UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 8, 2021

Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20044

RE: IRS REG-101657-20 - Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income

Dear Commissioner,

In September 2020, the US Department of the Treasury and the Internal Revenue Service issued proposed regulations [REG-101657-20] addressing various aspects of the foreign tax credit (FTC) regime (the 2020 FTC proposed regulations).

USCIB[1] is pleased to provide comments on certain sections of the proposed regulations regarding guidance related to the foreign tax credit and related provisions.

Introduction

The 2020 FTC proposed regulations make significant changes to the current FTC regulations that have been in place for decades – some for almost a century. These changes reduce flexibility in the application and administration of the FTC rules. They generally require foreign income tax systems to be technically consistent with current international tax norms (determined primarily by reference to the U.S. rules) regarding income computation, income allocation, nexus, sourcing rules and tax computation rules in order for their income taxes on U.S. taxpayers to be eligible for the U.S. FTC. These changes seem inconsistent with the current and evolving debate over changes to the relevant international income tax rules specifically addressing these topics, including changes to physical presence-based nexus and the recognition that the international income tax rules need to accommodate the limited tax administration capabilities of developing countries and a broader need for simplification for all countries.

The proposed changes will apply broadly outside the context of the “novel extraterritorial taxes” that were an important factor driving these proposed regulations and will result in significant additional double taxation and controversy for U.S. taxpayers doing business in foreign countries. These additional costs will reduce U.S. businesses’ competitiveness against foreign businesses not subject to the double taxation created by these rules and will operate in contradiction with the primary purpose of the U.S. FTC – to maintain and improve U.S. competitiveness in foreign markets by minimizing double taxation.

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[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

While the preamble to the regulations provides for tax treaties as the means for establishing a legitimate foreign taxing right when foreign sourcing rules differ from the U.S., the current limited U.S. tax treaty network and the historical difficulty in negotiating and approving U.S. tax treaties does not provide effective relief for U.S. taxpayers. In addition, CFC's of U.S. taxpayers do not directly benefit from existing U.S. tax treaties.

The following specific comments address proposed changes to the FTC rules for the: 1) jurisdictional nexus requirement, 2) net gain requirement, 3) amount of foreign tax that is creditable, 4) allocation and apportionment of foreign taxes, and 5) subtopics within these proposed regulation sections. We review evidence of prior Congressional intent, legislative and regulatory changes over the past 100 years, judicial interpretation of these rules, and the ongoing changes and evolution of international tax systems – a process that includes the U.S. Based on our analysis and the significant potential impact of these proposed regulations on the international competitiveness of U.S business, we recommend that the proposed regulations be withdrawn to permit a thorough review of the relevant policy objectives of the U.S. FTC regime within the context of the ongoing debate over the extension of the international tax system beyond traditional norms. While the USCIB strongly supports the U.S. government's strong defense of the current international tax system rules, we believe it is critically important to maintain the flexibility of the current U.S. FTC rules to accommodate the reality of foreign governments imposing taxes on U.S. taxpayers based on modifications to the existing international income tax rules. The U.S. FTC rules must continue to fulfill their objective of supporting U.S. competitiveness by continuing to minimize double taxation during this period of change.

Specific Comments

Prop. Treas. Reg. section 1.901-2(c)(1) tax on residents: jurisdictional nexus requirement: alternative tests

Summary of current law and proposed change

Section 901 currently provides a credit for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States."[2] Thus, section 901 provides a credit for any "income tax" with no suggestion that the jurisdictional basis for imposing the tax must adhere to U.S. law.

Current Treas. Reg. section 1.901-2(a)(1) generally provides that a foreign levy is a creditable "income tax" only if (i) it is a tax and (ii) its predominant character is that of an income tax in the U.S. sense,

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[2] Enacted in 1942 (in a predecessor Code section), section 903 provides that the term "income, war profits, and excess profits taxes" includes "a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed" by a foreign country or U.S. possession. The proposed regulations expressly would provide that an in lieu of tax must satisfy the proposed jurisdictional nexus requirement. Specifically, Prop. Treas. Reg. section 1.903-1(c)(1)(iv) invokes this requirement by virtue of the substitution requirement, by requiring that a section 903 tax (other than a covered withholding tax) must be in lieu of a net income tax that would satisfy the jurisdictional nexus requirement in Prop. Treas. Reg. section 1.901-2(a)(3). For covered withholding taxes, Prop. Treas. Reg. section 1.903-1(c)(2)(iii) expressly requires satisfaction of the nexus requirement described in Prop. Treas. Reg. section 1.901-2(c)(1)(ii), i.e., that any source-based nexus must be based on sourcing rules that are reasonably similar to U.S. sourcing rules. Thus, this comment focuses on the application of the jurisdictional nexus requirement both to foreign net income taxes under section 901, as well as to "in lieu of taxes" under section 903.

meaning that it is likely to reach net gain in the normal circumstances in which it applies and it is not a soak-up tax. Prop. Treas. Reg. section 1.901-2(c) would add a new requirement, namely that the basis for the imposition of the foreign tax must conform with what the preamble refers to as "established international norms, reflected in the Code and related guidance, for allocating profit between associated enterprises, for allocating business profits of nonresidents to a taxable presence in the foreign country, and for taxing cross-border income based on source or the situs of property (together, the proposed jurisdictional nexus requirement)." Specifically, for taxes imposed on non-residents, "each of the items of income" that is subject to the tax must either (1) be attributable to the nonresident's activities within the foreign country (including the nonresident's functions, assets, and risks located in the foreign country), based on "reasonable principles" that do not take into account as a significant factor destination-based criteria such as location of customers or users; (2) arise from sources in the foreign country based on source rules that are "similar to the sourcing rules that apply for Federal income tax purposes," including that services must be sourced based on the location where services are performed; or (3) reflect gains attributable to dispositions of real property located in the foreign country or movable property forming part of the business property of a taxable presence in the foreign country.[3] Furthermore, tax imposed by a foreign country on its own residents must determine the resident's income under arm's length principles rather than destination-based criteria.[4]

Summary of concerns and recommendation

Denying FTCs for taxes that do not meet the proposed jurisdictional nexus requirement is not consistent with the plain meaning, structure, or legislative history of the FTC provisions, or the tax policy reflected therein. Since 1921, when Congress repealed a jurisdictional nexus requirement, Congress has chosen to police concerns regarding jurisdiction to tax through the foreign tax credit limitation. The imposition of a new rigid requirement for another country's nexus rules to closely align with U.S. rules would be inconsistent with this history and the plain meaning of the text of section 901 (virtually unchanged since 1921), by severely restricting the availability of credits for foreign taxes imposed on *net income* and thereby undermining Congress's intent for the foreign tax credit to mitigate the double taxation of foreign income so that U.S. companies can compete abroad on an equal footing. This dramatic change would have particularly harsh results for companies operating in developing countries with less sophisticated approaches to determining the source and character of income. In addition, the proposed jurisdictional nexus requirement would lead to significant uncertainty and protracted controversies, in particular when only some aspects of a foreign levy run afoul of the requirement, with especially inequitable consequences for taxpayers that are not affected by those particular aspects of the rules.

We believe the proposed jurisdictional nexus requirement is inconsistent with the purpose of section 901 of mitigating double tax on foreign earnings and should not be pursued. Accordingly, we believe Prop. Treas. Reg. section 1.901-2(c) should be withdrawn. We elaborate on each of these points below.

Congress repealed an earlier jurisdictional nexus requirement for FTCs

The legislative history indicates that Congress explicitly rejected a prior statutory requirement that restricted FTCs to taxes imposed by a country on income derived from sources therein in favor of an FTC limitation determined by reference to the amount of U.S. tax on foreign source income. In the Revenue

[3] Prop. Treas. Reg. section 1.901-2(c)(1).
[4] Prop. Treas. Reg. section 1.901-2(c)(2).

Act of 1918 (actually passed in 1919), the United States enacted the first generally available foreign tax credit in the world, in order to mitigate the double taxation that otherwise would harm the competitiveness of U.S. companies operating abroad.[5] As originally enacted, there was no limitation against the use of foreign tax credits against U.S. source income, but a foreign tax credit was available only for a tax imposed by a foreign country "*upon income derived from sources therein*."[6] The legislative history does not discuss why credits were originally available only for taxes imposed by a foreign country "upon income derived from sources therein," but presumably this requirement was intended to protect U.S. taxing rights with respect to U.S. source income.

In 1921, the United States introduced the first limitation on FTCs, in the form of an "overall limitation," so that taxpayers could claim FTCs only against the U.S. tax on their foreign-source income.[7] The stated reason for the change, not surprisingly, was to prevent FTCs attributable to high-tax countries from offsetting U.S. tax properly attributable to income derived from U.S.-sources.[8] In adopting the FTC limitation, Congress repealed the restriction that made direct credits available only for tax imposed by a country "upon income derived from sources therein," or in the case of indirect FTCs, "upon income derived from sources without the United States." Accordingly, following the repeal of the jurisdictional

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[5] *See* Revenue Act of 1918, §§ 222(a)(1) and 238(a), 40 Stat. 1057, 1073, 1080-82 (1919) (providing a foreign tax credit for individuals and domestic corporations, respectively) [hereinafter, the 1918 Act]. During limited debate, Congress focused on the "very severe burden of double taxation" on U.S. companies engaging in foreign commerce, but some Congressmen also depicted the FTC "as a method to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation." Magill & Schaab, *American Taxation of Income Earned Abroad*, 13 Tax L. Rev. 115, 118 (1958) (*citing* 56 Cong Rec. 677-78 (1918)). *See also American Chicle Co. v. United States*, 316 U.S. 450, 451 (1942) ("The purpose of the [FTC]... is to obviate double taxation."); *Burnet v. Chicago Portrait Co.,* 285 U.S. 1, 7 (1932) ("The fact that the provision is for a credit to the domestic corporation, against income taxes payable here, of income taxes 'paid during the same taxable year to any foreign country,' itself demonstrates that the primary design of the provision was to mitigate the evils of double taxation.").

In later revisions to the FTC, Congress has repeatedly emphasized that competitiveness concerns lie at its heart. *See* 75 Cong. Rec. 6490 (Mar. 18, 1932) (statement of Rep. Crisp) ("They said that unless these American corporations doing business abroad are given this benefit they can not compete with the foreign companies, because it would mean they would have to pay double taxation on their income derived in the foreign country. . . . It was stated that unless this was continued, these American corporations doing business abroad would probably have to withdraw from business because they could not compete with the foreign companies which did not pay these taxes."); H.R Rep. No. 83-1337, at 76 (1954) ("The provision was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or engaged in business abroad.").

[6] The 1918 Act, §§ 222(a)(1) and 238(a), 40 Stat. at 1073, 1080-82. The 1918 Act also adopted the indirect FTC, which allowed U.S. companies a credit for foreign taxes paid by their foreign subsidiaries upon the payment of a dividend. § 240(c), 40 Stat. at 1082. For purposes of the indirect FTC, section 240(c) defined eligible foreign taxes as "any income, war-profits, and excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived *from sources without the United States*" (emphasis added). No explanation was given for the less restrictive rule regarding source.

[7] See Revenue Act of 1921, ch. 136, §§ 222(a)(5) and 238(a) (dealing with individuals and corporations, respectively), 42 Stat. 227 [hereinafter the 1921 Act], at 249, 258.

[8] Ways & Means Comm. Rpt. (67th Cong., 1st Sess., H. Rept. 350) ("Where foreign income or profits taxes are imposed at rates higher than those carried by the similar taxes in this country, this credit may wipe out part of our tax properly attributable to income derived from sources within the United States.") and Sen. Fin. Comm. Rpt. (67th Cong., 1st Sess., S. Rept. 275) (same).

nexus requirement, the overall limitation allowed foreign taxes imposed by a country on income derived in another country, including the United States, to be cross credited against other *foreign source* income of the taxpayer.

