March 4, 2022

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Mr. Kevin Nichols
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Dear Assistant Secretary Batchelder, Deputy Assistant Secretary Murillo, and Mr. Nichols:

On behalf of the undersigned organizations, representing globally engaged U.S. employers across all sectors of the U.S. economy, we write to express our strong objection to the final foreign tax credit regulations {T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022)}, released by the U.S. Treasury Department and the Internal Revenue Service and published in the Federal Register on January 4, 2022 (the "Final FTC Regulations").[1]

Executive Summary

Specifically, we respectfully request that Treasury immediately withdraw and repropose the portions of the Final FTC Regulations relating to:

1) The source-based attribution rules for royalties and services;

2) The requirement that allocations of income between related parties must be determined under arm's length principles to determine the tax base for foreign taxes imposed on residents of foreign countries;

3) The inclusion of a per se list of "significant costs and expenses" under the cost recovery requirement; and

4) The rules for allocating and apportioning foreign income taxes with respect to certain disregarded transactions.

Additionally, we respectfully request that Treasury delay the effective date of the net gain rule to provide taxpayers sufficient time to assess and reflect the impact of such requirements on their business operations and financial statements as well as assess the need to adjust their operations accordingly.

The Final FTC Regulations appear to deny foreign tax credits for run-of-the mill foreign taxes that have been creditable for decades. Particularly with respect to withholding taxes on royalties, the Final FTC

[1] *See* Federal Register, January 4, 2022, available at: www.federalregister.gov/d/2021-27887.

Regulations mark a surprising and dramatic change from the November 2020 proposed regulations (the "Proposed Regulations") without providing taxpayers sufficient notice or an opportunity to comment, as required under the Administrative Procedure Act. These final regulations generally took effect immediately upon being published in the Federal Register on January 4, 2022, three days after the calendar and fiscal year had already begun for many taxpayers. This left many taxpayers scrambling to assess the disparate, and in most cases unclear, royalty and other sourcing rules of many foreign countries. Publicly traded companies are also forced to quantify the cost of possibly denied foreign tax credits for financial statement purposes as soon as March 2022. The rules for allocating and apportioning foreign income taxes with respect to certain disregarded transactions generally had retroactive effect to taxable years that begin after December 31, 2019, and end on or after November 2, 2020, which has exacerbated the adverse impact of the regulations with respect to certain foreign taxes incurred while the regulations remained in proposed form for over a year.

These rules will impose significant competitive disadvantages on U.S. groups, especially compared to groups from other jurisdictions which relieve international double taxation through a credit mechanism, such as China. The double taxation burden will be imposed particularly on U.S. business sectors which are leaders in global technological innovation and content creation, and which license and sell their U.S. developments throughout the world.

We appreciate that Treasury and the IRS intended to provide taxpayers with additional flexibility and certainty under the Final FTC Regulations. However, the perhaps unintended outcome is that the Final FTC Regulations are quite inflexible and cause considerable additional uncertainty regarding the continued creditability of previously creditable foreign taxes, even as compared with the Proposed Regulations. It would be possible to correct the elements of these regulations which are overbroad and still appropriately address the creditability of novel unilateral measures, such as DSTs and significant economic presence nexus rules.

