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KPMG report: Proposed foreign tax credit regulations

Introduction

On November 18, 2022, the U.S. Treasury Department and IRS (collectively, "Treasury") released **proposed regulations** [PDF 371 KB] (REG-112096-22) ("2022 Proposed Regulations") that provide additional guidance relating to the foreign tax credit ("FTC"). The 2022 Proposed Regulations include guidance with respect to the reattribution asset rule for purposes of allocating and apportioning foreign taxes, the cost recovery requirement, and the attribution rule for withholding taxes on royalty payments. These 2022 Proposed Regulations would, if finalized, supplement and revise **final regulations** [PDF 1.2 MB] (T.D. 9959, and the "Final Regulations") as published in the Federal Register on January 4, 2022, and associated **correcting amendments** [PDF 252 KB] and **second set of correcting amendments** [PDF 225 KB] published in the Federal Register on July 27, 2022. Read a **January 2022 report** [PDF 1.5 MB] prepared by KPMG LLP that provides a discussion and initial analysis of the 2021 Final Regulations. The 2022 Proposed Regulations were filed with the Federal Register on November 18, 2022 and are scheduled to be published in the Federal Register on November 22, 2022.

The revisions in the 2022 Proposed Regulations that relate to the reattribution asset rule are proposed to be applicable to tax years that end on or after the date the final rules adopting these provisions of the 2022 Proposed Regulations are filed with the Federal Register. However, taxpayers may choose to apply the modified rules, once finalized, to tax years that begin after December 31, 2019, provided that they apply the rules consistently to their first tax year beginning after December 31, 2019, and any subsequent tax year ending before the date the final regulations adopting the rules are filed with the Federal Register.

The revisions in the 2022 Proposed Regulations that relate to the cost recovery requirement or the attribution rule for withholding taxes on royalty payments are proposed to be applicable to foreign taxes paid in tax years ending on or after November 18, 2022. However, taxpayers have some optionality in applying the attribution requirement for royalty payments or the cost recovery rules, once finalized, to short tax years ending earlier if the rules are applied consistently in each category. Taxpayers may choose to rely on either or both portions of the rules addressing the cost recovery requirement (Reg §1.901-2(b)(4)(i) and (iv), once finalized) and the attribution requirement for royalty payments (Reg §1.901-2(b)(5)(i)(B)(2) and (d)(1)(iii) and Reg §1.903-1(c)(2) and (d)(3), (4), and (8) through (11), once finalized) for foreign taxes paid in short tax years beginning on or after December 28, 2021, and ending before the effective date of final regulations adopting these rules provided that they apply those rules consistently.

The preamble to the 2022 Proposed Regulations also provides an express statement that a taxpayer may rely on all or part of the proposed regulations (rather than the finalized version of those regulations) for periods prior to the effective date of final regulations, subject to certain conditions generally related to consistency for relevant years. In particular, a taxpayer may choose to rely on:

- Proposed Treas. Reg. § 1.861-20(d)(3)(v)(6), relating to the reattribution asset rule, for tax years that begin after December 31, 2019, and end before the effective date of final regulations adopting modified rules,
- Proposed Treas. Reg. § 1.901-2(b)(4)(i) and (iv), relating to cost recovery requirements, for foreign taxes paid in tax years beginning on or after December 28, 2021, and ending before the effective date of final regulations adopting modified rules, and
- Proposed Treas. Reg. § 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), relating to the attribution rule for royalty payments for foreign taxes paid in tax years beginning on or after December 28, 2021, and ending before the effective date of final regulations adopting the modified rules.

If a taxpayer chooses to rely on any of the three portions of the 2022 Proposed Regulations, the taxpayer and its related parties 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 modified rules. For this purpose, a related party is defined to mean a related party within the meaning of section 267(b) (determined without regard to section 267(c)(3)) and section 7701(b)(1).

KPMG observation

Taxpayers with issues relating to the creditability of withholding taxes levied on royalty payments may in some cases need to take action to revise/clarify their written licensing agreements as described below to benefit from the new "single country license" exception. In particular, such taxpayers should be cognizant of the deadline for transitional relief for prior payments; such relief is available as long as the required agreement is executed no later than May 17, 2023.