The Code definition of a creditable foreign income tax has been virtually unchanged since 1921. Current section 901(b)(1) provides that, subject to the FTC limitation, an FTC is allowed for "any income, war profits, and excess-profits taxes paid <u>or accrued</u> during the ~~same~~ taxable year to any foreign country or to any possession of the United States." (Additions are underlined and deletions appear as strikethrough relative to the 1921 version).

The allocation of taxing rights among countries remained unsettled in 1921, similar to today

Congress was on notice that conflicting claims of source existed in 1921 when it replaced the restriction from the 1918 Act that required creditable taxes to have a jurisdictional nexus to the country imposing the tax with the overall limitation on the FTC.

Although the 1918 Act made the distinction between U.S.- and foreign-source income an organizing feature of our tax system by requiring the determination of the U.S.-source income on which foreign persons could be taxed and the foreign-source income on which U.S. persons could claim an FTC, the 1918 Act did not provide rules for determining source.[9] In the absence of statutory rules, the Attorney General established source rules through written opinions.[10] These rules were not without controversy. As Professors Graetz and O'Hear have observed, the Justice Department's judgment differed from that of the Treasury Department on at least two significant issues:

> First, the Attorney General decided that business income followed sales, regardless of where a product was manufactured or through whose hands it traveled to its final selling point. According to the Attorney General, . . . only the nation in which the sale was concluded could levy a tax on income arising from the sale. [Dr. T.S. Adams, an economic advisor to Treasury, described as the "father" of the 1921 Act[11]] objected that such a rule denied the United States authority to tax much income that was, in essence, produced domestically, and that such a rule was open to taxpayer manipulation. . ..

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[9] *See* Graetz & O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L.J. 1021, 1057 (Mar. 1997) [hereinafter Graetz & O'Hear] at 1057.

[10] *See* Graetz & O'Hear at 1057 (*citing* Internal Revenue: Hearings Before the Committee on Finance of the United States Senate on H.R. 8245, 67th Cong. 256 (1921) (statement of Senator LaFollette), *reprinted in* 95A Internal Revenue Acts of the United States 1909-1950: Legislative Histories, Laws, and Administrative Documents (Bernard D. Reams, Jr. ed., 1979) at 6, 65-67 [hereinafter 1921 Hearings]).

[11] Graetz & O'Hear at 1031. Dr. Adams has been credited with "putting in place the fundamental structure of both the U.S. tax law governing international taxation and the original model for bilateral tax treaties, the two building blocks which have governed U.S. taxation ever since." Graetz & O'Hear at 1031-33 (citing Robert M. Haig, *T.S. Adams 1873-1933*, 18 Bulletin of the Nat'l Tax Ass'n 7, 197 (A.E. Holcomb Ed. 1933)). Dr. Adams' greatest quality may have been his "practical common sense, which enabled him to thread his way so successfully amid the maze of conflicting opinions and which made him so valued a counselor to statesman. . . ." *See* Graetz & O'Hear at 1032 (*citing* Edwin Seligman, *T.S. Adams 1873-1933*, 18 Bulletin of the Nat'l Tax Ass'n 7, 196 (A.E. Holcomb Ed. 1933)) This practicality certainly would not have led Adams to recommend that double tax relief should depend on whether a foreign country's laws strictly adhere to the nascent U.S. nexus rules.

> The second major departure from Department of Justice policy sought by Adams concerned the source rule for interest income. The Attorney General, again guided by common law, allocated interest to the residence of the creditor. In contrast, Adams sought allocation to the residence of the debtor.[12]

In addition to replacing the jurisdictional nexus requirement with the foreign tax credit limitation, the 1921 Act included the first source rules for interest, dividends, rents, royalties, personal services, gains from the sale of real and personal property, and the manufacture and sale of personal property.[13] The controversy regarding the sourcing of sales was resolved by delegating authority to the Commissioner to develop "processes or formulas of general apportionment" for income derived from sources "partly within and partly without the United States," which expressly included income arising from the manufacture of goods in one country and the sale in another.[14] The 1921 Act also reversed the Attorney General's guidance that sourced interest based on residence.[15]

The United States was not alone in having under-developed sourcing rules in 1921. A brief review of the legislative history to the 1918 and 1921 Acts indicates that when the foreign tax credit was first allowed in 1919, and then revised in 1921 to drop the jurisdictional nexus requirement, there were no "established international norms" for sourcing income, with basic jurisdictional nexus questions regarding residence versus source remaining unsettled. In 1919, the newly formed International Chamber of Commerce (the "Chamber") adopted a resolution at its organizational meeting in Paris calling for "prompt agreement between the Governments of the Allied countries in order to prevent individuals or companies from being compelled to pay a tax on *the same income in more than one country*."[16] The Chamber prioritized the issue of double taxation because countries were making conflicting claims of taxing jurisdiction with respect to the same income. Treasury's representative to the Chamber, Dr. Adams, convinced the Chamber to develop proposals for specific source rules.[17] These proposals ultimately set the stage for the difficult debates at the League of Nations in 1927 and 1928, with the sourcing of interest and dividends being two of the most divisive issues.[18] The League of

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[12] Graetz & O'Hear at 1057 (*citing* 1921 Hearings at 6, 66-67) (footnote omitted).

[13] *See* Revenue Act of 1921, ch. 136, § 217, 42 Stat. 227, 243-45.

[14] *Id.* at § 217(e), 42 Stat. at 243-45.

[15] *Id.* at § 217(a), 42 Stat. at 243-44.

[16] Graetz and O'Hear, p.1066, *quoting* Organizational Meeting of the International Chamber of Commerce Res. 11 (June 28, 1919), Int'l Chamber of Commerce (emphasis added). The International Chamber was an umbrella organization with ties to the national chambers of commerce, including that of the United States. Its work formed an important prologue to the League of Nations work on bilateral tax treaties throughout the 1920s, which established the basic structure of "classification and assignment" that is used in "virtually all tax treaties" today. Graetz & O'Hear at 1066, n.181 (*quoting* Rosenbloom & Langbein, *United States Tax Treaty Policy: An Overview*, 19 Colum. J. Transnat'l L. 359, 365-66 (1981).

[17] Graetz and O'Hear at 1068, (*citing* Minutes of the Meeting of the Committee on Double Taxation of the International Chamber of Commerce 4 (Mar. 1, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921-1923 folder)). During his extensive testimony to the Senate Finance Committee on the 1921 Act, and specifically regarding the U.S. jurisdiction to tax dividends from foreign corporations, Dr. Adams noted that "this has just been the subject of an international conference on the question of double taxation resulting from conflict of jurisdiction." 1921 Hearings at 62.

[18] Graetz and O'Hear at 1070. This was not just a battle between capital exporting and capital importing countries. As Graetz and O'Hear explain, "[t]he British, for example, opposed the Americans on interest and dividends, calling for taxation exclusively by the recipient nation." *Id.* (*citing* Committee on Double Taxation of the International

Nations would not agree to the first model tax treaty to allocate taxing rights between countries until 1928. Thus, in 1921, as the United States struggled with its own sourcing rules and advocated at the Chamber and later the League of Nations for countries to work together toward global consensus, Congress was on notice that countries had legitimate disagreements regarding fundamental sourcing questions and that competing claims to tax the same income existed.

Considering this history, the notion that the term "income taxes" in the 1918 Act should be interpreted to encapsulate international norms regarding taxing jurisdiction seems patently wrong. The only concern regarding jurisdiction to tax discussed in the legislative history that accompanied the 1918 and 1921 Acts is the discussion in 1921 of the need to amend the law to preserve primary taxing rights over U.S. source income. Although the 1919 restriction that limited FTCs to taxes imposed by a country on income derived therein presumably was intended to preserve U.S. taxing rights over U.S.-source income, it did not work in the case of high-tax countries. With this issue resolved in 1921 through the innovation of the FTC limitation, Congress deliberately struck the language that limited creditable taxes to those imposed by a foreign country on income derived therein. We have highlighted legislative history dating back to the 1918 and 1921 Acts because the provision being interpreted by the 2020 FTC proposed regulations was enacted in 1919, with the only relevant subsequent amendment being the 1921 repeal of a jurisdictional nexus requirement. Set in this context, we believe a court's interpretation of the term "income tax" would be highly influenced by that legislative history.

The plain meaning of "income tax" does not incorporate a jurisdictional nexus requirement

In addition to the legislative history and historical context, requiring a jurisdictional basis for imposing tax is contrary to the plain meaning of the term "income tax." Not surprisingly, "income tax" is generally defined as any tax imposed on net income, indicating that one need only evaluate the measurement base for a tax without regard to the jurisdictional justification for its imposition.[19] Although the Supreme Court in *Biddle*, a technical taxpayer case, noted in passing that the reference to an "income tax" in the FTC provisions refers to an income tax "in the U.S. sense," the *Biddle* court gave no indication that it had in mind the U.S. nexus rules.[20] Thus, the dicta in *Biddle* cannot be described as blessing the new imposition of a jurisdictional nexus requirement. We are not aware of any court taking a contrary view.

Since rejecting the jurisdictional nexus requirement, Congress has focused on the FTC limitation to advance the objectives of mitigating double taxation while preserving U.S. taxing rights

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Chamber of Commerce, Observations of the American and British National Committees with Regard to Resolutions Presented at the Rome Congress by the International Chamber's Select Committee on Double Taxation (Aug. 29, 1923) (*available in* T.S. Adams Papers, Yale University, Box 12, 1923-1924 folder), at 2-3).

[19] As just a few examples:

- "A tax on an individual's or entity's net income." *Income Tax*, BLACK'S LAW DICTIONARY (11th ed. 2019).
- "A tax on the net income of an individual or a business." *Income Tax*, MERRIAM-WEBSTER ONLINE DICTIONARY, https://www.merriam-webster.com/dictionary/income%20tax (last visited Jan. 14, 2021).
- "A tax based on income, gross or net." *Income Tax*, BALLENTINE'S LAW DICTIONARY (3d ed. 1969).
- "Tax levied by a government directly on income, especially an annual tax on personal income." *Income Tax*, LEXICO.COM, OXFORD UNIVERSITY PRESS, https://www.lexico.com/en/definition/income_tax (last visited Jan. 14, 2021).

[20] *See Biddle v. Commissioner*, 302 U.S. 573, 578-79 (1938).

Since Congress eliminated the jurisdictional nexus requirement in 1921, congressional debate regarding the competing goals of mitigating double taxation while policing jurisdiction to tax has centered on the FTC limitation and protecting *U.S.* taxing rights. That is, in 1921 Congress rejected a rule focused on whether the foreign country had jurisdiction to tax the income in favor of a different jurisdictional focus—protecting the United States' primary right to tax U.S.-source income, and on occasion, the U.S. right to impose residual tax on low-taxed income.

As described below, Congress has gone back and forth on the ability to credit taxes imposed by one country against income that is sourced in another country, or the effect of losses in one country on the ability to claim credits on income sourced in another country, but this debate has been within the confines of the FTC limitation:

- From 1921 until 1932, Congress allowed taxpayers to compute the FTC limitation on an "overall" basis. That is, they could consider all foreign source income and losses when computing the limitation.
- From 1932 until 1954, taxpayers computed the FTC limitation using the overall limitation or a per-country limitation, whichever was less. As a practical matter, the overall limitation was operative under this lesser-of-approach only when a taxpayer earned income in one country and incurred a loss in another; in this situation the overall limitation was needed to protect the U.S.'s primary taxing right with respect to U.S. source income. The per-country limitation provided that "the credit for taxes paid to any country should not exceed the same proportion of the tax as the income *from that country* bears to the total income."[21]
- Apart from the FTC limitation, in 1942, Congress enacted the predecessor to section 903 to provide that the term "income, war profits, and excess profits taxes" includes a "tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed," partly in response to post-*Biddle* cases denying section 901 credits for taxes on gross income.
- In 1954, Congress eliminated the overall limitation, requiring only the per-country limitation.[22]
- Beginning in 1962, Congress allowed taxpayers to elect either a per-country or an overall limitation.[23] However, certain low-taxed, mobile income was subject to a separate country-by-country limitation to prevent cross-crediting with respect to this income.[24]
- In 1976, Congress eliminated the per-country limitation.[25]
- From 1976 through 2017, taxpayers generally could cross credit among all their active business income. Although the 1986 Act expanded the number of separate limitation categories, that expansion had a relatively limited effect on non-financial services companies, and most of the new categories were repealed in 2004.
- In 2017, Congress repealed deferral and enacted what is in effect a narrow participation exemption, while preserving much of the worldwide tax system through the new GILTI regime for most income earned through foreign subsidiaries that is not taxed under the subpart F and effectively connected income regimes. Congress also expanded the separate limitation categories to include foreign

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[21] Report-Ways and Means Committee, (72d Cong., 1st Sess., H. Rept. 708) (emphasis added).

