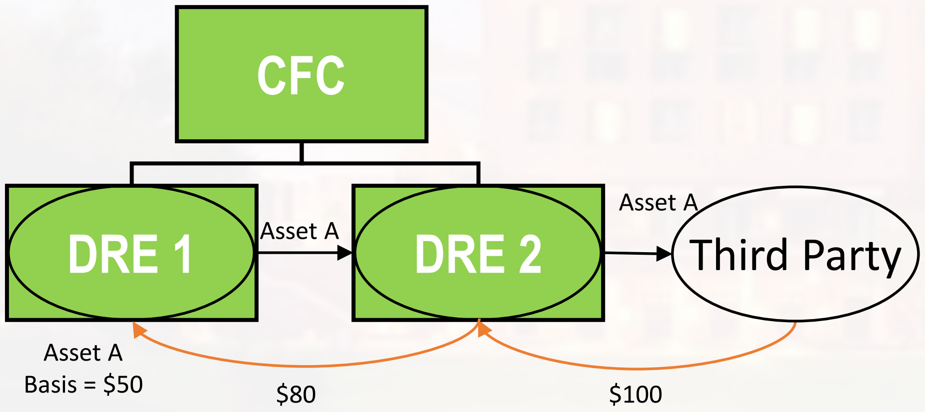
Allocation of Tax on Property Sales



- Applies to all disregarded sales of property (non-inventory and inventory)
- The technical corrections clarified that a portion of the payment can be treated as a "reattribution payment."
    - A disregarded payment in exchange for non-inventory property is allocated to regarded income from the sale of the property to the extent of the "adjusted disregarded gain."
- The remaining portion of the foreign gross income from the payment is assigned to the grouping to which the "corresponding U.S. item" would be assigned if the event giving rise to the foreign gross income resulted in the recognition of gross income or loss under U.S. federal income tax law.

Payments in Exchange for Property

Allocation of Tax on Property Sales – Reattribution Assets



- The Proposed Regulations provide that, although a portion of a disregarded payment in exchange for property can be treated as a reattribution payment, the disregarded payment does <u>not</u> give rise to any reattribution assets.
- Therefore, in this example, no assets would be reattributed from DRE2 to DRE1 for purposes of applying the remittance rule.

Applicability of FTC Proposed Regulations

- In general, except for proposed § 1.861-20(d)(3)(v)(E)(6), the proposed regulations are proposed to apply to taxable years ending on or after November 18, 2022. However, once the proposed regulations are finalized, taxpayers may choose to apply some or all of the final regulations to earlier taxable years, subject to certain conditions.

- Proposed § 1.861-20(d)(3)(v)(E)(6) is proposed to apply to taxable years ending on or after the date final regulations adopting these rules are filed with the Federal Register. Taxpayers may choose to apply the rules of § 1.861-20(d)(3)(v)(E)(6), once finalized, to taxable years that begin after December 31, 2019, and end before the date final regulations adopting these rules are filed with the Federal Register provided they apply § 1.861-20(d)(3)(v)(E)(6) consistently to their first taxable year beginning after December 31, 2019, and any subsequent taxable year ending before the date final regulations adopting these rules are filed with the Federal Register.

- Proposed § 1.901-2(b)(4)(i) and (iv), (b)(5)(i)(B)(2), and (d)(1)(iii) and proposed § 1.903-1(c)(2) and (d)(3), (4), and (8) through (11) are proposed to apply to foreign taxes paid in taxable years ending on or after November 18, 2022. Taxpayers may choose to apply the rules of § 1.901-2(b)(4)(i) and (iv), once finalized, for foreign taxes paid in taxable years beginning on or after December 28, 2021, and ending before November 18, 2022, provided that they consistently apply those rules to such taxable years. Taxpayers may also choose to apply the rules of §§1.901-2(b)(5)(i)(B)(2) and (d)(1)(iii) and 1.903-1(c)(2) and (d)(3), (4), and (8) through (11), once finalized, for foreign taxes paid in taxable years beginning on or after December 28, 2021, and ending before November 18, 2022, provided that they consistently apply those rules for such taxable years.

Applicability of FTC Proposed Regulations

- Finally, until the effective date of final regulations, a taxpayer may rely on all or part of the proposed regulations, subject to certain conditions. Specifically, a taxpayer may choose to rely on the provisions addressing the reattribution asset rule (proposed § 1.861-20(d)(3)(v)(E)(6)) for taxable years that begin after December 31, 2019, and end before the effective date of final regulations adopting these rules. A taxpayer may also choose to rely on the provisions addressing the cost recovery requirement (proposed § 1.901-2(b)(4)(i) and (iv)) for foreign taxes paid in taxable years beginning on or after December 28, 2021, and ending before the effective date of final regulations adopting these rules. Finally, a taxpayer may choose to rely on the provisions addressing the attribution requirement for royalty payments (proposed § 1.901-2(b)(5)(i)(B)(2) and (d)(1)(iii) and proposed § 1.903-1(c)(2) and (d)(3), (4), and (8) through (11)) for foreign taxes paid in taxable years beginning on or after December 28, 2021, and ending before the effective date of final regulations adopting these rules.

- If a taxpayer chooses to rely on any of the three portions of the proposed regulations described in the preceding paragraph, the taxpayer and its related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), must consistently follow all proposed regulations with respect to that portion for all relevant years until the effective date of the final regulations adopting the rules.

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