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Proposed U.S. Foreign Tax Credit Rules Provide Relief for Certain Taxpayers and Ideas for Others

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The U.S. Treasury Department recently issued proposed regulations[1] to address certain concerns raised by taxpayers and other stakeholders in response to final foreign tax credit regulations published in January 2022[2]. Although the proposed regulations do not grapple with some of the more fundamental problems previously identified by commentators, they do offer taxpayers relief in certain narrow circumstances. In general, the proposed regulations are proposed to apply to tax years ending on or after November 18, 2022 (i.e., starting immediately in 2022 for calendar-year taxpayers). Once the proposed regulations are finalized, taxpayers may choose to apply "some or all of the final regulations to earlier taxable years, subject to certain conditions" described in detail in the notice of proposed rulemaking. Until the effective date of final regulations, taxpayers may rely on the proposed regulations. If a taxpayer chooses to rely on a portion of the proposed regulations, taxpayers must consistently follow all proposed rules for that portion of the regulations for all years until final regulations are effective.[3]

Royalties

One of the primary areas of concern for taxpayers after the publication of the January 2022 final foreign tax credit regulations was the introduction of a source-based attribution requirement (described in earlier iterations of the regulations as the "jurisdictional nexus" requirement) that compares foreign laws governing the source of income with United States income tax laws to determine if a foreign tax should be creditable in the United States. Under the source-based attribution requirement in Treas. Reg. § 1.901-2(b)(5)(i)(B), a foreign tax imposed on a nonresident's income meets the attribution requirement only if the foreign tax law's sourcing rules are reasonably similar to the United States sourcing rules.

In the case of gross income arising from royalties, the foreign tax law must impose tax on the royalties consistent with the manner in which the Internal Revenue Code (the "Code") sources royalty income: i.e., based on the place of use or the right to use the licensed intangible property.[4] In this regard, the United States' place-of-use rule for sourcing royalties is far from representative of a global consensus. Other jurisdictions source royalties in a manner that does not fall neatly into that category, such as the United Kingdom, where a multi-factor approach is used to source royalties. As a result, in those countries where withholding taxes on royalties are imposed on the basis of some other approach, royalty withholding taxes would not be creditable against the recipient's U.S. tax liability even if the licensed intangible property is in fact used within the territory of the taxing jurisdiction.[5]

Complicating this inquiry is the lack of certainty that often arises when determining the location where intangible property is used. Although it may be easy to identify where certain manufacturing-related intangibles are used (e.g., at a multinational enterprise's manufacturing facility), it is more difficult in other situations, such as where employees in one jurisdiction use intangibles to generate sales through social media to customers

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residing in another jurisdiction.

The proposed regulations provide a limited exception to the source-based attribution requirement of the January 2022 regulations for situations in which the taxpayer can show that a withholding tax is imposed on royalties received in exchange for the right to use intangible property pursuant to a single-country license within the territory of the taxing jurisdiction. For this purpose, a payment is made pursuant to a single-country license if the terms of the license agreement under which the payment is made characterize the payment as a royalty and limit the territory of the license to the country imposing the withholding tax. Therefore, U.S. taxpayers may need to revise existing license agreements to qualify for the single-country license exception.

Cost Recovery Requirement

The proposed regulations also provide further insight into the net gain requirements that foreign income taxes must meet to give rise to U.S. foreign tax credits. The final regulations require generally that significant items of expense—including capital expenditures, interest, rents, royalties, wages and research and experimentation—must be recovered against income, but the proposed regulations permit a foreign tax to disallow significant costs and expenses if the disallowance is consistent with any principle underlying disallowances required under the Code.

For taxpayers determining whether a disallowance is consistent with Code-based principles, the proposed regulations provide helpful guidance. Treas. Reg. § 1.901-2(b)(4)(iv)(J), Example 10, makes clear that taxpayers would be permitted to claim foreign tax credits in respect of taxes paid to foreign taxing jurisdictions that do not allow any deductions for stock based compensation because the Code “contain[s] targeted disallowances or limits on the deductibility of certain items of compensation in particular circumstances based on non-tax public policy reasons, including to influence the amount or use of a certain type of compensation in the labor market,” citing sections 162(m) and 280G. Without the inclusion of Example 10 in the proposed regulations, it would not otherwise have been obvious that a complete disallowance of deductions for stock-based compensation would be considered to be consistent with (or resemble) the limitations in sections 162(m) and 280G.

For taxpayers analyzing whether any other type of disallowance under foreign tax law resembles a Code-based disallowance, the example and its principles should provide helpful authority in determining whether the net gain requirement is satisfied.

Summary

While the recently released proposed regulations do not address many substantive issues raised by taxpayers and other stakeholders in response to the January 2022 regulations, they do represent an effort to answer narrower problems identified by taxpayers, and they are designed in a way that allows taxpayers the opportunity to make broad arguments in other areas by analogy to these narrow rules. Given the relief provided in response to high profile comments from the technology and other sectors on royalty withholding issues in particular, interested parties with other specific issues should consider communicating those issues to the Treasury Department and the IRS with proposals for relief or clarification.

Please contact any Gibson Dunn tax lawyer for updates on this issue.

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[1] 87 Fed. Reg. 71,271, 71,275 (Nov. 22, 2022).

[2] T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022).

[3] Until the effective date of final regulations, taxpayers may rely on the proposed regulations. If a taxpayer chooses to rely on a portion of the proposed regulations, taxpayers must consistently follow all proposed rules for that portion of the regulations for all years until final regulations are effective. 87 Fed. Reg. 71,271, 71,277 (Nov. 22, 2022).

[4] Sections 861(a)(4) and 862(a)(4) of the Code.

[5] Foreign tax on royalties can often be eliminated altogether under United States income tax treaties that eliminate royalty withholding tax, in which case there is no need to claim a foreign tax credit. But foreign taxes on royalties are a significant focus of many U.S. taxpayers, as other U.S. treaties only reduce the royalty withholding tax, and many substantial U.S. trading partners, including Brazil, Singapore, and Hong Kong, do not enjoy tax treaties with the United States. We also note that in determining the availability of a deemed paid credit to a U.S. shareholder of a CFC, the IRS and Treasury have taken the position in the January 2022 regulations that a U.S. taxpayer may not rely on a U.S. treaty provision that a country's royalty withholding tax is creditable in a context where withholding taxes are imposed on royalties paid by one CFC to another CFC.

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Gibson Dunn lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, the authors, or any of the following leaders and members of the firm's Tax and Global Tax Controversy and Litigation practice groups:

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