Allocation and apportionment of foreign income taxes

Treas. Reg. § 1.861-20 provides rules for the allocation and apportionment of foreign income taxes to the relevant statutory and residual groupings (e.g., the foreign tax credit separate limitations). Generally, those rules allocate and apportion foreign income taxes between the groupings based upon the relative amount of foreign taxable income assigned to the groupings. Income items that are recognized for U.S. federal income tax purposes that correspond to the foreign income (defined by the Proposed Regulations "as a corresponding U.S. item") are used to assign foreign income to such groupings.

A taxpayer will not recognize a corresponding U.S. item related to a "disregarded payment." When the disregarded payment is a reattribution payment (i.e., a disregarded payment that results in the reattribution of income under the foreign branch rules of Treas. Reg. § 1.904-4(f) or the tested unit rules of 1.951A-2(c)(7)), Treas. Reg. § 1.861-20 provides that income recognized for U.S. federal income tax purposes is allocated from the payor to the payee. Such reattributed income is then used as the corresponding U.S. item to assign the foreign income (and therefore, any foreign income taxes attributable to such foreign income) to the relevant groupings.

Treas. Reg. § 1.861-20 also requires that assets of the payor be reattributed to the payee when the disregarded payment is a reattribution payment. As a result of a reattribution payment, assets are reattributed from the payor to the payee for purposes of assigning any foreign income taxes assessed on a "remittance" from the payee to the relevant groupings. Under the existing final regulations, asset reattribution occurs for any transaction giving rise to a reattribution of income, including disregarded payments for property (including inventory). Reattribution of U.S. income and assets of the payor in the disregarded purchase is made at the time the inventory is sold by the payor in a transaction that is recognized for U.S. federal income tax purposes.

The 2022 Proposed Regulations would retain the rule requiring that assets be reattributed from the payor to the payee when the disregarded payment is a reattribution payment. However, the 2022 Proposed Regulations would revise that rule such that reattribution of assets would not be made when the reattribution payment is a payment for property (including inventory).

KPMG observation

Taxpayers frequently operate limited risk distributors ("LRDs") as disregarded entities of controlled foreign corporations. Such LRDs often purchase inventory from suppliers that are also disregarded entities via disregarded payments that are reattribution payments. Under current Treas. Reg. § 1.861-20, such disregarded inventory purchases result in the reattribution of assets from the LRD to the disregarded supplier. That reattribution results in a reduction (on a relative basis) of the assets of the LRD that produce tested or subpart F income and increases (on a relative basis) the cash assets of the LRD. Because the cash assets of the LRD are often characterized as passive foreign personal holding company income ("FPHCI") assets, a significant portion of any taxes imposed on remittances from the LRD are characterized as passive FPHCI. The result of that characterization is often a loss within the FPHCI category of the controlled foreign corporation that owns the LRD, which prevents such foreign income taxes from being deemed paid and claimed as a foreign tax credit. Treas. Reg. § 1.861-20 as revised by the 2022 Proposed Regulations would provide some relief as its application will result in LRDs retaining a higher proportion of assets that are not passive FPHCI assets. The 2022 Proposed Regulation also reduces some of the complexity of the reattribution rules of Treas. Reg. § 1.861-20.

However, many LRDs do not own material assets other than cash and accounts receivable. Taxpayers had been hopeful that Treasury would revise the remittance rules of Treas. Reg. § 1.861-20 to provide for a method of allocating and apportioning foreign income taxes other than the current asset method. The 2022 Proposed Regulation retained the use of the asset method for purposes of assigning foreign income taxes with respect to remittances and did not provide any other relief for remittances from disregarded LRDs.

Creditability of foreign taxes—cost recovery requirement

The Final Regulations provided revised rules for determining whether a foreign levy is a creditable foreign income tax. Under those rules, a foreign tax is only a creditable net income tax if it satisfies the net gain requirement, which comprises the realization, gross receipts, cost recovery, and attribution requirements.