[22] "The effect of the limitation is unfortunate because it discourages a company operating profitably in one foreign country from going into another country where it may expect to operate at a loss for a few years. Consequently your committee has removed the overall limitation." House Report 83-1337 (Mar. 9, 1954), p. 77.

[23] 43 Pub. L. No. 87-834, § 10(a), 76 Stat. 960, 1002-03.

[24] S. Rep. No. 87-1881, at 72 (1962).

[25] Pub. L. No. 94-455, 90 Stat. 1520.

branch income and GILTI inclusions, but continued to allow geographic cross crediting within each separate limitation category. With the repeal of deferral, U.S. companies are more dependent than ever on the foreign tax credit to mitigate double taxation in order to compete abroad with foreign-parented companies.

The definition of "income tax" should be construed broadly, consistent with the goal of mitigating double taxation and the term's plain meaning

As discussed above, the legislative history indicates that Congress enacted the FTC because it believed American prosperity depended on the competitiveness of U.S. companies operating abroad and that double taxation would unfairly impede this competitiveness.[26] Although Congress could have addressed this concern in 1919 by providing an exemption system for foreign earnings, it chose instead to preserve U.S. residual taxing rights with respect to the foreign earnings of U.S. persons to the extent the income is taxed abroad at lower rates. More recently, Congress largely preserved this policy choice by enacting the GILTI regime.

Congress enacted the FTC, as reflected in the statutory language in place since 1921, to ensure that this preservation of worldwide taxing rights did not cause the foreign earnings of U.S. persons to be double taxed. The definition of "income tax" should be construed broadly, consistent with that goal and the term's plain meaning. Double taxation plainly can exist whenever the United States imposes tax on earnings that were subject to another country's tax, regardless of the other country's jurisdictional basis for the tax.

By repealing the jurisdictional nexus requirement in 1921, and then again when the later-enacted per-country limitation was carved back and eliminated in 1962 and 1976, respectively, Congress has in effect relinquished U.S. residual taxing rights in situations where the aggregate foreign tax imposed on all foreign source income in the separate limitation category exceeds the tentative U.S. tax on that income. That is, since 1976 (and in many cases, since 1962), taxpayers have been allowed to credit taxes imposed on income derived in one country (including the United States) against the residual U.S. tax imposed on income derived in a low-tax foreign country. Congress has acknowledged that this aspect of the overall limitation is consistent with the integrated nature of a multinational's operations.[27] In its General Explanation of the Tax Reform Act of 1986, the Joint Committee on Taxation noted that "it is frequently appropriate to allow cross-crediting of taxes paid by one unit of a worldwide business against income earned by another unit of that business."[28] Obviously, the integrated nature of a multinational's operations in 1962 pales in comparison to the disaggregated nature of today's supply chains, which has understandably made it more difficult for countries to agree on the assignment of income and taxing rights to the underlying activities.

Thus, Congress intentionally repealed the jurisdictional nexus requirement and eventually settled on an overall limitation on FTCs that allows cross-crediting across geographies. Interpreting the broad term "income tax," contrary to a natural reading, to include an implicit nexus requirement would directly contradict that Congressional intent by creating the potential for double tax whenever the foreign

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[26] *See supra* n.5.

[27] *See* S. Rep. No. 99-313, at 302-03 (1986).

[28] Staff of Joint Comm. on Taxation, 100th Cong., General Explanation of the Tax Reform Act of 1986, at 867 (Comm. Print 1987).

earnings of a U.S. company are (according to the United States) sourced in one country but subject to tax by another country. This situation regularly arises outside the context of the "novel extraterritorial taxes" that prompted the 2020 FTC proposed regulations, and surely occurred even more frequently in 1921, before the taxing rights with respect to such fundamental categories of income as dividends and interest had been agreed upon even among developed nations. That is, there currently is not and there never has been complete consensus on the allocation of taxing rights among nations, which can lead to double taxation absent relief.

Extraterritorial and divergent taxing rights are an inherent part of a global international tax system that require double taxation relief

Extraterritorial revenue assertions are not a new phenomenon. In 1934, Congress enacted section 891, which provides for a doubling of the U.S. tax rates on citizens and corporations of a foreign country if the President finds that "citizens or corporations of the United States are being subjected to discriminatory or *extraterritorial* taxes" under the laws of such country (emphasis added). This "reprisal tax" was enacted in direct response to a French law that required any company operating in France to pay tax on the profits earned by a parent company and all its subsidiaries around the world, purportedly to discourage profit shifting by French subsidiaries of foreign companies.[29] Apropos of current times, some commentators cautioned Congress to take a more conciliatory approach:

> The [Washington] Post suggested that the right approach was through bilateral and multilateral agreements. France's failure to ratify the 1932 treaty was a problem, but the paper urged American lawmakers to keep working for cooperative agreements, citing in particular a recent draft agreement from the League of Nations that tried to deal with double taxation in a systematic way. "Congress should be endeavoring to secure adherence to some comprehensive agreement of this sort instead of antagonizing other nations by its habitual method of threatening other countries," the editors wrote.[30]

Although the 1934 passage of section 891 is credited with persuading France to rescind its extraterritorial tax, the United States generally has sought to address differing views of taxing rights through bilateral treaties and multilateral engagement. Even the current model tax treaties, however, differ in their allocation of taxing rights. The current OECD Model, which builds off the League of Nations Model, was developed to facilitate the negotiation of tax treaties between developed nations.[31] In contrast, the United Nations (UN) Model was developed to facilitate the negotiation of tax treaties

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[29] France estimated the potential assessments under the tax at $122,650,000, and one company estimated the administrative burden of compliance at $70,000 (all in 1934 dollars). Thorndike, *Tax History: Threats, Leverage, and the Early Success of Reprisal Taxes*, TAX NOTES, Mar. 21, 2016 [hereinafter "Thorndike"] (*citing* THE NEW YORK TIMES, Dec. 15, 1933, at 5). As originally proposed, section 891 only explicitly addressed discriminatory taxes, but after the International Chamber of Commerce urged senators to "take steps to protect our enterprises from the imposition of taxes by foreign countries which are either discriminatory or extraterritorial in character," the Senate amended the text to clarify that extraterritorial taxes, as well as discriminatory taxes, could trigger the penalty rates. Thorndike (*citing* Hearings before the Senate Finance Committee, Revenue Act of 1934, 73d Cong., 2d session (1934), at 220). *Id.*

[30] Thorndike (*citing International Tax Reprisals,* THE WASHINGTON POST (1923-1954), Feb. 1, 1934, at 8.

[31] Donald. R. Whittaker, *An Examination of the O.E.C.D. and U.N. Model Tax Treaties: History, Provisions and Application to U.S. Foreign Policy*, 8 N.C.J INT'L L. & COM. REG. 39 (Winter 1982), at 44.

between developed and developing nations that would preserve more primary taxing rights to the country of source (as defined in the treaty).[32]

Differing views regarding the allocation of taxing rights between developed and developing countries result in a number of recurring situations where one country imposes tax on income that U.S. law would source to another jurisdiction. This could arise, for example, if a CFC sells stock in another CFC or disregarded entity and the target company is resident in a jurisdiction that imposes capital gains tax on the alienation of shares of a resident company by nonresidents. Another example is a CFC that provides technical services that are subject to withholding in the recipient's jurisdiction regardless of where they are rendered.[33] In either case, if the United States denies an FTC and fully taxes the income, that income would be subject to a double tax that a foreign competitor based in a country with a participation exemption would not suffer. Why should the United States impose double tax by denying a credit because, for example, two countries do not have a tax treaty in place, or the tax treaty is based on the UN Model rather than the OECD Model, thereby disfavoring less developed countries? As another example of how developing countries' tax laws might diverge from U.S. notions of international norms, the OECD, the World Bank, and other international organizations are exploring transfer pricing simplifications for developing countries, including safe harbors.[34] If the simplifications are considered non-arm's length, the 2020 FTC proposed regulations could cause U.S. companies that invest in those countries to be subject to double tax. Why should companies with operations concentrated in less developed countries suffer more double tax?

Other examples of conflicting assertions of taxing jurisdiction outside the context of "novel extraterritorial taxes" arise when countries do not agree on how to characterize a particular transaction. For example, Treasury has acknowledged the need for guidance on the classification and sourcing of income from cloud computing transactions, yet the 2019 proposed cloud regulations address only classification and not the source of cloud computing income, leaving the U.S. sourcing of cloud computing income uncertain.[35] Given the lack of U.S. guidance, it is not surprising that there is no international consensus on the classification and sourcing of income from cloud computing, a significant and growing sector of the U.S. economy. The proposed cloud regulations did, however, include one new sourcing rule, a *destination-based* rule that would deem an electronic sale of digital content to occur at the location of download or installation onto the end-user's device for purposes of applying the title passage rule for sales of digital content that is not produced by the taxpayer.[36] It is strange to think that evolving U.S. guidance on the character and source of cloud computing transactions and other transactions involving digital content could affect the availability of an FTC for foreign taxes imposed thereon apart from the application of the FTC limitation under section 904.

More recently, the prevalence of IP, the Internet, and the ability to make remote sales of products and services has led even some highly developed countries to argue that the traditional rules for allocating profits among countries are outmoded. These difficulties have contributed to a breakdown in the

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[32] *Id.* at 44-46.

[33] This issue is not limited to countries following the UN Model. Until the recently ratified protocol, the 1990 U.S.-Spain treaty allowed Spain, a founding member of the OECD, to tax technical services rendered outside of Spain.

[34] *See, e.g.,* OECD (2010a) TP Guidelines, nos. 4.93 et seq. and nos. 4.123 et seq. (APA) and the World Bank's Platform for Collaboration on Tax.

[35] *See, for e.g.,* Ryan Finley, *ABA Section of Taxation Meeting: Cloud Computing Regulations Will Address Character, Not Source*, TAX NOTES, Feb. 8, 2016, at 667.

[36] *See* Prop. Treas. Reg. section 1.861-18(f)(2)(ii) (2019).

consensus among formerly like-minded countries and prompted some such countries to develop "novel extraterritorial taxes" that diverge from traditional norms of taxing jurisdiction. The preamble to the 2020 FTC proposed regulations cites this development as the impetus for the proposed jurisdictional nexus requirement. That these taxes break with traditional sourcing norms, or in some cases appear to unfairly target U.S. companies, however, does not make U.S. companies any less reliant on the FTC to avoid double taxation on foreign earnings that otherwise will impair their ability to compete with companies headquartered in jurisdictions with a robust participation exemption.

In public comments, the government has raised an interesting thought experiment regarding taxes that have no nexus whatsoever to a jurisdiction. We agree that the imposition of a so-called "tax" on a business that has no connection whatsoever to a jurisdiction is not a tax because there could be no legitimate basis for the government to assert its taxing authority over a person that does not access the jurisdiction. We think this issue is a red herring, however, as we are aware of no such "taxes."

In contrast, an assertion of market-based taxing rights cannot be said to have no connection to a jurisdiction. In addition to Congress's own recent consideration of alternative destination-based approaches to the U.S. corporate income tax, the current OECD Pillar One discussions demonstrate that there is a legitimate debate underway about destination-based taxing rights. Regardless of which side of that debate one takes, destination-based *income* taxes are still income taxes.

