New Attribution Requirement Denies Foreign Tax Credits for Not-So-Novel Foreign Taxes

By Brian H. Jenn

On January 4, 2022, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued final regulations (Final Regulations) that deny a foreign tax credit (FTC) for certain foreign withholding taxes and other taxes that have been creditable for as long as Code Sec. 901 has been in the Internal Revenue Code (Code). In particular, the Final Regulations adopt a new "attribution requirement" (Attribution Requirement) that restricts the availability of FTCs to foreign taxes that the Treasury and the IRS consider to be similar to U.S. taxes.

Although these rules were previewed in 2020 proposed regulations that were intended to limit the creditability of certain "novel extraterritorial taxes" like gross-basis digital services taxes (DSTs), many observers expected that the Final Regulations would pare back the scope of the proposed regulations so as not to deny FTCs for withholding taxes commonly imposed around the world on royalties and service fees. To the surprise of many, the Treasury and the IRS held to the aggressively broad scope of the proposed regulations in the Final Regulations. As a result, taxpayers are now faced with cataloging the various foreign taxes for which they have claimed an FTC and determining whether an FTC will be available under the Final Regulations.

Beyond the new Attribution Requirement, the Final Regulations include a wide range of other modifications to the rules governing whether a particular foreign tax is eligible for an FTC under Code Sec. 901 or 903. Changes to Reg. §1.901-2 generally limit the extent to which foreign taxes may employ deeming mechanisms and allowances to approximate a net income tax base, abandoning the standard of prior case law and regulations that a foreign tax need merely have the "predominant character" of an income tax in the U.S. sense. In particular, a more stringent "cost recovery" requirement has raised questions about the creditability of foreign corporate income taxes that are imposed on resident corporations but partially deny deductions for outbound royalties or

BRIAN H. JENN is a Partner at McDermott Will & Emery LLP.

other payments. The changes to Reg. §1.903-1 generally limit the circumstances in which a foreign tax that is not an income tax may be eligible for a credit under Code Sec. 903 as a tax imposed "in lieu of" an income tax, demanding taxpayers to establish a "close connection" between the exemption of certain receipts from the income tax base and the imposition of the non-income tax on those receipts. While these are significant changes to longstanding regulations, this article focuses specifically on the Attribution Requirement.

The rules adopting the Final Regulations' Attribution Requirement are generally applicable for taxable years beginning on or after December 28, 2021.

I. The Attribution Requirement for Income Taxes

Under prior Reg. §1.902-2, finalized in 1983 (Prior Regulations), a foreign levy was considered an income tax if "the predominant character of that tax is that of an income tax in the U.S. sense." A foreign tax was considered to have the predominant character of an income tax in the U.S. sense if it was likely "to reach net gain in the ordinary circumstances in which it applies." This meant a tax must satisfy three requirements:

1. It is imposed upon certain realization events or pre-realization events (Realization Requirement).
2. It is imposed on the basis of gross receipts or a measure of deemed gross receipts that is not likely to exceed actual gross receipts (Gross Receipts Requirement).
3. It allows the recovery of significant costs attributable to the gross receipts or a measure of significant costs that is likely to approximate actual costs (Net Income Requirement).

If a tax satisfied these conditions, it was creditable under the Prior Regulations. There was no other requirement that a foreign tax resemble a specific U.S. tax.

The Final Regulations retain the Realization, Gross Receipts, and Net Income Requirements, albeit in a more stringent form, and add the new Attribution Requirement.[1] The Attribution Requirement takes a different form when applied to a tax on residents of the country imposing the tax, as compared to a tax on nonresidents.

For a tax imposed on a *resident* of the country imposing the tax, the Attribution Requirement generally requires that allocations of income among related parties to the taxpayer (*i.e.*, the country's transfer pricing rules) must be determined under arm's length principles. For the avoidance of doubt, the Final Regulations specify that allocations of income under the foreign tax must not "tak[e] into account as a significant factor the location of customers, users, or any other destination-based criteria."[2] It is not clear why the use of destination-basis principles would be an issue for a tax imposed by a jurisdiction on its own *resident* companies, particularly since the regulation explicitly acknowledges a tax on residents may include in its basis the resident's worldwide gross receipts.

