Deloitte Tax LLP | 21 November 2022

US International Tax Alert

Treasury, IRS release proposed foreign tax credit regulations

Overview

On November 18, 2022, the Treasury Department and Internal Revenue Service released much-anticipated proposed regulations (the "Proposed Regulations") regarding the foreign tax credit. These regulations would revise final regulations published in the Federal Register January 4, 2022 (the "Final Regulations") that are effective for taxable years beginning on or after December 28, 2021 (TD 9959). The Proposed Regulations are scheduled to be published in the Federal Register on November 22, 2022 and are generally proposed to apply to taxable years ending on or after the date the regulations are filed with the Federal Register (November 18, 2022). Taxpayers generally can elect to apply the Proposed Regulations retroactively to taxable years beginning on or after December 28, 2021, and ending before November 18, 2022, provided that they consistently apply all of the Proposed Regulations to such taxable years.

The Proposed Regulations would provide a narrow exception to the "reattribution asset" rule under Treas. Reg. § 1.861-20(d)(3)(v)(B) related to certain disregarded sales or exchanges of property, but primarily address creditability issues under Treas. Reg. §§ 1.901-2 and 1.903-1. Specifically, the Proposed Regulations would revise the "cost recovery requirement" under Treas. Reg. § 1.901-2(b)(4) and the source-based attribution rule for withholding taxes imposed on royalties under Treas. Reg. §§ 1.901-2(b)(5)(i)(B) and 1.903-1(c)(2).

The Proposed Regulations include:

- **Safe Harbors:** preventing a foreign county's denial of tax deductions from making that country's tax non-creditable under the "cost recovery requirement" of Treas. Reg. § 1.901-2(b)(4); and
- **"Single-Country License" Exception:** preventing a disparity between US and foreign source rules for royalties from making a foreign country's withholding taxes on royalty income of nonresidents non-creditable under the "attribution" rules of Treas. Reg. § 1.901-2(b)(5)—but only if the license agreement is executed by the date the royalty is paid (or if the royalty was or is paid before May 17, 2023, if the agreement is executed by May 17, 2023).

The overall impact of these changes is to provide taxpayers additional assurance that certain foreign income and withholding taxes are creditable. This alert provides a summary of the provisions of the Proposed Regulations.

Cost recovery

Under the Final Regulations, a foreign tax must permit the recovery of "significant costs and expenses" attributable, under reasonable principles, to gross receipts included in the foreign tax base. If "significant" expenses are disallowed, including certain expenses deemed always to be significant (interest, rents, royalties, wages, capital expenditures, and research and experimentation), the tax fails the cost recovery requirement unless the disallowance is consistent with a principle of a US disallowance rule.

The Proposed Regulations address cost recovery concerns through modifications to the regulation and the addition of several examples. These changes are summarized below.

1. "Substantially all" standard: Under Prop. Treas. Reg. § 1.901-2(b)(4)(i)(A), a foreign tax satisfies the cost recovery requirement if the base of the tax is computed by reducing gross receipts to permit recovery of substantially all of each item of significant cost or expense attributable, under reasonable principles, to gross receipts included in the tax base. The Proposed Regulations provide safe harbors that would deem the "substantially all" standard to be met.

    a. **25% 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% of the item (or items).
    b. **Qualifying cap safe harbor:** Foreign tax law may 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 so long as the cap, based solely on the terms of the foreign tax law, is not less than 15% of gross receipts, gross income, or a similar measure, or the cap is not less than 30% of taxable income or a similar measure, in the case of a cap based on a percentage of taxable income.

    Any expense disallowance not meeting the "substantially all" standard or deemed to meet it under a safe harbor could still be creditable under the "consistent with US principles" standard.

2. The Proposed Regulations include several examples illustrating the application of the substantially all standard (including the application of the safe harbor rules) to various foreign law disallowances of deductions for interest, rents, royalties, and stock-based compensation. In addition, the Proposed Regulations also include an example illustrating that denial of deductions for *stock-based compensation* is consistent with the cost recovery requirement, because such denial "reflects a principle of influencing the amount or use of a certain type of compensation . . . in the labor market," consistent with a "non-tax public policy consideration" "underlying the disallowances required under the income tax provisions of the Internal Revenue Code."

Royalty withholding taxes

Under the Final Regulations, a foreign tax imposed on a nonresident's income on the basis of source generally must meet the source-based attribution requirement, which requires the foreign tax law's sourcing rules to be reasonably similar to the sourcing rules that apply for Federal income tax purposes. Thus, in the case of gross income arising from royalties, the foreign tax law must source royalties based on the place of use of, or the right to use, the intangible property (IP).

The Proposed Regulations would provide for an exception to the source-based attribution requirement (the "single-country exception") for a foreign tax that is imposed on a royalty payment pursuant to a "single-country license."

To be a "single-country license," the agreement under which the payment is made must characterize it as a royalty and either:

1. Limit the territory of the license to the foreign country imposing the tax, or
2. Specify the portion of the royalty attributable to the part of the territory of the license that is solely within the taxing country.

The Proposed Regulations do not substantively change the general source-based attribution rule in Treas. Reg. § 1.901-2(b)(5)(i)(B), which still would require that the foreign law source royalties in a manner reasonably similar to US sourcing rules. Instead, it would treat a withholding tax imposed on gross royalty income received pursuant to a single country license as a "separate levy" under Prop. Treas. Reg. § 1.901-2(d)(1)(iii)(B)(3) and provide a "single-country exception" in Prop. Treas. Reg. § 1.903-1(c)(2)(iii).

The "single-country exception" provides an alternative way for a royalty withholding tax to satisfy the source-based attribution requirement. To meet the exception, the royalty must be paid pursuant to a single-country license of IP.

Additionally, the Proposed Regulations include a documentation requirement and an anti-abuse rule.

- To be treated as payment pursuant to a "single-country license," the relevant license agreement ("required agreement") must generally have been executed no later than the date of payment. A transition rule covers royalty payments made *before* an agreement is executed if (i) the required agreement is executed no later than May 17, 2023, and (ii) the agreement expressly states that it applies to royalties paid on or before the date of execution.
- If a taxpayer knows or has reason to know that, under the principles of sections 482 and 861, the terms of an agreement misstate the relevant territory in which the IP is used or overstate the amount of the royalty attributable to use of the IP in the taxing jurisdiction, then a royalty payment is *not* considered made pursuant to a single-country license for purposes of the exception.