To suggest otherwise would mean that most state corporate income taxes could fail to be "income taxes" in the U.S. sense. Nearly all states that impose a corporate income tax begin the computation of state taxable income with federal taxable income as determined under some variant of the Code. Decades ago, states generally determined the portion of a taxpayer's total taxable income subject to their corporate income tax based on a combination of a taxpayer's relative property, payroll, and sales in the taxing state (i.e., apportionment factors). Now, however, over half the states with a corporate income tax determine the portion of income subject to those taxes based solely on a single factor: the corporation's relative sales into the state. The number of states using a single sales factor to apportion income continues to increase nearly every year. Also, the threshold connection required for a state to impose a corporate income tax has shifted from one based on a physical connection with, or presence in, the state to merely having customers located in the state (so called "economic nexus"). Should other countries deny a foreign tax credit for otherwise eligible state corporate income taxes simply because the states rely on sales-based apportionment factors to source income and a market-based jurisdictional nexus standard? Such an approach would seem severely out of step with a policy designed to minimize instances of double taxation, especially considering the income subject to state corporate income taxes is based in significant respects on the taxpayer's taxable income determined under the Code.

Finally, the notion that foreign "income taxes" should be construed broadly to mitigate double taxation without undue focus on the similarity to U.S. rules is reinforced by the existence of section 904(d)(2)(H)(i), which provides a rule for basketing foreign tax imposed by a foreign country "on an amount that does not constitute income under [U.S.] tax principles." This provision illustrates that Congress has explicitly considered that foreign taxes imposed on amounts that literally do not constitute income for U.S. tax purposes may still be considered income taxes that must be assigned to a section 904 separate limitation category. Similarly, several courts have allowed an FTC when the foreign tax was imposed on amounts either fully or partially exempt from U.S. income taxation.[37] One such court has stated that "[e]xact congruence between the foreign tax statute and American tax law is not necessary to establish that a tax is an 'income tax.'"[38]

The 2020 FTC proposed regulations would create a new, expanded role for tax treaties, but potentially leave CFCs out in the cold

The preamble states that "the proposed regulations, when finalized, would not affect the application of existing income tax treaties to which the United States is a party with respect to covered taxes (including any specifically identified taxes) that are creditable under the treaty." In fact, under the proposed rules, tax treaties are the *only* mechanism to recognize that a legitimate taxing right can exist that warrants relief from double taxation despite differing from the nexus rules set forth in the Internal Revenue Code. Significantly, the deference to tax treaties is discussed only in the preamble to the proposed regulations; in the event the proposed regulations are finalized, this deference should be incorporated explicitly into the regulatory text.

Recognizing that other countries have legitimate claims to taxing jurisdiction that differ from the Code and U.S. Model Tax Treaty, the U.S. approaches treaty negotiations with non-OECD countries expecting to compromise, such that one can see traces of both the UN and OECD Models in the resulting treaty. Several U.S. treaties concede taxing rights (and an associated U.S. obligation to relieve double taxation, including through resourcing provisions) to the treaty partner with respect to income that would not be sourced therein under U.S. source rules, such as with respect to technical services performed abroad or a nonresident's gain on the alienation of shares in a resident company. Such concessions involve explicitly treating such taxes as taxes on income for purposes of the relevant tax treaty. However, the U.S. tax treaty network is relatively small (around 60 treaties covering 68 countries), especially as compared to trading partners like the UK and the Netherlands. Thus, it is unrealistic to rely on tax treaties as the sole mechanism for identifying legitimate assertions of taxing rights that differ from the current U.S. rules.

In particular, a number of South American, African, and Asian countries impose withholding tax on technical services without regard to where the services are performed, and these countries generally seek to preserve this taxing right in their treaties. As noted, the UN Model recognizes a "source-based" taxing right in a jurisdiction that benefits from the receipt of technical services performed abroad, and the United States has recognized the legitimacy of such claims to taxing jurisdiction by conceding them in certain tax treaties, though its general policy is for such countries to surrender those taxing rights in treaty negotiations. The U.S. treaty network is particularly sparse in South America and Africa, however.

Negotiating tax treaties is an extremely laborious process. Due in part to resource constraints, it has never been the practice of Treasury to negotiate a tax treaty with every trading partner whose tax system differs from that of the United States. To the contrary, in deciding how to deploy scare negotiating resources, the United States considers the level of trade and investment between the countries, with the result that the United States historically has declined to negotiate a tax treaty with

[37] *See Helvering v. Campbell*, 139 F.2d 865 (4th Cir. 1948); *Dexter v. Commissioner*, 47 B.T.A. 285 (1948), appeal dismissed per curiam 32 AFTR 1642; *Schering Corp. v. Commissioner*, 69 T.C. 579 (1978); *but see Wilson v. Commissioner*, 7 T.C. 1469 (1946).

[38] *Schering*, 69 T.C. at 592 (allowing a section 901 credit for Swiss withholding tax imposed on a foreign law dividend that was regarded as a principal repayment for U.S. purposes).

many smaller economies, including developing countries. The United States often responds to requests by smaller economies that the U.S.'s generous foreign tax credit mitigates any double taxation caused by overlapping taxing rights. Other barriers also can prevent the United States from concluding a tax treaty, such as the U.S policy on information exchange or tax sparing agreements, as well as the status of diplomatic relations (consider, for example, Taiwan).

It does not seem equitable for Treasury to maintain these lines if the proposed jurisdictional nexus rule is finalized such that a tax treaty is the *only* way to mitigate double taxation for U.S. companies operating in jurisdictions with different nexus rules. Why should a U.S. company suffer double tax when it sells technical services to customers in Angola, Brazil, or Colombia, countries with which the United States does not have a treaty, but not to customers in India, with which there is a U.S. treaty? For all these reasons, Treasury historically disfavored the codification of policies that would provide preferential treatment to countries that have a tax treaty with the United States.

Because CFCs are not U.S. residents, they generally do not benefit directly from U.S. treaties. Thus, any taxes they pay on foreign-to-foreign payments generally would not be creditable *under a U.S. tax treaty*. Does this mean that a foreign tax might not be creditable when accrued by a CFC, but could be creditable as a covered tax if owed directly by a U.S. taxpayer to a treaty partner? In this context, the United States clearly has acknowledged the legitimacy of the "source" country's claim to a taxing right, even though it conflicts with the traditional *domestic* source rule. Yet, the 2020 FTC proposed regulations reflect a determination that the U.S. parent of the CFC has no legitimate claim for relief from double tax when the same income is earned through a CFC? Alternatively, if the "source" country conceded its taxing rights in its treaty with the United States, should CFCs be left to owe double tax because they are resident in a jurisdiction that either negotiated different terms or has no treaty with the "source" country?

Determining whether foreign sourcing rules are "reasonably similar" to U.S. sourcing rules would be complex and result in significant uncertainty, inconsistent outcomes, and protracted controversies

Our sourcing and taxable presence rules are not sufficiently defined for this amplified role. As in 1921, taxpayers and the IRS continue to struggle with the proper sourcing of income in a myriad of circumstances, and these difficult questions are further confounded by increasingly difficult questions regarding the character of income in the context of the digitalization of the economy.

The economic analysis section of the preamble notes that, for business profits, an approach based on the U.S. rules defining effectively connected income was rejected because that standard has developed in case law and is not strictly delineated. However, difficult sourcing issues for royalties and services are similarly addressed only in case law that is not well-developed and reaches inconsistent holdings on significant issues. For example, it will be extremely difficult to apply the sparse and inconsistent U.S. case law on royalty sourcing to determine whether another jurisdiction's rules for sourcing royalties are reasonably similar to the U.S. sourcing rules for royalties. Moreover, our own nexus rules have historically reflected other domestic policies in addition to jurisdiction to tax, including administrative simplifications such as the title passage rule and incentives for certain activities such as former section 863(b). Why should the United States refuse to mitigate the double taxation of U.S. companies because another country balances these competing policies differently for a particular category of income?

As under prior law, Prop. Treas. Reg. section 1.901-2(a)(1)(i) provides that a foreign tax either is or is not a foreign income tax, in its entirety, for all persons subject to the foreign tax. Thus, the proposed rules would require taxpayers to evaluate each separate levy in the abstract, rather than as applied to the taxpayer's specific facts. Determining whether a particular levy as a whole is reasonably similar to U.S. nexus rules may be especially challenging, because the levy may be similar as applied to some facts but not as applied to others, and the degree of similarity required is entirely unclear. In addition, Prop. Treas. Reg. section 1.901-2(d)(1)(iii) provides that a withholding tax on gross income of nonresidents is treated as a separate levy with respect to each class of gross income (as listed in section 61) to which it applies, so this determination will need to be made separately for compensation for services, business profits, gains from dealings in property, interest, rents, royalties, and dividends, among others.

For example, assume Country X imposes a withholding tax on services that applies both to fees paid for services performed in Country X (Case 1), as well as to technical service fees paid by a recipient in Country X regardless of where the services are rendered (Case 2). Under the proposed rules, a taxpayer that is subject to withholding for performing services in Country X (and thus is entirely unaffected by Case 2), would need to determine whether Country X's sourcing rules for services as a whole, taking into account their application to both Case 1 and Case 2, are reasonably similar to the U.S. rules for sourcing services. In considering this question, does it matter how important technical services are vis a vis the Country X economy? Could the expansion of technical services cause a withholding tax that previously was creditable to no longer be creditable? Even if Case 2 is a significant part of Country X's services economy, does it make any sense for Country X's assertion of taxing rights over technical services to taint the creditability of fees that artists and athletes earn from performing in Country X? There is no reason for them to even be aware of how Country X sources technical services.

Would the result be different if instead of applying its withholding tax for service fees to Case 2, Country X characterized technical service fees as royalties? In that case would the artists and athletes FTCs be restored, but now we would need to evaluate the magnitude of the technical services relative to the scope of "real" royalty flows to determine if true licensors lose their credits? Could other disagreements about character cause the withholding tax on royalties to be disqualified, if the effect of the disagreement caused significant amounts of payments for U.S. source services or sales to be characterized as royalties subject to Country X withholding tax? For example, what if Country X subjects all sales of copies of software to the withholding tax on royalties? Are taxpayers required to evaluate separately an application of royalty withholding tax as it applies to shrink-wrapped software because that is a withholding tax on business profits (as viewed from the U.S. perspective)?

Summary and recommendation

We do not believe the policy reflected in the proposed jurisdictional nexus requirement should be pursued. The plain meaning of the term "income tax" refers to the measurement of the base and not the jurisdictional justification for imposing a tax. In fact, when that term was first adopted in the 1918 Act, the allowance of a foreign tax credit for "income, war profits, and excess profits taxes" was expressly limited to taxes imposed by a foreign country "upon income derived from sources therein." In 1921 Congress explicitly replaced that jurisdictional nexus requirement with the predecessor to current section 904 as the better approach to protect U.S. taxing rights with respect to U.S. source income. The context in which Congress enacted these provisions belies any suggestion that Congress intended for the term "income taxes" to lock in U.S. sourcing and nexus rules (which were generally nonexistent in 1919 and certainly did not rise to the level of "established international norms" upon their enactment in 1921) or to make the definition ambulatory to require other countries' nexus laws to evolve with the Internal Revenue Code. This legislative history to the 1918 and 1921 Acts should not be ignored in interpreting current sections 901 and 903 and supports construing "income tax" broadly, consistent with its plain meaning.

There has never been complete consensus on questions of jurisdictional nexus, and extraterritorial revenue grabs are not new; however, they also are not, and never have been, a section 901 (and by extension, section 903) issue. We simply do not see the relevance of so-called "international norms" to the definition of a creditable foreign income tax in section 901 given both the provision's singular motivating purpose of mitigating double taxation and the complete absence of "international norms" when the relevant text came to rest in 1921. Extraterritorial taxes can result in double taxation like any other tax. As was the case in 1921, since 1976 when Congress repealed the last vestige of the per-country limitation, the only relevance of our sourcing rules to the foreign tax credit has been to protect the U.S. right to tax U.S. source income.

