FTC Developments

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Foreign tax credits: Overview

What is a creditable tax under Sections 901 and/or 903?

- Creditability analyzed in respect of each separate levy
- A foreign levy is creditable under section 901 if:
  - It is a "tax," defined as a *compulsory payment* pursuant to a foreign country's authority to levy taxes
  - It satisfies certain key requirements, namely:
    - » realization, gross receipts, and cost recovery requirements that were substantially revised in 2021 Final Regulations under Reg. § 1.901-2, as well as a new attribution requirement (discussed in subsequent slides).
  - It is not a soak up tax:
    - » A tax is a soak-up tax if liability for the tax is dependent on the availability of a credit for the tax against the payer's income tax liability to another country

Section 901: Income Taxes

Changes to creditable "net income taxes" in TD 9959 (2021 final FTC regulations)

- The creditability of a given foreign levy is determined separately from the creditability of any other foreign levy
  - Levies constitute separate levies if:
    - Imposed by different foreign tax authorities
    - Separate bases
    - Imposed on nonresidents versus imposed on residents
    - Withholding tax as applied to each separate class of income described in section 61, as well as certain *subsets* of income
    - Foreign levy as modified by a treaty or contract with the foreign country is separate from the general levy
- In order for a levy to be a creditable foreign income tax, it must be a foreign tax and qualify as either a net income tax or an "in lieu of" tax in its ***entirety*** for all persons subject to the tax
- Applicability date – taxes paid or accrued in tax years beginning on or after December 28, 2021 (with a delayed effective date for certain taxes paid to Puerto Rico)
- Corrections to final Regulation (87 Fed. Reg. 45018) published on July 27, 2022 (the "Technical Corrections"), and proposed regulations in November 2022 (the "Proposed Regulations")
- For purposes of the corporate AMT, foreign taxes will need to satisfy these rules too

Per se significant costs and expenses – Proposed regulations

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Attribution requirement in final FTC regulations (TD 9959)

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Attribution requirement in final FTC regulations (TD 9959)

- Situs -based nexus (nonresident taxes continued)
  - Applies with respect to taxes imposed based on situs of real property or business property of a taxable presence
  - Sale or disposition of stock satisfies situs

Section 903: In Lieu of Taxes

U.S. FTC considerations: Section 903 taxes

Section 903 ("in lieu of taxes") creditability requirements:

- A good generally imposed net income tax (" GINIT") creditable under Section 901
- Non-duplication: No net income tax in the country applies to the same base
- Close connection: GINIT would have applied to that base if "in lieu of" tax didn't apply
- Attribution : If the GINIT, or a hypothetical new separate levy with respect to the GINIT, were applied to the tax base of this levy, such GINIT or separate levy would meet the attribution requirements
- Immaterial whether the base bears any relation to net gain

"Covered WHTs" imposed on non-residents need to satisfy only non-duplication and source- based attribution requirements

- Existence of a good GINIT
- Must be imposed on non-residents
- Non-duplication requirements
- Source-based attribution requirements
- Note: WHT with respect to each class of income (or certain subsets thereof) tested as separate levies

Single Country License Exception

Single country license (SCL) exception for royalty WHTs—Proposed regulations

- "Place of use or right to use" in the U.S. vs. residence of payor or location of registration in many other jurisdictions
- Proposed FTC regulations introduced the "single-country license" exception:
  - License should limit the use of the IP to the territory of the country imposing the tax.
  - Portion of the royalty WHT may satisfy if underlying agreement delineates the portion related to in-country use (whether via a specified amount or a formula).
  - License agreements to be provided within 30 days of request and must generally be executed no later than m

- Facts:
  - CFC enters into a written agreement with USP for the right to use USP's IP in the ASPAC region.
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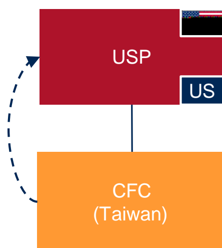
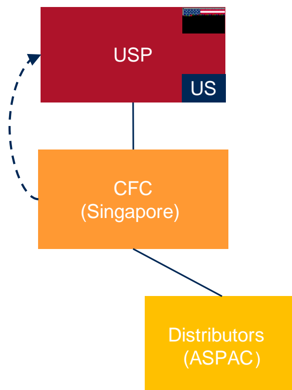


