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Applying the New Foreign Tax Credit Regulations

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5:00 pm

Kenneth Murwanto

RSM US LLP

Joe Calianno

Andersen

Matt Jenner

Baker McKenzie

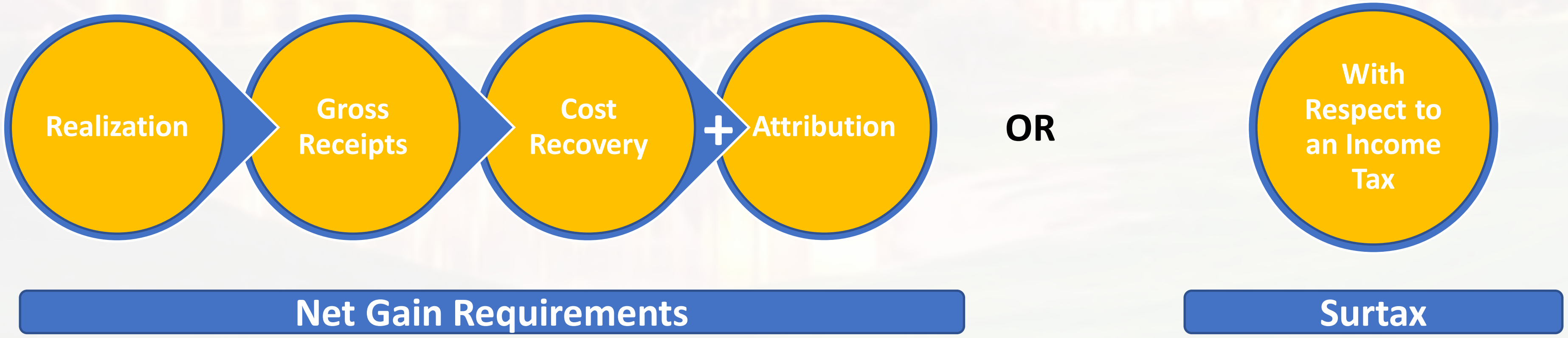
Introduction: Foreign Tax Credit Regulations

- 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
- 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

<u>OR</u>

Source

<u>OR</u>

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

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Sections 901 & 903

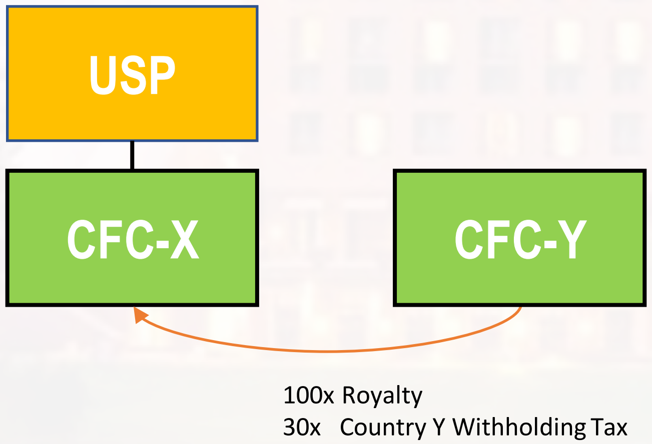
Attribution – Nonresidents (e.g. US Co generating income without doing business directly in Foreign Country)

- 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 must be sourced based on the place of use of, or the right to use, the intangible property
- 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



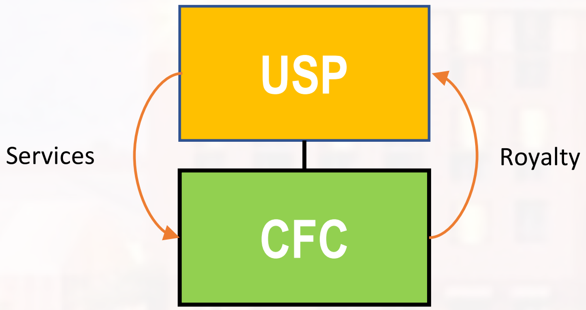
Facts

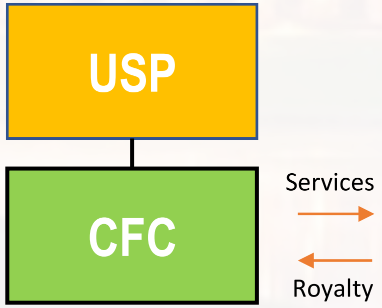
- CFC-Y pays a 100x royalty to CFC-X, which is subject to a 30% Country Y withholding tax that is payable regardless of CFC-X's presence in Country Y
- 50% of the royalty is attributable to use of the IP in Country Y and 50% is not
- Under the US-Country Y treaty, Country Y may only impose withholding tax on royalties paid to a US resident for IP used in Country Y
- No Country X-Country Y treat exists

Analysis

- CFC-X is not a US resident and is thus ineligible for benefits of the US-Country Y treaty
- Country Y's withholding is a separate levy with source rules for royalties based on the payor's residence and not source and thus source-based attribution standard is not satisfied
- As such, none of the 30x Country Y 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

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

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.