That we have returned to a time when even formerly like-minded countries disagree on essential aspects of the allocation of taxing rights does not help to justify imposing double tax on the foreign earnings of U.S. companies. We see no reason the status of a destination-based income tax for U.S. foreign tax credit purposes should change because the U.S. view of the legitimacy of such taxing rights evolves. An implication of the proposed regulations seems to be that a destination-based income tax is only an "income tax" that could cause double tax if the United States reaches a new agreement endorsing such an approach—but until such time there is no double tax if a U.S. company is subject to both a destination-based income tax and U.S. tax on the same foreign earnings. But evolving international norms—or a breakdown therein—have nothing to do with the determination of whether foreign earnings are subject to double tax, though they can certainly increase the incidence thereof.

The U.S. government should not impose double tax on domestic companies because it disagrees with another country's jurisdictional basis for imposing a tax. While we understand the government's frustration with the proliferation of unilateral claims of taxing rights, including by treaty partners through provisions that appear inconsistent with the spirit of the treaty, leadership in the OECD Pillar One and Pillar Two negotiations, as well as treaty negotiations, is the better avenue to address the issue—as opposed to using the mechanism for providing double tax relief to U.S. taxpayers as a tool to influence foreign jurisdictions to change their rules. Indeed, we think it is unlikely that imposing double taxation on U.S. multinationals will be effective in convincing foreign jurisdictions to change their rules.

Moreover, the proposed rules are significantly broader than the novel extraterritorial taxes that motivated them, and would affect many longstanding taxes, especially of less developed countries, hurting the ability of U.S. multinationals to compete abroad and particularly in emerging markets. In addition to the economic burden of double taxation, and in particular with respect to non-OECD countries, we believe the requirement to do a comprehensive comparison of a country's nexus rules to those of the United States for each "separate levy" will impose substantial administrative burdens and uncertainty as to when a deviation in a country's rules "tips the scale." Given the many ways in which such rules could diverge, this uncertainty will undoubtedly result in inconsistent outcomes and numerous, protracted disputes regarding what is "reasonably similar."

The regulatory process is not the appropriate avenue for dealing with such major policy decisions with wide-reaching economic impact on U.S. companies. We do not believe that any version of a jurisdictional nexus requirement is consistent with the legislative history or policy motivating the foreign tax credit of mitigating double taxation on foreign earnings.

Finally, the jurisdictional nexus requirement is proposed to apply to foreign taxes paid or accrued in taxable years that begin on or after the finalization of the regulations. As discussed above, this requirement would deny FTCs for foreign taxes imposed under many longstanding foreign laws, including in particular certain withholding taxes that have applied for many decades. Many current structures would not be sustainable in the event of the significant amounts of double tax that would result, such that taxpayers would be forced to restructure their arrangements. Given the uncertainty regarding the status of the regulations it is not reasonable to expect companies to restructure their operations prior to the finalization. Accordingly, in the event the proposed regulations are finalized, we respectfully request Treasury and the IRS to further delay the effective date to allow taxpayers ample time to assess the impact on their business and adjust their operations accordingly.

Prop. Treas. Reg. section 1.901-2(b) FTC net gain requirement: cumulative tests: realization, gross receipts and cost recovery

The current FTC regulations, finalized in 1983, provide that "a foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements . . . ." Treas. Reg. section 1.901-2(b). The 2020 FTC proposed regulations revise these rules by eliminating the practical guardrails of "normal circumstances" and "predominant character," and providing that "a foreign tax satisfies the net gain requirement only if the tax satisfies the realization, gross receipts, and cost recovery requirements . . . ." Prop. Treas. Reg. section 1.901-2(b)(1). Because the more flexible standard in the current regulations has been in existence for almost four decades, it has been the basis upon which U.S. multinational taxpayers have made long-term decisions to invest and conclude contracts globally. We believe a significant departure from the current regulations will negatively impact taxpayers who have made those investments and structured those operations. USCIB members believe that the 2020 FTC proposed regulations would likely upend existing, legitimate business structures and transactions and should be withdrawn and re-proposed with less radical change and more reliable transition rules.

We encourage Treasury and the IRS to weigh their ambition to simplify the application of the rules against the impact of the proposed rules on double taxation. Weighed against the policy goals behind enactment of sections 901 and 903 of the Internal Revenue Code, we are of the view that the changes in the proposed regulations would subject foreign source income of U.S.-based multinationals to unsustainable double taxation in many circumstances. Even if we were to assume that the stated goals of Treasury and the IRS underpinning the changes in the proposed regulations outweigh or otherwise comport with the statutory goal of mitigating double taxation, we believe that the proposed rules would create significant administrative costs and difficulties. If finalized, these rules would require companies to assess and compare U.S. and foreign tax laws, statutes, regulations, case law, rulings and pronouncements in totality on a real-time basis. Availability of such information in many jurisdictions may prove to be quite problematic. Changes in these rules would need to be evaluated and re-evaluated, resulting in a never-ending cycle of additional costs and administration. As such, we think that the proposed regulations do not result in simplification and clarification as compared to the existing regulatory framework. We note that the IRS would also need to devote significant resources for taxpayer meetings, audits, and potential litigation to address the myriad uncertainties and disputes that would arise with such regulatory changes in the FTC rules.

In addition, because the 2020 FTC proposed regulations require foreign tax rules to effectively mirror U.S. tax rules, they will have the unfortunate impact of placing U.S. multinational companies operating in developing countries at a significant disadvantage compared with foreign competitors operating without either the administrative burdens or double taxation risk (due to participation exemption regimes). International norms and the U.S. tax rules change over time. In some instances, the United States implements an anti-abuse rule before other countries; for example, the conduit financing arrangement rules in Treas. Reg. section 1.881-3. In other instances, international norms move prior to the U.S. tax rules; for example, the OECD's anti-hybrid limitations pre-date section 245A(e). Tax jurisdictions in developing countries often possess limited resources and may implement limitations which do not conform with those in the United States, at any given time, or the OECD. The existence of the United Nations Model Double Taxation Convention reflects this reality. These regulations render U.S. multinationals less competitive against companies headquartered in foreign jurisdictions. If a U.S. multinational company and a Chinese multinational company are both bidding on a multi-year, multi-billion dollar project in a developing country with an income tax which is not creditable, the U.S. company will be at a competitive disadvantage and less able to submit a competitive bid.

Net Gain Requirement

Under the current FTC regulations, in order for a foreign tax to be creditable, the foreign tax must be likely to reach net gain in the normal circumstances in which it applies ("net gain requirement"). Treas. Reg. section 1.901-2(a)(3). A tax is likely to reach net gain in the normal circumstances in which it applies if, and only if, the tax, judged on the basis of its predominant character, meets: (1) the realization test; (2) the gross receipts test; and (3) the net income test. Treas. Reg. section 1.901-2(b). Notably, the 2020 FTC proposed regulations would significantly limit the definition of gross receipts and narrow the scope of what is considered net income.

- **Gross receipts test**

Under the current FTC regulations, a foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of either gross receipts or "gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value" ("alternative gross receipts test"). Treas. Reg. section 1.901-2(b)(3)(i). In the preamble to the 2020 FTC proposed regulations, Treasury and the IRS explain that the alternative gross receipts test "purports to allow for foreign taxes to be imposed on an amount greater than the amount of income actually realized, or the value of the property being taxed, and the Treasury Department and the IRS have determined that such a tax should not be considered to be a tax on income, since it can be imposed on amounts in excess of actual gross receipts." While it is theoretically possible that this may be the result in some cases, it is also important to consider that the alternative gross receipts test requires showing that the method used likely would not produce an amount in excess of fair market value. As a result, the likelihood that the estimated gross receipts would exceed realized income appears slim.

It is not unusual for taxing jurisdictions to implement rules that represent an estimate of gross receipts. In most cases, alternate measures of gross receipts are implemented to avoid compliance difficulties. As an example, under U.S. tax rules, certain lenders are treated as receiving interest at the applicable federal rate (these rates are determined and published by the IRS monthly). Presumably, such rates represent a measure of value for the forgone interest. If a foreign jurisdiction provides a similar rule, which measures gross receipts tied to some other computation intended to approximate fair market value, such receipts should continue to satisfy the gross receipts test. It is also unclear how the proposed rules would apply in situations where the foreign jurisdiction imposes a levy on a combination of actual gross receipts and receipts computed based on some other method. We believe this could be an area of uncertainty and, therefore, encourage Treasury and the IRS to clarify the application of the gross receipts test in this situation. While we encourage Treasury and the IRS to provide more clarity on application of the proposed rules, we generally do not favor the elimination of the alternative gross receipts test because we believe that elimination would create more administrative burden and highly formalistic results. To avoid this result, we encourage Treasury and IRS to retain the current alternative gross receipts test.

- **Net income test**

Under the current FTC regulations, a foreign tax satisfies the net income requirement if the foreign tax is imposed on a base of gross receipts that is reduced by (1) significant costs and expenses (including capital expenditures) attributable, "under reasonable principles" to such receipts or (2) "significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses." Treas. Reg. section 1.901-2(b)(4)(i)(B). The current FTC regulations provide taxpayers some flexibility by allowing cost recovery through alternative allowances. It provides that "a foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses" ("alternative allowance rule"). *Id*. The 2020 FTC proposed regulations significantly depart from these rules by drawing a bright line distinction between a creditable income tax (essentially, limited to income taxes that "conform in essential respects" to U.S. income tax rules) and non-creditable income taxes (essentially, those that do not "conform in essential respects" to U.S. income tax rules). Although we certainly appreciate that rules yielding clear results enhance administrability of the foreign tax credit, we find it difficult to square this line-drawing exercise with the purpose of mitigating double taxation. In fact, we believe these proposed rules (if finalized) will result in double taxation for many taxpayers. This is especially true for U.S. multinationals operating in countries with less sophisticated tax systems since those rules are unlikely to conform in essential respects to U.S. income tax rules. It is also important to note that we believe a portion of the burden of this double taxation will almost certainly fall on American workers in the form of reduced wages, benefits, and jobs. This new burden of double taxation would fall on taxpayers beyond the "digital economy" targeted by Action 1 of the BEPS Project or the global intangible low-taxed income tax of section 951A, enacted as part of the TCJA. It is unclear why changes to long-standing regulations are required. In particular, these changes harm the competitiveness of U.S. multinationals and cover all multinational, including taxpayers operating outside the "digital economy."

Net income test – *per se* list of significant costs and expenses

The 2020 FTC proposed regulations impose several stringent restrictions in order to satisfy the net income test including a list of expenses that are considered *per se* "significant." This *per se* list includes interest, rents, royalties, services, and research and experimentation costs. Under the proposed rules, these costs are considered significant (and a foreign jurisdiction's disallowance of these costs will result in denial of creditability for the underlying foreign taxes) regardless of whether the taxpayer claiming the foreign tax credit actually incurs any of the listed costs. We appreciate that the rationale for adding a *per se* list may be grounded in creating objective rules, but this *per se* list creates complexities. As mentioned above, determining the creditability of foreign income taxes which provide for limitations on deductions requires continued evaluation and re-evaluation of both U.S. and foreign tax rules – imposing new administrative burdens on taxpayers and the IRS. The definition of these expense items and their limitations vary significantly across jurisdictions, depending on economic policies and political climate, among others.