Under the Final Regulations, the cost recovery requirement is satisfied if the foreign tax base allows the recovery of "significant costs and expenses" attributable to the gross receipts included in the foreign tax base. Costs and expenses related to capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation are always treated as significant (collectively, "*per se* significant costs"). Other costs or expenses may be significant if, 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. A disallowance of a deduction for all or a portion of one or more of significant costs would result in a failure to meet the cost recovery requirement unless the foreign law disallowance is consistent with the principles underlying the disallowances required under the Internal Revenue Code (the "Code") (the "disallowance rule") such as those underlying section 163(j) or section 267A, including disallowances intended to limit base erosion or profit shifting ("BEPS") similar to those disallowances contained in section 162.

Treasury on July 26, 2022, released corrections to the Final Regulations ("Technical Corrections") that clarified that the cost recovery requirement is satisfied if a disallowance of a deduction for a significant cost or expense is consistent with *any* principle underlying the disallowances required under the Code, including the principles of limiting BEPS and public policy concerns. The corrections also modified an example demonstrating a permissible disallowance by removing certain details of a hypothetical foreign tax law relating to a permissible interest disallowance (i.e., by striking a reference to a 10 percent cap on interest deductions) and removed language providing that the permissible disallowance under the hypothetical foreign tax law is "based on principles similar to those underlying" section 163(j).

"Substantially all" relaxation and safe harbor rules

The 2022 Proposed Regulations retain the general cost recovery requirement but relax the standard in several ways. First, they provide that the relevant foreign tax law need only permit recovery of "substantially all" of each item of significant costs and expenses including the *per se* significant costs. The inquiry as to whether a foreign tax permits the recovery of "substantially all" of each item of significant cost or expense is based solely on the terms of the foreign tax law.

The 2022 Proposed Regulations also introduce several safe harbor rules. Where the foreign tax law imposes certain limitations on the deductibility of one or more items of significant costs and expenses, the foreign tax may still be considered to permit the recovery of "substantially all" of each such item of significant cost or expense if the limitations imposed meet the requirements of any of the following safe harbors:

- The stated portion of the item (or items) of significant costs that are disallowed does not exceed 25% of such costs.
- The deductibility of an item of significant costs or multiple items of costs relating to a single category of significant costs is capped at a stated amount not less than 15% of gross receipts, gross income, or a similar measure.
- The deductibility of an item of significant costs or multiple items of costs relating to a single category of significant costs is capped at a stated amount not less than 30% of the taxable income or similar measure, determined without regard to the item at issue (a provision similar to section 163(j)).

KPMG observation

It seems reasonable to interpret the proposed change to only require "substantially all" of each significant cost or expense to be recovered as intended to provide relief where recovery of a relatively insignificant portion of a significant cost is disallowed even if no safe harbor applies because the disallowance is not based on a "stated portion" of an item of significant costs or a receipts-based or income-based measure. However, this reading is arguably inconsistent with the caveat that the determination of whether a foreign tax permits recovery of substantially all of each significant cost or expense is "determined based solely on the terms of the foreign law," which indicates that taxpayers may not be permitted to rely on empirical evidence in any way in establishing that the cost recovery requirement is satisfied as to *per se* significant costs. In particular, it is unclear how a taxpayer could demonstrate the insubstantiality of any disallowance that is not based on a "stated portion" of a measure without resorting to empirical evidence.

Permissible disallowances consistent with U.S. principles

As was the case in the Final Regulations, the 2022 Proposed Regulations provide that where a foreign tax does not appear to allow the recovery of "substantially all" of each item of significant cost or expense because of a disallowance of all or a portion of a significant cost, it may nonetheless meet the cost recovery requirement if the disallowance is based on principles which are consistent with U.S. principles. The 2022 Proposed Regulations further revise the clarifications made in the Technical Corrections regarding permissible disallowances of significant costs and expenses. Whereas the cost recovery requirement, as modified by the Technical Corrections, permits disallowances required under the Code including the principles of limiting BEPS and public policy concerns, the 2022 Proposed Regulations modify this language to refer to limiting BEPS and "non-tax public policy concerns" that are similar to those reflected in the Code. The preamble to the 2022 Proposed Regulations states that this change is intended to clarify that if the disallowance is based on non-tax public policy, it must be a non-tax public policy concern that is similar to the non-tax public policy concerns reflected in the Code. The 2022 Proposed Regulations also clarify that disallowances must be similar to principles in the *income tax provisions* of the Code rather than the Code more generally.