For a tax on a *nonresident* of the country imposing the tax, the Attribution Requirement generally provides that attribute gross receipts and costs must be attributed based on one of three principles—activities, source, *or* the situs of property—and must satisfy one of the following conditions:

1. **Attribution based on activities.** A foreign tax imposed on the basis of a nonresident's activities must be limited to the gross receipts and costs that are attributable, "under reasonable principles," to the nonresident's activities within the foreign country imposing the tax.[3] Attribution based on reasonable principles includes attribution based on the nonresident's functions, assets, and risks located in the country, such as provided for under the Code Sec. 864(c) rules (ECI rules) for determining income effectively connected with a U.S. trade or business. The Final Regulations specifically exclude foreign rules that consider the location of customers, users, or similar destination-based criteria or the location of a supplier. They also exclude foreign rules that deem a permanent establishment, or attribute gross receipts or costs, based on the activities of a person other than the nonresident (besides an agent).
2. **Attribution based on source.** A foreign tax imposed on a nonresident based on a source rule must be limited to gross income arising from sources within the foreign country that imposes the tax. The sourcing rules of the foreign tax law must also be "reasonably similar" to the sourcing rules of the Code.[4] When evaluating whether a foreign law source rule is reasonably similar to the rules that apply under the Code, the character of an item of gross income generally is determined under foreign law. For example, if a payment would be characterized as a service under U.S. principles but as a royalty under foreign law, then to satisfy the Attribution Requirement, the foreign law source rule for royalties must be similar to the U.S. source rule for royalties.

   Perhaps in recognition that the sourcing of service fees and royalties is not always perfectly clear under the source rules of Code Secs. 861–865, the Final Regulations provide additional guidance on the

conditions under which a source-based tax on such payments can satisfy the Attribution Requirement.[5] For services, the payment source must be determined based on where the services are performed, as determined under reasonable principles. The Final Regulations expressly state that reasonable principles *do not* include determining the place of performance based on the location of the service recipient. For royalties, the source of the payment must be determined based on the place of use of, or the right to use, the licensed intangible property (IP). The preamble to the Final Regulations allows that foreign countries may employ different concepts of "use" and still be considered reasonably similar to the U.S. rule for royalties.

3. **Attribution based on situs of property.** A foreign tax based on gains of nonresidents from the sale or disposition of property, including stock or partnership interests, generally must only apply in cases where U.S. law would tax a nonresident's capital gains.[6] For a tax imposed on gains from the disposition of real property, the foreign law generally must only apply in circumstances analogous to those in which the Foreign Investment in Real Property Tax Act (FIRPTA) rules of Code Sec. 897 apply. For a tax imposed on gains from the disposition of property other than real property, the base may only include gross receipts that are attributable to property forming part of the business property of a taxable presence in the foreign country under rules reasonably similar to the ECI rules of Code Sec. 864(c).

   The Final Regulations provide that gross receipts from property sales must be included in the foreign tax base on the basis of the situs of the property or based on the nonresident's in-country activities (as described above), rather than under a source rule.[7] Additionally, a transaction that is treated as a sale of copyrighted articles for U.S. purposes can only satisfy the attribution requirement if the transaction is treated for foreign law purposes as a sale of tangible property and not as a license of IP. This rule effectively overrides the general rule above that in the case of a source-based tax, foreign law controls the determination of character of gross income.

II. The Attribution Requirement for Section 903 Taxes—Including Withholding Taxes

Although the new Attribution Requirement is located in the Code Sec. 901 regulations, which apply for determining whether a foreign levy is an income tax, the Final Regulations include important changes to Reg. §1.903-1 that incorporate aspects of the Attribution Requirement into the Code Sec. 903 regulations for determining creditability of certain non-income taxes.

Regarding whether a foreign levy qualifies as a tax imposed "in lieu of" an income tax, the Final Regulations provide that the general income tax which the foreign levy is imposed in substitution for must meet the Attribution Requirement. This rule prevents a jurisdiction from actually, or theoretically, expanding the reach of its general income tax beyond the scope reflected in U.S. rules and then imposing a non-income tax purportedly in lieu of the broadly scoped income tax. It appears to be aimed at an excise tax adopted by Puerto Rico in 2011 that applies in lieu of an expansion of the jurisdictional reach of the income tax that was adopted at the same time.[8]

The Final Regulations contain special rules governing the circumstances under which a "covered withholding tax" is creditable under Code Sec. 903. In addition to being imposed on a nonresident and not overlapping in scope with the general income tax, the withholding tax must satisfy the conditions of the Attribution Requirement for a source-based tax. Meaning, the withholding tax must be imposed on the basis of a source rule rather than solely on the basis that it is an outbound payment (*i.e.*, from resident to nonresident). The source rule must also be "reasonably similar" to the U.S. source rule for a payment of the same character, as such character is determined under foreign law.