The 2020 FTC proposed regulations appear to provide some relief by permitting some disallowance "if such disallowance is consistent with the types of disallowances required under the Internal Revenue Code." The unfortunate reality is that this consistency standard will result in significant controversy, administrative burden for the IRS, and compliance burden for taxpayers—counter to Treasury and the IRS's stated policy goals for changing the rules. First, it is unclear the degree to which the U.S. and foreign tax rules need to be consistent in order to satisfy this requirement. Second, it is also unclear how taxpayers would apply the consistency standard for temporary changes to U.S. tax rules that are intended to ameliorate certain shorter-term economic or policy concerns (e.g., changes to section 163(j) in the CARES Act). Because the proposed rules do not provide clarity on the application of the consistency standard, the proposed rules, if finalized, would leave serious gaps to be resolved in the ruling or audit processes, or through the courts. The current FTC regulations, which have been in place for almost 40 years, followed decades of controversy surrounding the creditability of foreign taxes. The proposed rules, if finalized, would invite significant uncertainties and undoubtedly many tax controversies.

The proposed changes to the cost-recovery requirement add more complexity, rather than simplicity. We encourage Treasury and the IRS to maintain the current standard. If the current standard is to be changed, Treasury and the IRS should provide some relief by limiting application of the *per se* list to taxpayers who, in fact, incur a significant amount of such costs. A taxpayer should not be subject to double taxation simply because a jurisdiction, for a policy or political reason, decides to (for example) deny deductions for interest expense when such taxpayer incurs $0 interest expense. While this may result in taxpayers operating in the same foreign jurisdiction being treated differently (which may run counter to the all-or-nothing approach taken in Treas. Reg. section 1.901-2(a)(1)), such taxpayers are not incurring the same costs. There has been no disallowance of interest expense with respect to a taxpayer which incurs no interest expense. Such limited deviation does not impact the stated goal of creating unambiguous rules that do not run counter to the broad policy goals. This recommended change to the bright lines drawn in the proposed rules would not require any empirical analysis, would not impose significant administrative or compliance burdens for the government or taxpayers, and would provide the necessary certainty in applying these rules.

Net income test – definition of "significant"

The 2020 FTC proposed regulations also provide that the "significance" of a cost or expense 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." Prop. Treas. Reg. section 1.901-2(b)(4)(i)(B)(2). As Treasury and the IRS recognize, this test, similar to application of the alternative allowance rule (and, to some extent, the alternative gross receipts test), will require an empirical analysis and reliance, among others, on foreign tax return information with respect to persons subject to the foreign tax. In determining whether a cost is significant, Treasury and the IRS require an empirical analysis of information which is not readily available to individual taxpayers. However, Treasury and the IRS have rejected the use of empirical analysis with respect to alternative allowances. There is no clear explanation for this different approach to empirical analysis in the different contexts, and it runs counter to the stated objective of simplicity that is articulated as the rationale for moving away from an empirical analysis.

Treasury appears to reduce the uncertainty in determining whether a cost or expense is significant by including a *per se* list of costs and expenses that are considered significant. This *per se* list, however, will create more controversy and administrative burdens for the government because it is not clear how the consistency standard is applied (see discussion above). To avoid such controversy and burdens, Treasury and the IRS should consider either maintaining the current alternative allowance rule or including a safe harbor that would treat a cost or expense (including a *per se* significant cost or expense) as insignificant if such cost or expense is less than a certain percentage of taxpayer's gross receipts. In this way, any empirical analysis is eliminated. There is support for such a safe harbor approach under the Internal Revenue Code. For example, the base erosion anti-abuse tax under section 59A ("BEAT") only applies to certain taxpayers that have deductions with respect to amounts paid or accrued to foreign related parties that are greater than 3% of their total deductions. Similarly, section 954(b)(3) provides a de minimis rule for certain foreign base company income. While we recognize that this may result in different treatment for taxpayers in the same jurisdiction, a limited exception to the all-or-nothing approach should be acceptable given the stringent lines drawn in the 2020 FTC proposed regulations and is in the interest of sound tax administration and takes into account the purpose behind enactment of the statute of avoiding double taxation.

Net income test – alternative allowances

In addition to severely restricting the cost-recovery requirement, the 2020 FTC proposed regulations also limit the scope of the alternative allowance rule by limiting the use of alternative allowances to cases where the foreign law guarantees that the alternative allowance will equal or exceed the disallowed cost. Treasury and the IRS explain in the preamble to the 2020 FTC proposed regulations that one of the reasons for eliminating the alternative allowance rule in the current regulations is that it "fundamentally diverges from the approach to cost recovery in the Internal Revenue Code." In substance, however, alternative allowances represent an estimate of expenses that may be recovered by a taxpayer operating in a particular jurisdiction in substitution for disallowed expenses. The U.S. tax rules have allowed the use of estimates of expenses in certain circumstances through, for example, application of the *Cohan* rule (a judicial doctrine that goes back to the 1930s). *See Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930). This rule permits courts to "make as close an approximation as it can" to determine a tax benefit (e.g., a deduction) if a taxpayer proves entitlement to a tax benefit but fails to substantiate the amount of the benefit. Further, we believe that the alternative allowance rule is not a divergence but consistent with the recognition that substance, rather than a bright line, should govern in this instance. Additionally, alternative allowances can be found in the Internal Revenue Code for determining the appropriate amount of deductions in certain circumstances. For example, for individual taxpayers, standard deductions can be viewed as a form of alternative allowance. Further, certain safe harbor methods for determining home office deductions may be considered another example where a reasonable estimate is permitted in determining recovery of expenses for tax purposes. We recognize that these examples provide alternative methods for determining deductions; they are not in substitution for disallowed deductions. However, the rationale behind these rules is similar to the rationale of foreign jurisdictions for alternative allowances—reducing administrative burden and controversy while improving certainty.

Another rationale provided in the preamble to the 2020 FTC proposed regulations for eliminating the alternative allowance rule is that it is unduly burdensome. The administrative burdens associated with the alternative allowance rule for the IRS and compliance burdens for taxpayers do not outweigh the burdens of double taxation. The preamble also explains that it "may be impossible as a practical matter, for taxpayers and the IRS to determine whether an alternative allowance under foreign tax law effectively compensates for the nonrecovery of significant costs or expenses attributable to realized gross receipts under that foreign law." This assertion is flawed because the alternative allowance rule is a question of fact rather than a theoretical exercise (similar to application of the substance over form doctrine). Further, taxpayers and the government are more than well-equipped in addressing such questions. See, e.g., Texasgulf, Inc. v. Comm'r, 107 T.C. 51 (1996), aff'd, 172 F. 3d 209 (2d Cir. 1999). In sum, the elimination of the alternative allowance rule would deny creditability for foreign taxes that are in substance and effect an income tax because of formalistic lines drawn in the 2020 FTC proposed regulations. We agree with Treasury Secretary Janet Yellen's response to questions posed as part of her confirmation hearing that "regulatory decisions should be made based on careful consideration of the effects of potential regulatory choices."

Maintaining the net gain requirement in the current FTC regulations limits the harmful effects of double taxation in furtherance of the purpose of section 901 while, at the same time, ensuring that there are appropriate safeguards to avoid crediting non-income taxes. Securing the competitiveness of U.S. companies in the evolving global landscape should be a priority in promulgating rules under section 901. Under the 2020 FTC proposed regulations, U.S. companies will be at a competitive disadvantage compared to foreign competitors in jurisdictions with non-creditable income taxes because most foreign competitors are subject to participation exemptions in their home jurisdiction and, for the few exceptions, we are not aware of any foreign tax credit regime that would require the foreign tax base to be so closely aligned to the home jurisdiction's rules for determining taxable income. Therefore, we request that Treasury withdraw the changes to the alternative allowance rule.

USCIB respectfully requests that Treasury and the IRS withdraw the changes to the net gain requirement in Prop. Treas. Reg. section 1.901-2(b).

Prop. Treas. Reg. section 1.901-2(e) amount of foreign tax that is creditable

Summary of current law and proposed change

The 2020 FTC proposed regulations would deny a foreign tax credit for any portion of a taxpayer's tentative foreign income tax liability that is offset by a tax credit, including a credit that is refundable in cash to the extent it exceeds a taxpayer's foreign income tax liability.[39] This proposed rule would change the current treatment of expenditure-based government incentives (for example, R&D or investment incentives) that do not depend on a taxpayer owing income tax but which, for administrative convenience, are administered through the tax system and provided first as an offset to any income tax otherwise due.

Both federal, state, and foreign governments commonly implement non-tax incentive programs through the tax system for administrative ease, including by requiring the incentive to first offset any income tax due before becoming payable in cash, in order to ease the burden associated with administering the payments. Such regimes typically include refundable tax credits that are determined by reference to the

[39] Prop. Reg. § 1.901-2(e)(2)(ii), 85 Fed. Reg. 72131 (Nov. 12, 2020).

gross amount of qualifying expenditures incurred in a narrowly defined activity, such as R&D or investment in qualifying property (expenditure-based credits). Governments adopt such regimes to incentivize businesses to engage in the subsidized activity in the jurisdiction. The decision to make the credit refundable reflects a policy determination that the incentive should apply equally to businesses that do not owe current tax, for example, due to losses. Because refundable expenditure-based credits do not depend on any measure of net income or tax liability, such incentives are properly viewed as being separate and apart from the income tax system.

In 1983, Treasury and the IRS issued final regulations under section 901 addressing the creditability of foreign taxes. Those regulations include Treas. Reg. section 1.901-2(e)(2)(i), providing that an amount paid to a foreign country is not a tax (and thus cannot be a creditable foreign tax) "to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven." Although the current regulations are silent regarding the specific subject of refundable credits, in administering the rules the IRS has advised that the application of expenditure-based refundable credits to reduce foreign tax does not reduce the amount of foreign income taxes paid for purposes of the foreign tax credit if the refundable credit functions more like a government payment to the taxpayer for engaging in the incentivized activity. For example, in 1989, the IRS issued Technical Advice Memorandum ("TAM") 200146001. The TAM concluded that a French research credit that could be used to offset income tax liability or refunded to the extent the taxpayer did not have sufficient income tax liability available for offset over a period of years was not a credit within the meaning of Treas. Reg. section 1.901-2(e)(2)(i). Because taxpayers received the full amount of the credit, either as an offset against their tax liability or in cash, the IRS determined that the use of the credit as an offset against tax liability should be treated as a means of paying the incentive rather than as a credit against tax liability within the meaning of Treas. Reg. section 1.901-2(e)(2)(i), and consequently, did not reduce the amount of creditable foreign tax.[40]

The 2020 FTC proposed regulations would amend Treas. Reg. section 1.901-2(e)(2) to address perceived uncertainties, including with respect to multiple levies (where one tax may be credited against a second tax) and credits computed by reference to a base other than foreign taxes. To address these concerns, Prop. Treas. Reg. section 1.901-2(e)(2)(ii) would reverse the IRS's longstanding position addressed in the TAM, by providing as follows:

(ii) Credits. Except as provided in paragraph (e)(2)(iii) of this section [overpayment of one tax allowed as a credit against a second tax], an amount of foreign income tax liability is not an amount of foreign income tax paid to the extent the foreign income tax is reduced, satisfied or otherwise offset by a tax credit, regardless of whether the amount of the tax credit is refundable in cash to the extent it exceeds the taxpayer's liability for foreign income tax.

The Preamble to the 2020 FTC proposed regulations explains the reason for the change with respect to refundable credits as follows:

[40] *See also* Rev. Rul. 86-134, 1986-2 C.B. 104 (investment incentive reduced tentative Dutch income tax liability during the period in which the incentive could be claimed only as an offset against the income tax liability, rather than as a refundable credit); General Counsel Memorandum 39617 (Aug. 27, 1986) (concluding that the same Dutch incentive did not reduce tentative Dutch income tax liability during the period when the incentive was a refundable credit).

The Treasury Department and the IRS have determined that the current uncertainty as to how to properly account for tax credits leads to inconsistent interpretations, administrative challenges to assess information, and that a single, clear rule (or "one size fits all" approach) regarding the treatment of tax credits would improve the consistency in outcomes for taxpayers. In addition, the Treasury Department and the IRS are concerned that if the use of tax credits can be treated as a means of payment of a foreign income tax for foreign tax credit purposes, then foreign countries, rather than reducing their tax rates, could instead offer tax credits that would have the same economic effect without reducing the amount of foreign income tax that is treated as paid by taxpayers for purposes of the foreign tax credit. The Treasury Department and the IRS have also determined it is too administratively challenging to determine whether a foreign country whose law provides for nominally refundable credits in practice actually issues cash payments to taxpayers that do not have income tax liabilities equal to the credit.