The Attribution Requirement - Royalties and Payments for Services

As described in many comment letters in response to the Proposed Regulations, section 901 of the Internal Revenue Code unambiguously requires, at the taxpayer's election, a credit for "the amount of any income . . . taxes paid or accrued during the taxable year to any foreign country." This basic tenet of U.S. international taxation has been enshrined in the Code largely unchanged since The Revenue Act of 1918 in order to mitigate the double taxation that would otherwise harm the competitiveness of U.S. companies operating abroad. Until the Proposed Regulations, Treasury and the IRS had not even hinted that ordinary withholding taxes on services, much less royalties, should not be creditable. Indeed, as the preamble to the Final FTC Regulations acknowledges, the former regulations—in effect for almost 40 years—specifically included an example that allowed a foreign tax credit for withholding taxes imposed on payments for services based on the location of the service recipient. Eliminating foreign tax credits for withholding taxes on U.S.-based services directly impacts U.S. jobs, incentivizing location of services work hours outside the U.S., and adversely affecting the competitiveness of the U.S. Similarly, withholding taxes imposed on royalties based on the residence of the payor have also been creditable—without question—since the Revenue Act of 1942. Such withholding taxes do not represent the type of "novel extraterritorial taxes" that were the primary intended target of the Final FTC Regulations. For example, we believe that Treasury could have designed a more narrowly tailored rule that would have been limited in its application to the type of novel extraterritorial taxes (and possible future iterations thereof) with which Treasury was concerned without impairing the ability of taxpayers to claim credits for a variety of withholding taxes on royalties and services that have long been creditable. However, we

are hopeful that Treasury did not intend to preclude foreign tax credits for such ordinary withholding taxes, but rather that the scope of the regulations was unintentionally over-broad.

The Final FTC Regulations are also premised on the faulty assumption that the specific provisions of the Internal Revenue Code are the sole expression of international tax jurisdictional norms. We understand Treasury's view to be that foreign tax credits should be available only with respect to foreign taxes that apply U.S. tax jurisdictional principles, including the particular and unusual U.S. sourcing rules for royalties and services. In fact, the U.S. sourcing rule for royalties—based on the place of use of the intangible property—is an outlier. Rather, the international standard for sourcing royalty income is usually based on some combination of the residence of the payor and/or the place of business activity of the payor, sometimes expressly based on the theory that a withholding tax is appropriate when the payor claims a deduction for the royalty against locally taxed income. Similar principles underlie the justification for imposing withholding taxes on payments for services by resident taxpayers in the source state. Such withholding taxes are neither novel nor controversial. Indeed, many U.S. income tax treaties that provide for a positive rate of withholding tax on royalties and fees for services include sourcing rules that deem such royalties and services to arise in a contracting state where the payor is a resident of that state.

In this regard, it strikes us as odd and discriminatory that the Final FTC Regulations draw a seemingly arbitrary distinction between foreign taxes imposed by countries that are party to a U.S. income tax treaty and other foreign taxes. For example, take two identical foreign taxes imposed by Countries A and B under their domestic law that apply a withholding tax on royalties based solely on the residence of the payor, in violation of the attribution requirement. Country A has an income tax treaty with the United States, while Country B has not concluded an income tax treaty with the United States. The Country A tax is creditable (assuming that the requirements under the treaty are satisfied), while the identical Country B tax is not creditable. Further, the same Country A tax may not be creditable if imposed on a payment to a foreign subsidiary of the U.S. group, unless the relevant foreign-to-foreign treaty includes provisions that are unlikely to exist in practice. We fail to understand how section 901 justifies the difference in result, and we doubt that the treaty negotiators intended to concede to Country A the benefit of making its taxes creditable when the tax would not be creditable under the attribution requirement but for the treaty. Given the relative dearth of U.S. tax treaties, particularly with developing countries, this puts U.S. firms in a competitive disadvantage as compared to groups headquartered in jurisdictions with broader tax treaty networks.

To further elaborate on the relative uniqueness of the U.S. sourcing rule for royalties, we have preliminarily analyzed the sourcing rules for royalties in several foreign countries. Our review confirms that the specific terms of the U.S. place-of-use rule, which apparently is mandated as the comparator for foreign tax law under the Final FTC Regulations (royalties "***must be*** sourced based on the place of use"), is more the exception than the norm under foreign tax law. Most countries' sourcing rules for royalties include, on their face, some combination of a residence of payor rule and a rule that references the place of business activity of the payor. Other countries include an exclusive residence of payor rule. Yet other countries include an exception from the residence-of-payor rule where either (1) the royalty is attributable to a local permanent establishment, in which case a payment by a nonresident which is allocated to the PE in the source state may be subject to withholding, or (2) a resident makes the payment but it is allocated to a permanent establishment outside the taxpayer's country of residence, in which case the payment is not subject to withholding tax by the state of residence.