KPMG observation

While most of the changes in the 2022 Proposed Regulations related to the creditability of foreign taxes reflect a relaxation of the rules, the revisions to the permissible disallowance rules include one apparent tightening of the rules. Arguably, the Final Regulations could be read to permit a disallowance if it relates to

public policy concerns, including tax-motivated policy concerns, even in the case of concerns that are not similar to concerns reflected in the income tax provisions of the Code. The change in the 2022 Proposed Regulations seems to clarify that the rules related to permissible disallowances are not intended to be interpreted so broadly.

Per an example included in the 2022 Proposed Regulations, a foreign income tax that allows deductions for each item of significant cost or expense, but fully disallows all expenses relating to stock based compensation, apparently continues to satisfy the cost recovery requirement because the underlying policy rationale —influencing the type of compensation in the labor market—is similar to the principles underlying disallowance provisions under the Code, including section 162(m) and section 280G. Similarly, disallowances pursuant to anti-hybrid rules are considered permissible disallowances under the 2022 Proposed Regulations notwithstanding that the portions of significant costs that they disallow may exceed the safe harbors included in the 2022 Proposed Regulations and the mechanism for limiting hybrid mismatches may differ from those found in the Code.

Creditability of foreign taxes—attribution rule for withholding taxes on royalty payments

In response to questions and criticism surrounding the application of the source-based attribution requirement of the Final Regulations to withholding taxes on royalties, the 2022 Proposed Regulations include a limited "single country license" exception. Under this exception, a withholding tax on royalties will be considered a potentially creditable foreign income tax if a taxpayer provides documentation establishing that the withholding tax is imposed on royalties received in exchange for the right to use intangible property solely within the taxing jurisdiction.

The Final Regulations added a test based on jurisdictional nexus (referred in the regulation as an "attribution requirement") as a component of the general net gain requirement for foreign taxes, and extended this attribution requirement to taxes that are creditable under section 903. Section 903 allows a taxpayer to claim a foreign tax credit in respect of certain foreign taxes paid "in lieu of a tax on income, war profits, or excess profits" imposed by a foreign country or U.S. possession (an "in lieu of tax"). An in lieu of tax is not subject to the net gain requirement, and therefore its base may be gross income or receipts, as is the case with many foreign withholding taxes. To qualify as an in lieu of tax under section 903 a foreign levy must: (1) be a tax and (2) satisfy a substitution requirement. However, the Final Regulations provide an alternative to the substitution requirement for "covered withholding taxes." A critical component of a covered withholding tax under the Final Regulations is the source-based nexus requirement.

Under this source-based nexus requirement, the foreign tax law sourcing rules must be reasonably similar to the corresponding sourcing rules that apply under the Code. The Final Regulations specifically provide that a foreign tax on gross income from royalties must be sourced—as is the case in the Code—based on the place of use of, or the right to use, intangible property. According to the preamble of the 2022 Proposed Regulations, taxpayers had raised questions about the sourcing requirement and requested that a different standard apply for determining whether a foreign levy should be a creditable tax, particularly in situations in which the foreign law sources royalties (as many countries do) based on the residence of the payor. The preamble acknowledges that in cases in which the foreign law sources royalties based on the residence of the payor, but a taxpayer licenses intangible property solely for use in the country in which the licensee is resident, the foreign jurisdiction imposing tax on the income should, from a U.S. tax perspective, have the primary taxing right over the royalty income. In such case, the intangible property giving rise to the payment is, in fact, being used solely in that foreign country.

The new "single country license" exception provides potential relief in such situations by allowing taxpayers to substantiate that an intangible property license is used solely in the taxing jurisdiction. If the exception applies, a foreign levy on payments pursuant to the license will be treated as a separate levy from a withholding tax that is imposed on other gross royalty income or any withholding tax imposed on other nonresidents and will qualify as a covered withholding tax. In order to qualify for this exception, a taxpayer must have a written license agreement in place prior to the payment (subject to certain transition rules) that both characterizes the payment as a royalty and specifies the portion of the payment that is for the use of the intangible property in the foreign country imposing the tax.