We believe the current law treatment of refundable expenditure-based credits that are available without regard to a taxpayer's tax liability is sufficiently clear and aligns with the economic substance of such credits as government subsidies that are only administered through the tax system. As explained below, for this same reason, companies generally do not reduce their income tax expense by such credits for financial reporting purposes, and the OECD has proposed a similar rule for purposes of the Base Erosion and Profit Shifting ("BEPS") Pillar Two global anti-base erosion ("GloBE") rules. In addition, for the reasons explained below, we disagree with the concerns expressed in the preamble regarding the current law treatment of refundable credits, and in any event believe such concerns could be addressed through clarifying changes, without resort to a one-size-fits-all rule that ignores economic substance.

Nonconformity with U.S. GAAP and BEPS Pillar Two

The proposed rule would depart from the general treatment of refundable credits for purposes of determining income tax expense under U.S. GAAP. Accounting Standards Codification ("ASC")[41] paragraph 740-10-15-3 states that the Income Taxes Topic applies to "[d]omestic federal (national) income taxes . . . and foreign, state, and local (including franchise) taxes based on income," such that only taxes that are assessed on an income-based measure generally are accounted for under ASC Topic 740 (Income Taxes).[42] Thus, companies generally do not treat refundable tax credits (e.g., where a taxpayer may receive a refund despite being in a taxable loss position) as part of income taxes for financial statement reporting purposes. Consequently, the benefit from the refundable credit generally is not recorded as a reduction to income tax expense, but rather as an adjustment to pre-tax income (e.g., a reduction of R&D expense). Underlying this approach is the understanding that the tax system of the jurisdiction providing the credit serves only as a mechanism for administering the refunds to eligible taxpayers.

The proposed rule also would be inconsistent with the suggested treatment of refundable tax credits for purposes of determining the tax base and covered taxes under the OECD's BEPS Pillar Two GloBE rules. These rules generally provide that refundable tax credits do not reduce covered taxes and are instead

[41] The Financial Accounting Standards Board ("FASB") ASC is the source of authoritative U.S. GAAP recognized by the FASB for nongovernmental entities. *See* FASB Accounting Standards Codification: About the Codification, v.4.10 (Financial Accounting Foundation, 2014) (*available at* https://asc.fasb.org/imageRoot/71/58741171.pdf).
[42] ASC Topic 740 (Income Taxes) provides a methodology to recognize income tax expense for financial reporting under U.S. GAAP by focusing on the differences between the tax bases of assets and liabilities and the carrying amounts of assets and liabilities recognized for financial reporting.

included in the tax base, provided that the credit becomes refundable within four years from when it is first provided. The OECD determined that this approach generally aligns with the financial accounting treatment of government grants versus non-refundable tax credits under IFRS, and, therefore, that such treatment will not require adjustments to the financial statements under the GloBE rules.[43]

The Pillar Two blueprint notes that the appropriate accounting treatment under IFRS for a refundable expenditure-based tax credit is determined based on a qualitative analysis of the legal requirements that must be met in order to get the credit.[44] If realization of the credit does not depend on taxable profit or past or future income tax liability, the OECD determined that it likely would be accounted for under IAS 20 (Government Grants) and recorded in the financial accounts as other income.[45] As such, the OECD's approach is based on the expectation that under IFRS and equivalent accounting standards, any such refundable credits generally are treated as income and accounted for, by analogy, with the requirements of IAS 20, whereas non-refundable tax credits generally are treated as a reduction in tax liability.[46] The term "refundable" for this purpose is construed broadly and covers credits that may become payable in cash or available as cash equivalents, including being available to be used to discharge liabilities other than a covered tax liability.[47] The OECD's rationale for treating such refundable credits in the same way as a grant is that, similar to grants, the taxpayer's entitlement to a refundable tax credit is not tied to its income or income tax liability, and the economic substance of grants and refundable tax credits are equivalent.[48]

Treasury and IRS concerns regarding nominally refundable tax credits

The preamble to the 2020 FTC proposed regulations raises the issue of administrative challenges in determining whether a foreign country whose law provides for nominally refundable credits in practice actually issues more than *de minimis* cash payments to taxpayers whose credits exceed their income tax liabilities.[49] This concern is consistent with the desire expressed throughout the preamble to reduce the need to evaluate how a foreign country administers its laws by shifting the focus to the objective terms of foreign law.

First, the concern about the ability to obtain data regarding the extent of actual refunds does not take into account the sophistication of most countries' computer systems, which should allow countries to furnish data to the IRS regarding the amount of refunds actually paid with respect to a particular refundable credit. Thus, we do not believe the ability to access that data, which is objective in nature, presents the type of administrative difficulties with obtaining empirical evidence that Treasury and the IRS seek to reduce through the proposed regulations.

If, however, the government remains concerned about credits that are refundable in name only, the regulations could be modified to adopt an approach similar to that outlined in the BEPS Pillar Two blueprint discussed above, whereby a credit must become refundable within a specified time period

[43] Tax Challenges Arising from Digitalisation – Report on the Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, para. 239 (OECD Publishing, Paris 2020) (*available at* https://doi.org/10.1787/abb4c3d1-en).
[44] *Id.* at para. 234.
[45] *Id.* at para. 235.
[46] *Id.* at para. 236.
[47] *Id.*
[48] *Id.*
[49] 85 Fed. Reg. 72093 (Nov. 12, 2020).

(e.g., four years) to avoid treatment as an offset to foreign income taxes paid. Such an approach would be consistent with the goal of making the FTC regulations more objective while fully addressing the government's concern regarding nominally refundable credits. Apart from the possibility of unduly long delays, it is not realistic to think that an expenditure-based credit could result in only de minimis refunds, considering the number of taxpayers in taxable loss positions that inevitably make qualifying expenditures. For example, R&D expenditures, which may be the most subsidized expenditure, often contribute to large net operating losses before the related products become marketable, just as loss-making start-up companies can be expected to take advantage of other investment incentives. Thus, we believe that instances in which refundable tax credits are not in fact paid are uncommon and, in any case, can be addressed through a requirement that refunds be issued within a limited period of years, like the Pillar Two approach.

Treasury and IRS concerns regarding the use of refundable credits to achieve an economic effect similar to a reduction in the foreign income tax rate

The preamble to the 2020 FTC proposed regulations also states that Treasury and the IRS are concerned that countries could use tax credits to achieve the economic effect of a reduction in the tax rate without reducing the amount of foreign income tax treated as paid for purposes of the U.S. foreign tax credit. Current law, however, fully addresses this concern by correctly distinguishing between expenditure-based refundable credits that are determined wholly apart from a taxpayer's income tax liability but happen to be administered through the tax system, and other credits that may achieve the effect of a reduction in the foreign income tax rate. That is, to raise the concern expressed in the preamble, the refundable credit would need to apply generally to all taxpayers and bear a relationship to the overall foreign income tax base or the amount of tax paid. The existing rules for subsidies in Treas. Reg. section 1.901-2(e)(3) are targeted at precisely this concern and would require a reduction to the amount of income tax treated as paid for any such credit.

In contrast, an *expenditure*-based credit for engaging in specific activities that is available without regard to whether a business has taxable income cannot be economically equivalent to a general reduction in the tax rate on *income*. Rather than using refundable credits as a backdoor general reduction in rates, governments provide such credits to incentivize all businesses to engage in a particular activity without regard to whether they have current income. We believe current law, as reflected in Treas. Reg. section 1.901-2(e)(3) and administrative interpretations, adequately protects against the concern raised in the preamble because only credits that in fact function like a government payment for engaging in the incentivized activity would qualify for above-the-line treatment. If, however, Treasury and the IRS want more certainty in this regard, the regulations could explicitly limit this treatment to refundable credits that are determined directly by reference to the quantum of gross expenditures incurred in a narrowly defined activity.

It should also be noted that, following the TCJA, most U.S. taxpayers are in an excess credit position with respect to their foreign operations, whether conducted through a foreign branch or a CFC. As a result, we seriously doubt that, even in the absence of Treas. Reg. section 1.901-2(e)(3), another country would engineer refundable credits as a backdoor reduction in general income tax rates with a view to luring general investment by U.S. companies through a foreign tax system that produces inflated foreign tax credits.

Request for comments regarding rules for government grants not administered through the tax system

The preamble to the 2020 FTC proposed regulations requests comments on whether rules should be provided to address government grants that are not administered through the foreign tax system, and the circumstances in which such grants should also be treated as a reduction in the amount of tax paid. We agree with the concern underlying this request that, when taxpayers are eligible for the full amount of an incentive without regard to the amount of their local tax liability, a foreign government's choice to administer payments of the incentive through the tax system for taxpayers that owe tax should not be determinative of the treatment of the incentive for FTC purposes. The request for comments implicitly acknowledges that such a line is arbitrary, but seems to suggest that this arbitrariness might properly be resolved by requiring offsets to a taxpayer's creditable foreign taxes for government grants that are not administered through the tax system. This suggestion seems wholly divorced from the emphasis in other parts of the proposed regulations on ensuring that creditable net income taxes be determined by reference to net gains, and we question whether Treasury and the IRS have the authority to require a reduction in creditable taxes for government subsidies with no connection to the foreign tax system.

The arbitrariness implicitly acknowledged by the comment request should be addressed by treating refundable expenditure-based credits that are determined without regard to local income tax liability in accordance with their substance as government grants whose only relationship to the tax system is as a mechanism for administering the payments. It is indeed wholly arbitrary for a government's decision to administer an incentive through the tax system or for the application of an incentive in a particular case as an offset to a taxpayer's tax liability to be determinative of its treatment. Instead, administration of an incentive through the tax system should be interpreted merely as a means of making payments so that qualifying taxpayers are not treated differently depending on whether they owe local country income tax.

Interaction with the multiple levy rule (Prop. Treas. Reg. section § 1.901-2(e)(4))[50]

The 2020 FTC proposed regulations would clarify the multiple levy rule in Treas. Reg. section 1.901-2(e)(4)(i) and add an example to illustrate the application of Prop. Treas. Reg. sections 1.901-2(e)(2) and (e)(4). In the proposed example, the taxpayer's tentative liability is reduced by (i) a credit for a separate foreign levy that does not qualify as an income tax that was imposed on gross services income and (ii) a credit for charitable contributions that is refundable in cash to the extent it exceeds the foreign income tax liability after applying the credit for the tax on gross services income. The analysis provides that the taxpayer's foreign income tax paid for FTC purposes is reduced by both credits. Neither the facts nor the analysis treats the refundable credit for charitable contributions as a separate levy, and we agree with that characterization.

Similar to a refundable charitable contribution credit, a refundable credit that incentivizes certain business activities should not be treated as a separate levy under the multiple levy rule. Thus, finalization of the proposed multiple levy rule should not affect the treatment of refundable credits. The example, however, should be revised to reflect that, as a refundable expenditure-based credit (whether or not administered through the tax system), the charitable contribution credit is not properly viewed as part of the single levy that includes the normal income tax, but instead is a subsidy for charitable

[50] 85 Fed. Reg. 72135 (Nov. 12, 2020).

contributions that is separate and apart from the foreign income tax system. Accordingly, the charitable contribution credit should not reduce the taxpayer's foreign income tax paid for FTC purposes.

Disadvantage to U.S. companies vs. foreign companies

The proposed rule would disadvantage U.S. companies as compared to their foreign competitors. Under the proposed rule, U.S. companies that receive a benefit from a refundable tax credit that is treated as reducing their creditable foreign income taxes may owe residual U.S. tax (e.g., as a GILTI inclusion) with respect to foreign income earned in a high tax environment, whereas foreign-parented companies generally would not owe residual tax on such income, either because they are parented in the jurisdiction offering the incentive or due to the availability of a participation exemption.