Comments to the Proposed Regulations observed that the place-of-use rule for sourcing royalties is not well developed under U.S. domestic law, in large part due to ambiguities in the analysis of where a licensee might "use" intellectual property rights under relevant IP law when its business activities involve cross-border transactions. In response, the preamble to the Final FTC Regulations helpfully explains that foreign countries need not apply a particular interpretation of the place-of-use rule. However, the problem lies in the mandate of the Final FTC Regulations to use a place-of-use rule for royalties, as such a rule in that literal form does not exist in other countries to any significant degree. Further, determining whether the application of a foreign country's sourcing rule for royalties is "reasonably similar" to the U.S. place-of-use rule has proven to be quite challenging in light of the variety of sourcing rules that different countries have adopted. Instead, the regulations should recognize that long-standing international tax norms accept royalty withholding taxes as appropriate when the payor claims a deduction for the royalty against locally taxed income without tying to intellectual property concepts of where a taxpayer uses intangible property rights.

We believe that these rules can be appropriately amended without limiting the Treasury's ability to address the foreign tax credit consequences of novel unilateral measures such as digital services taxes.

Section 482 Requirement

We respectfully request that Treasury reconsider its position to apparently deny foreign tax credits for all foreign taxes, regardless of whether they satisfy the attribution requirement, unless any allocation of income made pursuant to a foreign country's transfer pricing rules is determined under arm's length principles (the "section 482 rule"). A possible interpretation of this rule is that foreign tax credits are denied for all corporate income taxes imposed on a resident if the country uses non-arm's length transfer pricing principles to determine the base on which the income tax is imposed. Under such an interpretation, the foreign country's income tax is not considered to be a creditable foreign tax in its entirety (*i.e.*, with respect to corporate income tax paid on *all* of *any* resident's taxable income) because it does not satisfy the attribution requirement for taxes imposed on residents of the foreign country. In addition, and as a result, any foreign tax imposed by such country that would otherwise satisfy the requirements for constituting an eligible "in lieu of tax" (*e.g.*, withholding taxes on dividends and interest) automatically also becomes non-creditable. This is because the underlying corporate income tax that is imposed on a gross income base that tests related party transactions under non-arm's length principles does not qualify as a net income tax and therefore the in lieu of tax does not satisfy the substitution requirement. This is apparently true even if the in lieu of tax satisfies the attribution requirements.

If our interpretation of the regulations is correct, the section 482 rule represents another astonishing divergence from well-established U.S. international tax policy. Specifically, under the prior regulations and IRS Revenue Rulings, foreign income tax imposed on income determined under non-arm's length principles was denied a foreign tax credit but only in respect of the portion of the taxes attributable to the non-arm's length income allocation. Former Treas. Reg. 1.901-2(e)(5)(ii), Ex. 2 and Rev. Rul. 92-75. We can understand the policy rationale of these and related regulations and rulings, which reflect two reasonable policy positions: that taxpayers must take appropriate steps to minimize foreign tax and that foreign tax credit computations will be based on U.S. tax law. However, these policies do not imply that there should be a broader rule declaring that a foreign tax is not an "income tax" because of particular transfer pricing provisions that the IRS believes to be non-arm's length, even where such provisions have no applicability to the taxpayer at issue. For Treasury to adopt a rule that denies foreign tax credits in their entirety, regardless of a taxpayer's effort to minimize foreign tax and a taxpayer's foreign tax credit

computations and limitations, inappropriately punishes taxpayers in a way that is completely disconnected from Treasury's stated policy objectives and is a bridge too far.