KPMG observation

The single country license exception is a departure from the general rule in the Final Regulations that a foreign tax either satisfies or does not satisfy the definition of a foreign income tax in its entirety, for all persons subject to the foreign tax. Similar to the special rules for foreign levies that are modified by an applicable income tax treaty or an agreement entered into with a foreign country, the withholding taxes that are covered withholding taxes under the single country license exception are treated as a separate levy. This approach seems to reflect a general intent to provide relief where it can be demonstrated that the foreign country imposing the tax has the primary taxing right over the income, but will not assist taxpayers that do not qualify for one of these special provisions even if they could establish that a foreign levy is not overreaching as applied in their particular facts and circumstances.

The 2022 Proposed Regulations provide some flexibility to taxpayers by allowing for reliance on a license agreement that does not limit the territory of the license to the jurisdiction imposing the tax, as long as the agreement separately states the portion (whether as a specified amount or as a formula) of the payment subject to the tested foreign tax that is characterized as a royalty. The agreement also must specify that the portion of the payment is with respect to the part of the territory of the license that is solely within the foreign country imposing the tax.

The 2022 Proposed Regulations include anti-abuse rules regarding the use of the single country license exception. The single country license exception will not apply if the taxpayer knows, or has reason to know, that the relevant agreement misstates the territory in which the intangible property is used or overstates the amount of the royalty that relates to the territory that is within the foreign country imposing the tested foreign tax. The taxpayer is required to apply the standards of a "reasonably prudent person" with respect to its knowledge of the relevant facts and circumstances involving the license. The principles of section 482 and section 861 undergird this analysis.

To rely on the single country license, the taxpayer must maintain the written agreement and provide it within 30 days of a request by the Commissioner, or another period agreed to by the Commissioner and the taxpayer. The agreement generally must be executed by the date of the payment that gives rise to the gross royalty income. The 2022 Proposed Regulations provide some transitional relief for prior payments, as long as the required agreement is executed no later than May 17, 2023, and the agreement states that royalties paid on or before the date of execution of the agreement are considered paid pursuant to the terms of the agreement.

Examples illustrating the single country license exception in the 2022 Proposed Regulations highlight several points. First, the examples confirm that for the exception to apply, the payment must be characterized as a royalty under the foreign country's law. A payment that is characterized as a royalty pursuant to a license agreement but that is characterized as a service payment under the taxing country's law would not qualify for the exception. More generally, the examples confirm that taxpayers cannot "fix" other withholding taxes, such as those imposed on services, through contractual limitations between the parties. The examples also illustrate that the agreement must explicitly limit the territory of the license or separately state the portion of the payment that is with respect to the part of the territory of the license that is solely within the taxing jurisdiction.

KPMG observation

The preamble to the 2022 Proposed Regulations suggests that the need for the agreement to explicitly limit the territory of the license or separately state the portion of the payment that relates to the territory is to avoid the "unduly burdensome" exercise of determining the place of use of intangible property on a country-by-country basis. However, for license arrangements that require sales-based payments, the very mechanical requirement for the agreement to explicitly state the amount of royalty (which may be done by formula) attributable to a particular territory may produce an arbitrary distinction between substantively identical arrangements. For example, an agreement imposing a royalty of $X per unit shipped would appear not to qualify for the exception, but an agreement imposing a royalty of $X per unit shipped to Country Y and $X per unit shipped to country Z appears to satisfy the documentation requirement.

The 2022 Proposed Regulations also make several housekeeping changes by reordering the sourcing rules and clarifying that "reasonable principles" apply for purposes of applying both the royalty sourcing rule and the services sourcing rule. Taxpayers had questioned why the attribution rule with respect to the services sourcing referenced "reasonable principles" but the attribution rule with respect to the royalty sourcing rule in the Final Regulations did not; the 2022 Proposed Regulations conform the language of the royalty sourcing rule to the language in the services sourcing rule.

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