Example – IP hub



- Facts:
  - CFC enters into a written agreement with USP for the right to use USP's IP in the ASPAC region.
  - USP's IP includes all of the rights to make and sell products, including product and process patents, manufacturing know how, and trademarks.
  - CFC hires Contract Manufacturers in China to manufacture the products.
  - CFC sells finished goods to Distributors in ASPAC.
  - CFC gives the Contract Manufacturers and Distributors a royalty-free right to use the IP.
- Discussion:
  - Economically, most of the profit resulting from making and selling the products using the IP will be earned in Singapore.
  - However, use of a royalty (unlike a service fee) does not depend on where the licensee conducts activities, but rather where the IP is exploited.
  - Because no manufacturing or selling activities occur < .7(c)-6(al)patu alu7(i)-0.6(Ju

Interaction with Tax Treaties

Creditability of foreign taxes under an income tax treaty

- Foreign taxes that would not be creditable under the 2022 Final FTC Regulations *may* nonetheless be creditable under the relief from double taxation article of a US income tax treaty (see Reg. § 1.901-2(a)(1)(iii))
  - The relevant foreign tax must be treated as an income tax under the treaty
  - The foreign tax must be paid or accrued by an eligible US resident or citizen that elects to claim the benefit
  - Some treaties may contain a "resourcing" provision that treats income that is otherwise US source income (e.g., stock gains recognized by a US resident, such as a RIC) as foreign source, subject to limitations under the Internal Revenue Code
    - Code provisions such as sections 865(h) and 904(d)(6) may require separate "basketing" of resourced income and associated taxes for FTC limitation purposes
  - Reporting of treaty-based return positions on IRS Form 8833 is generally required under section 6114

Interaction of 2022 final FTC regulations with tax treaties

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Relief in the form of Notice 2023-55

Notice 2023-55

- Temporary relief under Notice 2023-55 issued on July 21, 2023 ("Relief Notice")
    - The IRS issued the Relief Notice announcing temporary relief for taxpayers determining whether a foreign tax is eligible for a foreign tax credit under sections 901 and 903
    - For foreign taxes paid during 2022 and 2023, taxpayers may apply:
        - Former § 1.901-2(a) and (b), before it was amended by the 2022 FTC final regulations, but subject to a modification to the non-confiscatory gross basis tax rule as described in the notice.
        - Existing § 1.903-1 without the attribution requirement
- Definition of "Relief Period" in Notice 2023-55
    - For calendar year taxpayers – from 1/1/22, through 12/31/23 (i.e., TY22 and TY23);
    - For fiscal year taxpayers – for tax years beginning after 1/1/22, and ending before 12/31/23 i.e., fiscal year ending in 2023 (unless there is a short period)
    -

Digital Service Taxes (DSTs)

- DSTs generally seek to tax revenue earned by foreign corporations that access a country's market without having physical presence there
    - A substantial proportion of the corporations that meet this description are US-headquartered, creating tension between the US and the countries implementing DSTs
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Selected Digital Service Taxes

Country	Status	Effective Date	Rate	Notes
Austria	Enacted	Jan 2020	5.0%	Agreed to unilateral measures compromise
Belgium	Proposed	TBD	3.0%	Development on hold pending Pillar 1 outcome
Canada	Proposed	Jan 2024[(1)]	3.0%	Will enact without further delay
Croatia	Proposed	TBD	7.0%	
France	Enacted	Jan 2019	3.0%	Agreed to unilateral measures compromise
Italy	Enacted	Jan 2020	3.0%	Agreed to unilateral measures compromise
India	Enacted			Agreed to unilateral measures compromise
Kenya	Enacted	Jan 2021	1.5%	
Mexico	Proposed	TBD	2.0%	
New Zealand	Proposed	Jan 2025*	3.0%	
Poland	Proposed	TBD	7.0%	Development on hold pending Pillar 1 outcome
Slovakia	Proposed	TBD	TBD	
Spain	EnacDov3.T5(i)-5036 Tw -34.423 -1.954 Td [t*			EnacDov3.T5(i)-5036 Tw -34.423 -1.954 Td [t73]TJ EMC /P <</MCID 31 /P <<EMC

But wait,
BEPS…

Overview: The Pillar 2 charging rules

Policy objective :

To ensure that large multinational companies pay a 15% minimum level of tax on income earned in every jurisdiction they operate.