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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).

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).
- Future guidance from Treasury???

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

Reattribution Payments

Allocation of Tax on Reattribution Payments

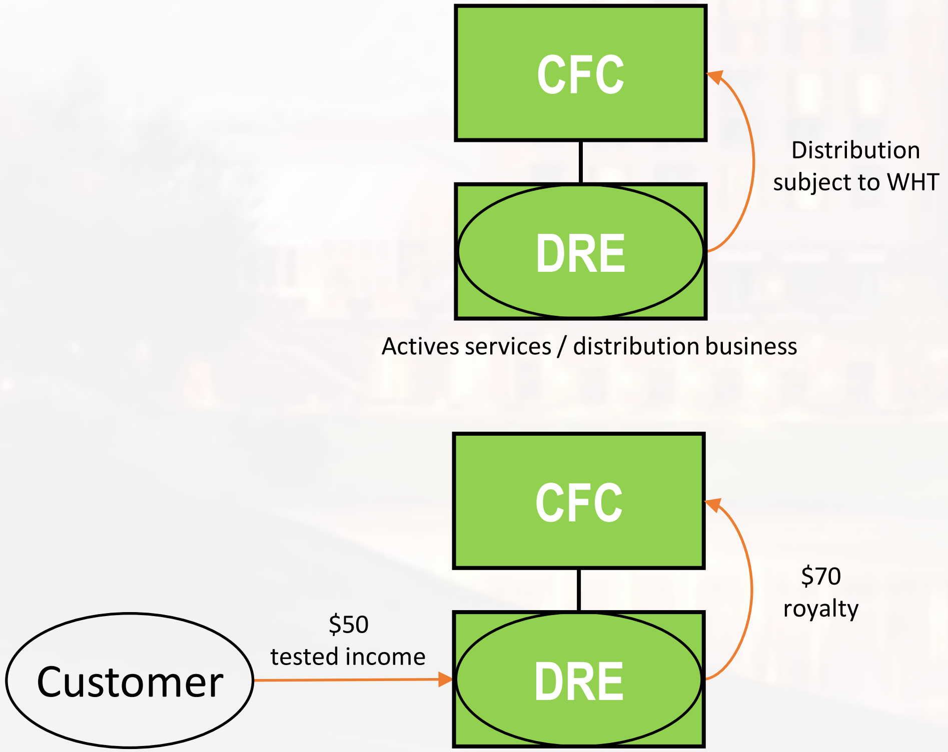
- A “reattribution payment" arises when a disregarded payment is allocable to the U.S. gross income or reattributed income of the payor taxable unit. That income is then reattributed to the payee taxable unit.
- The income tax (and withholding tax, if any) from the reattribution payment is allocated 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 groupings 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.
- 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

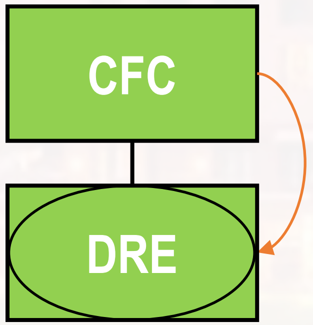
- Potentially causes a significant allocation to the subpart F passive income grouping even though cash arises from active business operations.
- May make it more difficult to credit WHT on disregarded dividends because of § 904 limitation, for lack of income in the passive basket.

Scenario 2: Deductible payment exceeding regarded income

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

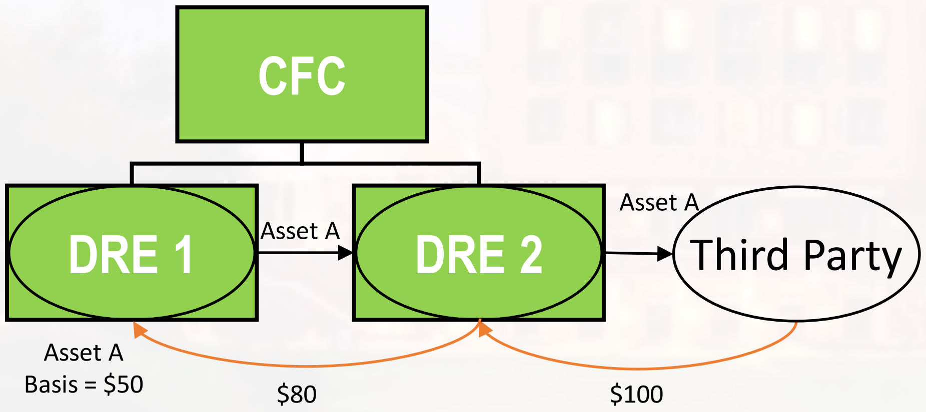
Contributions

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.

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