Similar to our thoughts regarding the over-breadth of the attribution requirement, we believe that the solution presented by the Final FTC Regulations is not narrowly tailored to the perceived problem of the non-arm's length income allocations that Treasury intended to address. In this regard, we assume that the section 482 rule is intended to apply to countries that apply formulary apportionment in their income taxes including for purposes of attributing profit pursuant to a significant economic presence nexus standard. Our assumption is based on the following clause at the end of Treas. Reg. § 1.901-2(b)(5)(ii): "without taking into account as a significant factor the location of users, customers, or any other similar destination-based criterion." However, in addressing that narrow problem, the Final FTC Regulations have exacted significant collateral damage. For example, some countries (such as Brazil) employ fixed margins in their domestic transfer pricing legislation due to lack of capacity in their tax agencies to administer factually intensive and complex rules like section 482. Brazil has had such fixed margins in its transfer pricing legislation for many years. Such rules are hardly an example of novel extraterritorial taxes that warrant the harsh treatment that the Final FTC Regulations seem to require.

Cost Recovery Requirement

The Final FTC Regulations impose a new cost recovery requirement for a foreign tax to satisfy the net gain requirement and therefore be considered a creditable net income tax. 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" attributable to such gross receipts. In general, whether a cost or expense is significant for these purposes 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. However, the regulations then set forth a *per se* list of "significant costs or expenses," including those "related to" capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation, for which foreign law *must* allow a deduction.

Treasury and the IRS concluded that "double taxation that merits relief under section 901 occurs only if there is *substantial conformity* in the principles used to calculate the foreign tax base and the U.S. tax base." Such a rationale suffers from the same fatal flaw that underlies the attribution requirement, namely, the assumption that the particular elements of U.S. tax law uniquely represent international tax norms. That is simply not the case. For example, in certain jurisdictions deductions are not available for stock-based compensation and/or for goodwill amortization. A tax deduction for those expenses is allowed through particular provisions in the Code, namely sections 83 and 197. Many countries do not have legislation granting a tax deduction for those items. It is hard to see why that legislative choice should cause the normal income tax in such countries to become non-creditable.

Moreover, the effect of the Final FTC Regulations is to deny a foreign tax credit for *all* taxpayers if the foreign law is determined not to allow the recovery of one or more deemed significant costs and expenses. This is true even in the case of a particular taxpayer that does not incur any (or only a *de minimis* amount) of those costs and expenses that are determined to be "significant."

We respectfully request that Treasury reconsider its position by returning to the more flexible empirical test under the prior regulations. At a minimum, we request that Treasury remove the *per se* list of significant costs.

Allocation and Apportionment of Foreign Income Taxes with Respect to Certain Disregarded Transactions

The Final FTC Regulations include highly complex rules for allocating and apportioning foreign income taxes with respect to certain disregarded transactions and for reattributing certain income and assets between one or more "taxable units" arising from disregarded transactions. In the case of a remittance received by the taxpayer from a taxable unit in a transaction that is disregarded for U.S. federal income tax purposes (e.g., a dividend from a disregarded entity to its regarded CFC owner), the regulations assign the item of foreign gross income to the statutory or residual groupings out of which the payor made the remittance. Such a remittance is considered to be made ratably out of all of the accumulated after-tax earnings of the taxable unit. However, for these purposes, the accumulated after-tax income of the taxable unit that pays the remittance is deemed to have arisen in the statutory and residual groupings in the same proportions as the proportions in which *the tax book value of the assets of the taxable unit* are assigned for purposes of apportioning interest expense under the asset method in Treas. Reg. § 1.861–9 in the taxable year in which the remittance is made.

These rules have a material distortive effect, especially in the case of taxpayers that generate cash from the collection of receivables for services or goods in the active conduct of a trade or business and that, therefore, maintain a potentially significant amount of cash on their balance sheets throughout the year. The cash balances may be quite large relative to other assets that the taxable unit holds, even for entities that are engaged in an active trade or business and have no material income from financing or investment activity. In those cases, the tax book value method generally causes a significant allocation to the subpart F passive income grouping even though the cash arises from active business operations. When the taxable unit subsequently distributes a dividend subject to withholding tax, an allocation to the subpart F passive income grouping will create a material distortion compared to the actual source of the income. In many cases in practice, the amount of the withholding tax can far exceed the actual amount of passive subpart F income to which the foreign income tax is allocated, thereby causing an effective denial of foreign tax credits for a material amount of the foreign withholding tax on dividends.