Three shots at achieving this policy objective (in order of priority application) :

Local country measure

Qualified Domestic Minimum top -up tax ("QDMTT")

Allows the local jurisdiction to collect any top-up tax to the 15% minimum tax rate that would otherwise be paid to another jurisdiction under Pillar 2.

"Parent" country measure

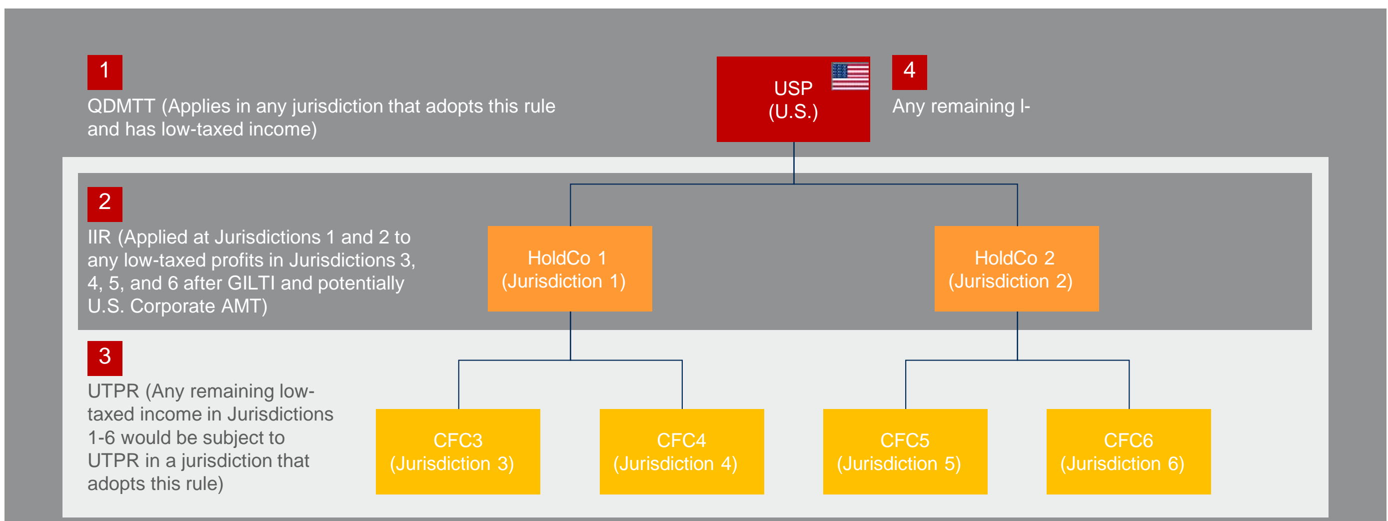
Income Inclusion Rule ("IIR")

Triggers top-up tax at the level of a Parent company where the income of a subsidiary or other constituent entity ("CE") (aggregated at the jurisdictional level) is taxed at a rate less than 15%.

Backstop measure

Undertaxed profits rule ("UTPR")

1. UTPR is the ultimate backstop measure
2. The top-up tax is allocated among relevant jurisdictions that adopted UTPR
3. It operates by denying deductions (or an "equivalent adjustment").
4. Applies to income in ultimate parent jurisdiction, including the U.S.



Treatment of Pillar 2 taxes

- Qualified Domestic Minimum Top Up Tax (QDMTT)
  - Expected to be the primary charging provision that will apply to collect top up tax
    - QDMTT expected to be creditable and guidance on how these taxes will be accounted for may be released before the end of the year
- Income Inclusion Rule (IIR)
  - Commentary to Article 4.3.2 generally provides that to preserve the rule order, domestic tax regimes should not provide a foreign tax credit for any tax imposed under an IIR or UTPR
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Foreign Tax Redeterminations, Contested Taxes, and Timing

The “relation-back” doctrine

- Regulation § 1.905-1 regifies the longstanding relation- back doctrine
  - This principle provides that if there are any changes in a taxpayer's foreign tax obligations, such as extra payments made after settling a dispute with a foreign tax body, these changes are treated as if they were due at the end of the foreign tax year they relate to. This is especially the case for taxpayers who use the accrual accounting method.
  - If there's a "foreign tax redetermination" (as outlined in Regulation § 1.905-3), the taxpayer must reassess their US tax obligations for the year the foreign tax relates to, as well as any other impacted