III. Relief for Taxes Covered by a U.S. Tax Treaty (but not CFC-Paid Taxes)

Fortunately, the Attribution Requirement does not apply where a tax is directly paid by a U.S. resident and is treated as an income tax under an applicable U.S. income tax treaty.[9] To confirm that a particular foreign tax is creditable under a treaty, it is important to determine whether that tax is a covered tax under the treaty, which may be a question of if the tax is imposed based on a law adopted or modified after the treaty was signed. Generally, a covered tax under a treaty is a tax that was in existence at the time the treaty was signed or a later-adopted tax that is "identical or substantially similar" to such pre-existing taxes.

In the case of a tax paid by a controlled foreign corporation (CFC) and deemed paid by a U.S. shareholder

under Code Sec. 960, no relief from the Attribution Requirement would be available under a treaty. For purposes of determining whether the Attribution Requirement is satisfied with respect to such a tax, however, any modifications to the foreign tax pursuant to a treaty between the country imposing the tax and another foreign country would be considered.

Based on the Treasury's general policy of limiting creditable taxes under a treaty to those that are creditable under the Code, it may be expected that in future treaty negotiations, the Treasury will seek to limit the scope of covered taxes to those that would satisfy the Attribution Requirement.

IV. Foreign Taxes for Which FTCs Could be Denied Under the Final Regulations

As noted above, although the Treasury and the IRS cited "novel extraterritorial taxes," and particularly DSTs, as the motivation for modifying the Prior Regulations, the Final Regulations potentially apply to a significantly broader range of foreign taxes. Many common foreign withholding taxes—the creditability of which had never previously been in doubt—apparently would no longer be the basis for a claim of an FTC. Foreign taxes, both novel and run-of-the-mill, potentially affected by the Final Regulations include the following:

- **Royalty-withholding taxes.** In order for a withholding tax on what foreign law regards as a royalty payment (other than a payment for what U.S. law regards as a sale of a copyrighted article) to satisfy the Attribution Requirement, withholding must be limited to royalties for the use of IP in that foreign country. This requirement seems to exclude the wide variety of royalty-withholding taxes that countries commonly impose, based on a residence principle, on any outbound payment.

  A pair of examples in the regulations reveal the Treasury's intent for the Attribution Requirement to apply broadly in the case of royalty-withholding taxes. The examples conclude that a withholding tax on a royalty paid for the use of IP does not employ a source rule reasonably similar to U.S. source rules, and would not meet the Attribution Requirement, in a case where the country requires withholding on all royalties paid by a resident to a nonresident.[10]

  Because the Final Regulations only require that a foreign source rule be "reasonably similar" to U.S. source rules—and because the location of IP use is not always clear under U.S. law (particularly in the case of patents or manufacturing IP)—there should be some leeway for foreign law to employ different principles to determine the location where IP is used *and* still satisfy the "reasonably similar" requirement. In particular, because the concept of location of use of IP is not well defined in the Code or regulations, royalty-withholding-tax-imposing countries that similarly do not have clearly defined concepts of location of use may be able to satisfy the Attribution Requirement.
- **Service-payment-withholding taxes.** Like royalty-withholding taxes, withholding taxes imposed on service payments—including commonly used withholding taxes on fees for technical services—may not satisfy the Attribution Requirement. If imposed on a source basis, such withholding taxes would need to apply only to payments for services performed in-country and not based on the location of the service recipient. If any outbound service payment (for services of a specific kind, like technical services) would be subject to withholding based on a residence principle, the withholding tax may not satisfy the Attribution Requirement regardless of whether the nonresident performs services in-country. This treatment of service-payment-withholding taxes clearly reverses the result under the Prior Regulations, which included an example (now removed) explicitly concluding that a residence-based withholding tax on payments for technical services was creditable under Code Sec. 903.[11]
- **Capital gains taxes on share disposal.** Taxes imposed by a country on a nonresident's disposal of shares in a company organized in that country, or on the disposal of shares in an upper tier holding company directly or indirectly owning that company, may not satisfy the Attribution Requirement. To do so, any such capital gains tax generally would need to be imposed only in situations FIRPTA would tax a nonresident on disposal of shares of a real estate holding company.
- **Taxes on sales of copyrighted articles.** A tax imposed by a country on the sale of a copyrighted article (*e.g.*, software, whether or not digitally delivered) by a nonresident may not satisfy the Attribution Requirement if—as is the case in certain jurisdictions—the foreign country imposes the tax

without regard to whether the nonresident has activities or a physical presence in the country.