Commenters to the Proposed Regulations had warned of these distortive effects, explaining that remittances should instead be characterized proportionately to the current or accumulated earnings of the taxable unit making the remittance. In the case of an active product distribution or service business, such an approach would properly allocate the foreign withholding tax to the active income to which the cash collected by the business actually relates (*i.e.*, to the activities that generated the earnings from which the taxable unit makes a remittance). In the preamble to the Proposed Regulations, Treasury and the IRS specifically "acknowledge[d] that any asset method for associating foreign gross income included by the remittance recipient with the payor's accumulated earnings may lead to inexact determinations of the grouping of the accumulated earnings out of which a remittance is paid . . . [including] *to the extent the characterization of the tax book value of an asset based on the income generated by the asset in the current taxable year does not reflect the characterization of the income generated by the asset over time*." Indeed, the prior 2019 proposed regulations recognized the potential for mismatch and allowed taxpayers not to use the tax book value method where such method "results in a material distortion." The preamble to the Final FTC Regulations included another acknowledgement by Treasury that the tax book value method "may not be a perfect surrogate for the accumulated earnings of [the] taxable unit", while still concluding that it is a better surrogate than current year earnings. With respect to an allocation base of accumulated earnings, the preamble seems to concede that using accumulated earnings based on maintaining "multi-year accounts tracking accumulated earnings of a taxable unit"

would provide a more accurate result, but still justifies the tax book value method due to concerns relating to "administrability, compliance burdens, manipulability, and accuracy."

We believe that a rule allocating the tax according to current and accumulated earnings included in the distribution, or at least allowing the taxpayer an election to do so, would not be particularly challenging to administer. Taxpayers commonly track the history and source of their earnings for normal tax compliance purposes. Regarding compliance burdens, Treasury and the IRS have not shied away from promulgating rules that impose significant compliance responsibilities on taxpayers in order to promote precision in tax reporting, notably including in the foreign tax credit context. The 2019 proposed regulations addressed the potential for manipulability by including an anti-abuse rule where a payment was made "with a principal purpose of avoiding the purposes of an operative section" (*e.g.*, section 904). The preamble itself concedes that this method would be more accurate.

To strike an appropriate balance here, we respectfully request that taxpayers be provided an election to use current and accumulated earnings of the taxable unit making the remittance where such reliable information is available to the taxpayer.

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The Final FTC Regulations place U.S. taxpayers at a significant competitive disadvantage compared to their foreign competitors, especially as compared with other countries that also use a foreign tax credit system, such as China. The United States still maintains a global lead in intellectual property innovation. Imposing double taxation on intangible property royalties burdens U.S. taxpayers in one of the U.S.' critical competitive sectors, one in which China in particular is becoming a formidable competitor. For the reasons discussed above, we would appreciate if Treasury and the IRS would reconsider the aspects of the Final FTC Regulations addressed in this letter.

We would appreciate the opportunity to meet with you to discuss these points at a mutually convenient time in the near future.

Sincerely,

Alliance for Competitive Taxation
American Bankers Association
American Council of Life Insurers
American Petroleum Institute
Business Roundtable
Footwear Distributors and Retailers of America
Global Business Alliance
Information Technology Industry Council
Medical Device Competitiveness Coalition
Motion Picture Association
National Association of Manufacturers
National Foreign Trade Council
National Retail Federation
Securities Industry and Financial Markets
Silicon Valley Tax Directors Group
Software Finance and Tax Executives Council
TechNet
U.S. Chamber of Commerce
United States Council for International Business