FTRs: Mechanics

- Notification Requirements
  - Corporations must file amended returns, including preparing an amended Form 1118 and adding Schedule L
    - If there is an increase in US tax liability the amount is due with original return (including extensions) of year in which FTR occurs
    - Decrease in US tax liability that is due within 10-year SOL for claiming FTC refunds
    - Special rules for multiple redeterminations
    - Exceptions for filing amended returns and Forms 1118 (but not statements) if no change in US tax liability, meet

Credit vs. deduction

- Special 10- year statute of limitations under section 6511(d)(3) allows taxpayer to change from deduction to credit, and to change the amount of FTC, including correcting math errors
- The 10-

Pre-TCJA years and the SOL

- USP has owned a German GmbH, which is a CFC, for 30 years. In 2023, GmbH settles an audit with the German government with respect to 2010 that results in it paying EUR 50 in additional German tax for that year.
- This EUR 50 of additional German tax would be deemed paid under section 902 in 2016.
- Section 6511(d)(3)(A) states: “If the claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country or to any possession of the United States for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of section 901 or the provisions of any treaty to which the United States is a party, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 10 years from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued.”
- How does the SOL apply with respect to the EUR 50 of additional tax?

Payment of contested taxes

- The new regulations make it harder to claim foreign tax credits for taxes that you've paid but are still contesting.
- To claim a "provisional" credit, you'll need to enter a "provisional foreign tax credit agreement" with the IRS through Form 7204.
  - This agreement will require you to agree not to assert the statute of limitations for 3 years after you notify the IRS of the resolution of the contest.
  - You'll also need to provide an annual notice each year with your timely filed tax return until the contest is resolved. You will do so on Form 1118 schedule L and Form 1116 schedule 6.

Noncompulsory Payments

Noncompulsory payments: 1.901-2(e)(5)

- Taxpayers wishing to claim foreign tax credits have an obligation to not pay more than they are required to pay under foreign law. Payments will not be considered an amount of foreign income tax paid to the extent it is not compulsory
- To ensure a payment is considered compulsory taxpayers must:
  - Minimize their foreign income tax liability by reasonably interpreting and applying foreign tax law
  - "Exhaust all effective and practical remedies" to reduce their foreign tax liability over time
    - This includes seeking competent authority relief, where relevant
    - The time value of money is ignored for these purposes
- However, taxpayers are not required to reduce their foreign income tax liability if the arm's length costs of doing so "would exceed the amount by which the liability could be reduced."
  - Put into an equation, this could be read as saying no action is required to minimize foreign tax liability if:
  - >
  - This may be simplified as >

Noncompulsory payments - Measurement

- Costs incurred
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Selected Jurisdictional Considerations

Creditability of Brazilian corporate income taxes

- The Brazilian corporate income tax likely failed two aspects of the net gain requirement with the final foreign tax credit regulations were issued in 2022
  - The disallowance of deductions for related party transactions (e.g., extremely low royalty rates required under Brazilian law) violated the cost recovery requirement
  - Brazilian transfer pricing methodology did not follow the arm's length standard – which likely violated the attribution requirement
- Subsequently Brazil has passed legislation to bring their transfer pricing rules in line with OECD arm's length guidelines
  - This removes the biggest impediment to Brazilian corporate income taxes being considered a creditable foreign tax for US federal income tax purposes
  - However, taxes paid prior to 2023 would still be noncreditable under the final regulations

Creditability of Mexican corporate income taxes

- Mexico's corporate income tax contains an inflation adjustment which seeks to recognize the effects of inflation for tax purposes in the areas of monetary assets and liabilities and depreciable property
  - No similar concept exists in the United States, which raises the question of whether Mexico's corporate income tax satisfies the realization requirement under the 2022 final regulations?
  - Because a foreign tax is either creditable or noncreditable in its entirety, the 2022 regulations could effectively treat all corporate income taxes paid to one of our largest trading partners as noncreditable

Disregarded Payments and Treas. Reg. § 1.861-20

Allocation of foreign income taxes: Three-step approach

- That amount of foreign gross income in Step 1 is determined according to foreign law
- The character and grouping of foreign gross income is determined based on a US Corresponding Item ("US CI

Applying the disregarded payment rules: 1.861-20(d)(3)(v)