- **Digital services taxes.** Depending on the specifics of foreign law, a DST potentially may be analyzed as an income tax or an "in lieu of" tax. The Treasury considered both possibilities in the Final Regulations and included examples illustrating how various flavors of a DST would fail to satisfy the Attribution Requirement because the hypothetical tax does not satisfy the requirements for attributing gross income based on activities, source, or the situs or property, as applicable.[12]
- **Diverted profits taxes.** "Diverted profits taxes" (DPTs), such as those adopted by the United Kingdom and Australia, were explicit targets of the Final Regulations along with DSTs and unsurprisingly may fail the Attribution Requirement. DPTs generally apply in different ways to residents and nonresidents of the levying country. A DPT imposed on a resident of the country may fail the requirement that transactions with related parties are priced in a manner consistent with the arm's length principle. A DPT imposed on a nonresident may fail the requirement that any activity-based principle for attribution of gross receipts be based on the nonresident's activities within the foreign country.
- **OECD Pillar 1 and 2 taxes.** Measures for taxing "Amount A" under a country's rules implementing Pillar 1 of the Organisation for Economic Co-operation and Development (OECD) BEPS 2.0 project would employ a destination-basis principle to reallocate to a country income that, under the arm's length principle, was properly allocated to another country. Such a tax would be problematic under the Attribution Requirement, which requires taxes on a nonresident to be applied consistent with the arm's length principle.

  Under the Pillar 2 "undertaxed payment rule" (UTPR), a country would deny deductions or impose other adjustments to the income of a taxpayer that is a member of a multinational group with affiliates that have effective tax rates below 15%. Taxes paid under a UTPR also may fail the Attribution Requirement, assuming the UTPR is treated as a separate levy. (If it is not a separate levy, there may be issues as to whether the UTPR causes the corporate income tax to fail the cost recovery requirement.)

Although the preambles to the Prior Regulations and the Final Regulations indicate that the Treasury and the IRS may revisit the application of the Final Regulations in the event a new international consensus is reached through the OECD, whether the United States will adopt Pillar 1 or fully comply with Pillar 2 remains to be seen, leaving open the possibility that the Final Regulations would not be amended to accommodate foreign taxes agreed on as part of BEPS 2.0.

V. Conclusion

The Final Regulations potentially disallow FTCs for foreign withholding taxes that have long been eligible for one, as well as the "novel extraterritorial taxes" explicitly targeted by the Treasury and the IRS. As such, taxpayers may need to survey the foreign taxes they currently incur around the world and consider whether these taxes satisfy the Attribution Requirement. In making this determination, it may be necessary to seek the advice of foreign counsel in order to understand the basis under foreign law for the imposition of the tax. If it is determined that a particular foreign tax is not eligible for an FTC under the Final Regulations, taxpayers may wish to consider alternative structures that could alter the particular mix of foreign taxes that apply with respect to their commercial engagement in a country.

ENDNOTES

1 The Net Income Requirement is redesignated as the "cost recovery requirement."
2 Reg. §1.901-2(b)(5)(ii).
3 Reg. §1.901-2(b)(5)(i)(A).
4 Reg. §1.901-2(b)(5)(i)(B).
5 Reg. §1.901-2(b)(5)(i)(B)(1) and (2).
6 Reg. §1.901-2(b)(5)(i)(C).
7 Reg. §1.901-2(b)(5)(i)(B)(3).
8 The Final Regulations have a delayed applicability date with respect to the Puerto Rico tax, applying only for tax years beginning on or after January 1, 2023.
9 Reg. §1.901-2(a)(1)(iii).
10 Reg. §1.903-1(d), Ex. 3 and 4.
11 Prior Reg. §1.903-1, Ex. 3.
12 Reg. §1.901-2(b)(5)(iii), Ex. 1 and 2; Reg. §1.901-3(d), Ex. 1 and 2.