- The methodology for applying the disregarded payment rules (part of Step 1 in the allocation of foreign income taxes) is as follows:
  - Identify the taxable units and disregarded payments
  - Characterize each disregarded payment as one of the following:
    - Reattribution Payment
    - Remittance
    - Contribution
    - Disregarded Payment in Exchange for Property
  - Apply rules based on whether there is a US CI
  - Apply the multiple payment rules

1. Identify taxable units and disregarded payments

- Types of taxable units
  - Individuals and Domestic Corporations: Foreign branches, foreign branch owners, non-branch taxable units (e.g., foreign disregarded entities)
  - Foreign Corporations: A taxable unit is a "tested unit" as defined in the high-tax exception regulations (see1.951A-2(c)(7))
- Disregarded payments exist in transactions where:
  - Property is transferred to or from a taxable unit
  - The transaction is disregarded for US federal income tax purposes, and
  - The transaction is recorded on the books of the taxable unit
- Disregarded payments can include all of the following:
  - Transfers that would have been contributions to capital if regarded
  - Transfers that would have been a distribution if the transferor were considered a US corporation
  - Sales of depreciable and non-depreciable property
  - Any other payment that would have impacted income, gain, deduction or loss calculations at the taxable unit if the transaction was regarded for US federal income tax purposes

2. Characterize disregarded payments

- Reattribution payments
  - Primarily non-property dealings that are part of either the branch's or the owner's ordinary business
  - Assign income and assets for purposes of 1.861-20, but do not assign taxes
  - Reattribution is limited to the payor taxable unit's taxable income. Any excess is treated as either a contribution or a remittance
- Remittances
  - Primarily equity related transactions between the business and the business owner
  - Considered made ratably out of all the accumulated after-tax income of the taxable unit
    - Accumulated after tax income of the taxable unit is determined by reference to the tax book value of the taxable unit's assets

2. Characterize disregarded payments

- Contributions
  - The excess amount of a disregarded payment (other than a disregarded payment received in exchange for property) made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment, if any, that is a reattribution payment
  - Taxes associated with contributions are allocated to the residual category, which results in no credit for CFCs under §960
- Disregarded sales and exchanges
  - Characterized and assigned as a timing difference in the taxation of the property's built-in gain
  - Characterized and assigned to the grouping to which such corresponding US item would have been assigned if the deemed sale were recognized under federal income tax law

2. Characterize disregarded payments

- Types of taxable units for individuals and domestic corporations
  - Foreign branches
  - Foreign branch owners
  - Non-branch taxable units (e.g., foreign disregarded entities)
- Types of taxable units for foreign corporations
  - A taxable unit is a "tested unit" as defined in the high-tax exception regulations (see1.951A-2(c)(7))
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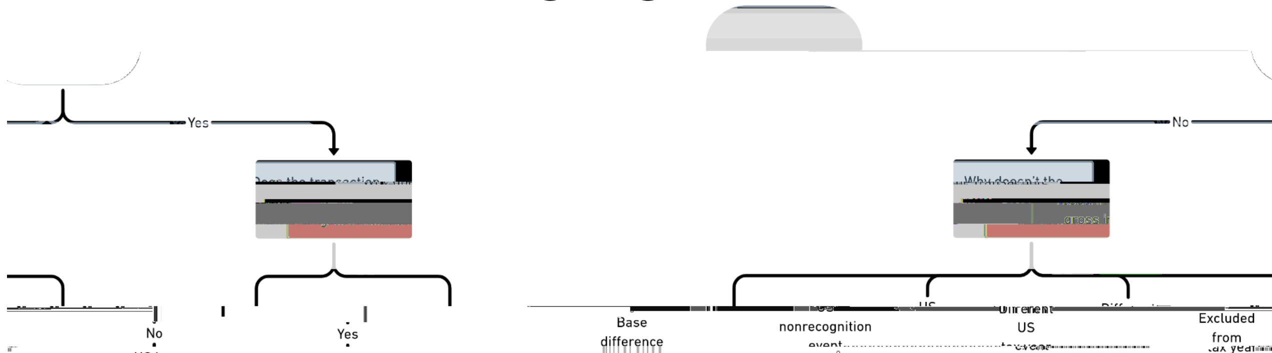
3. Allocate and apportion taxes by foreign gross income



Questions?