This result is particularly disadvantageous to U.S. technology companies that commonly use foreign acquisitions to augment their technology portfolio. Many of these targets have significant operations in otherwise high-tax jurisdictions that provide R&D incentives through a refundable credit regime (e.g., the UK, the Netherlands, France, and Canada). Consequently, the residual U.S. tax that a U.S. company would owe under the proposed rule would significantly hurt that company's ability to compete with a foreign competitor's offer to acquire a foreign target.

Congress enacted GILTI as a base protection measure because it believed that, in the absence of such a provision, the new participation exemption would incentivize U.S. companies to shift U.S. income to foreign affiliates operating in low-tax jurisdictions.[51] This reasoning is similar to that proffered by the Obama administration for its proposal for a minimum tax on foreign earnings.[52] Both proposals included a reduced rate and an offset for foreign income taxes paid in recognition of the fact that U.S. taxation of the earnings of U.S. companies operating in high tax jurisdictions would hurt their competitive position relative to their foreign counterparts.[53] The availability of a refundable incentive for engaging in certain activities in a jurisdiction does not affect the marginal rate of foreign tax on any income allocated to that jurisdiction because a refundable credit is available without regard to the amount of taxable income. It is contrary to the policy objective of GILTI and our national interest to require U.S. companies to pay double tax on income earned in a high-tax jurisdiction that happens to administer a refundable incentive regime through the tax system.

Today, U.S. multinationals operate through interconnected global supply chains that may cause a change in one country to have a ripple effect across multiple jurisdictions. For example, assume a U.S. multinational engages in R&D activities in Country A, which has a refundable R&D credit, uses the intangible property developed to produce products in Countries A, B, and C, and then sells those products worldwide through sales entities. If creditable foreign taxes in Country A decrease because the proposed regulation is finalized, the increased cost impacts the cost of producing products, which then would need to be recouped by increasing the price charged to sales affiliates and, ultimately, consumers within and outside the U.S. While the pricing adjustments may necessitate new transfer pricing studies within the global supply chain, the additional costs may cause meaningful disruption in the well-

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[51] *See* S. Prt. No. 115-20, Reconciliation Recommendations Pursuant to H. Conf. Res. 71 (2017), *available at* https://www.gpo.gov/fdsys/pkg/CPRT-115SPRT27718/pdf/CPRT-115SPRT27718.pdf [2017 SFC Report], p. 365.

[52] General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (the "Obama Green Book"), p. 20.

[53] 2017 SFC Report, p. 365. The Obama Green Book does not discuss why it structured the minimum tax as a "top-up" tax at a reduced rate, but Administration officials frequently described the decision this way.

established supply chains of U.S. multinationals that have relied on the existing regulations resulting in a competitive disadvantage.

Summary and recommendation

We respectfully request that the IRS and Treasury not finalize Prop. Treas. Reg. section 1.901-2(e)(2)(ii) and instead preserve the longstanding conclusion set out in the IRS's historical administrative guidance, the prevailing interpretation of U.S. GAAP, and the proposed BEPS Pillar Two approach, providing that expenditure-based refundable tax credits should not reduce foreign income taxes for FTC purposes. In all three cases, the adopted approach recognizes that such credits are more appropriately treated as a subsidy for the relevant expenditure that is separate and apart from the foreign tax system.

The preamble to the 2020 FTC proposed regulations does not attempt to provide an economic justification for its departure from these prevailing treatments other than citing to a theoretical and unfounded risk that another country could disguise a general rate reduction as a refundable credit. The existing rules in Treas. Reg. section 1.901-2(e)(3), however, clearly distinguish credits that might be a disguised rate reduction from expenditure-based refundable credits that have no nexus to foreign income tax other than their administration through the tax system.

For the reasons discussed above, changing the IRS's longstanding position that refundable credits do not reduce creditable foreign taxes is not necessary to reduce administrative complexity or prevent foreign countries from adopting tax systems that harm the U.S. Further, such a change would likely place U.S. multinationals at a competitive disadvantage when compared to foreign multinationals making similar investments abroad.

We believe current law's substance-over-form approach to refundable credits that are not in substance part of a foreign levy on net income tax is sufficiently clear. However, if Treasury and the IRS disagree, the regulations could be revised to specifically address refundable credits and create bright-line parameters by restricting the above-the-line treatment to credits that are expenditure-based incentives that become refundable within a set number of years, as under the BEPS Pillar Two approach.

Prop. Treas. Reg. section 1.861-20 allocation and apportionment of foreign income taxes under

Prop. Treas. Reg. section 1.861-20 issues, re-proposes, and expands new rules of allocating and apportioning foreign taxes, and introduces new concepts such as a taxable unit. The Treasury and the IRS requested comments on several new concepts introduced in such proposed regulations. However, Prop. Treas. Reg. section 1.861-20 (other than Prop. Treas. Reg. section 1.861-20(h)) is proposed to apply to taxable years that begin after December 31, 2019 and end on or after November 11, 2020, meaning the 2020 FTC proposed regulations would apply to a 2020 calendar taxable year.

Given the extensive changes made by the 2020 FTC proposed regulations to various important disregarded payment rules, USCIB recommends that the proposed section 1.861-20 regulations be effective for taxable years that begin after the date when the final regulations are filed in the Federal Register.

Among other proposed changes, the 2020 FTC proposed regulations would introduce rules that would be used to allocate and apportion foreign taxes arising with respect to disregarded payments made by reference to the taxable unit (as defined in the regulations)[54]. See Prop. Treas. Reg. section 1.861-20(d)(3)(v)(B). Further, in order to apply these mechanical rules, a taxpayer would first be required to determine its taxable units and reattribution payments under complex new rules that will require taxpayers to perform extensive analysis on foreign taxes paid not only at a CFC level and a qualified business unit ("QBU") level, but also on tested unit levels.

Requiring the taxpayers to perform extensive analysis with respect to foreign taxes paid at a taxable unit level is unduly complex, unnecessary, and burdensome and counter to the congressional intent of the foreign tax credit regime, which is to eliminate (double taxation) burdens of doing business in jurisdictions outside the U.S.

USCIB recommends that the foreign taxes paid should be allocated and apportioned (or assigned) at the QBU level, and the taxes paid by each QBUs should be summed at the CFC owner level.

USCIB members are concerned about the provisions for assigning items of foreign gross income to the statutory and residual groupings in Prop. Treas. Reg. section 1.861-20(d). Specifically, the concern is that the use of tax book value and interest expense apportionment rules to characterize remittances creates unusual results. For example, when a taxable unit is an operating entity that sells to customers, it accumulates cash and accounts receivables ("A/R") throughout the year. The income would be considered general category income upon receipt by the taxable unit. However, when a remittance is made to the controlled foreign corporation ("CFC") owner of the taxable unit, the remittance is not characterized by the type of income earned by the taxable unit. Instead, the rules look to the tax book value of the taxable unit's assets. Many operating entities have few assets besides cash and A/R. Cash and A/R may be considered passive assets for the purposes of interest expense apportionment because they either generate interest income or have no identifiable yield even though they were derived directly from an active trade or business. Use of tax basis for the taxable unit may, therefore, result in unusual apportionment of the remittance between general and passive.

We believe that remittances should be characterized proportionately to the earnings of the taxable unit making the remittance.

Prop. Treas. Reg. section 1.245A(d)-1 disallowance of foreign tax credit or deduction

Treasury requested comments regarding whether taxpayers should, as part of Prop. Treas. Reg. section 1.861-20(d), maintain separate E&P accounts with annual adjustments to reflect transactions that occurred under foreign law but not under Federal income tax law. Taxpayers are currently required to demonstrate the availability of foreign tax credits. USCIB members do not believe that additional tracking and reporting is required for purposes of ensuring compliance with section 245A(d). The associated compliance burden is disproportionate to the scope of any potential issue, especially in light of the anti-abuse rule contained in Prop. Treas. Reg. section 1.245A(d)-1.

Prop. Treas. Reg. section 1.903-1(c) substitution requirement: existence of generally imposed net income tax, non-duplication, close connection to excluded income, jurisdiction to tax excluded income

[54] We note that the concept of a "taxable unit" is similar to the "tested unit" concept introduced in the high-taxed income exclusion ("HTE") regulations under section 951A in September 2020.

Section 903 provides that the term income taxes include "a tax paid in lieu of a tax on income . . . otherwise generally imposed by any foreign country . . . ." The current FTC regulations provide that a foreign tax is a substitute for a generally imposed income tax if, in fact, it operates "in substitution for, and not in addition to" the foreign country's income tax. Treas. Reg. section 1.903-1(b)(1). The 2020 FTC proposed regulations created a new four-part substitution test for a tested foreign tax to meet the "in lieu of" requirement. Prop. Treas. Reg. section 1.903-1(c)(1). First, under the proposed rules, a separate levy that is a foreign income tax meeting the requirements under the stringent section 901 proposed regulations must be generally imposed by the same foreign country. Second, neither this generally imposed income tax nor any other foreign income tax is imposed "on any persons" with respect to "any portion of the income" that form the basis of the tested foreign tax ("excluded income"). Third, "but for" the existence of the tested foreign tax, the Excluded Income would be subject to tax under the generally imposed net income tax. Fourth, if the generally imposed net income tax were applied to the Excluded Income, the generally imposed net income tax would either continue to qualify as a net income tax under Prop. Treas. Reg. section 1.901-2(a)(3) or would constitute a separate levy that would so qualify. Similar to the harmful line-drawing exercise in the proposed changes to the net gain requirement in Prop. Treas. Reg. section 1.901-2, these changes reflect a significant departure from the current rules that will have significant impact on creditability of taxes as an "in lieu of" tax under section 903.

Because the generally imposed net income tax must satisfy the test for creditability under Prop. Treas. Reg. section 1.901-2(a)(3) (a more restrictive, proposed test for creditability), the substitution requirement would not be met for any foreign tax potentially creditable under section 903 imposed in a jurisdiction in which the generally imposed income tax provides for limitations on, for example, the deductibility of interest in a manner which is not consistent with the Code. This would set a very high new bar in evaluating another country's in lieu of tax. As explained in our comment above, we have grave concerns that the new, formalistic rules under the proposed net gain requirement will, in many occasions, subject many taxpayers to double taxation. In the case of a foreign tax potentially creditable under section 903, the imposition of double taxation is even more inappropriate. Perceived shortcomings in a foreign income tax which the taxpayer is not paying could result in such taxpayer being subject to double taxation. While obtaining simplicity and certainty in applying the rules are important goals, we encourage Treasury and the IRS to weigh such goals against the detrimental effects of the proposed changes. Together, we believe that the proposed amendments to the section 901 and 903 regulations could result in jurisdictions with no creditable foreign income taxes, thereby limiting the competitiveness of U.S. multinationals relative to their global competitors.

Prop. Treas. Reg. section 1.904-4(e) separate application of section 904 with respect to certain categories of income

The 2020 FTC proposed regulations would introduce a new requirement in Prop. Treas. Reg. section 1.904-4(e) that income be earned only from unrelated customers to be treated as qualifying income. We are concerned that companies that maintain treasury centers[55] that lend to related parties and enter into hedging transactions with related and unrelated parties to manage foreign exchange or interest rate risk on an overall group basis would fail to qualify under the revised definitions in most cases. Although the income of these entities is from legitimate, bona fide risk management activities on behalf of the group, it would be treated as passive basket income. In addition, taxpayers would be unable to use prior year treasury center losses to reduce current year treasury center income under the

[55] "Treasury center" as defined in Prop. Treas. Reg. section 1.1471-5(e)(5)(i)(D).

qualified deficit rules, introducing volatility and resulting in double taxation in many fact patterns without an identifiable policy reason.

We respectfully urge Treasury to reconsider these proposed changes and either retain current law definitions or revise the definitions to provide that entities such as those that operate as treasury centers for a group of related companies be permitted to treat related party income (i.e., from lending or hedging activities) as qualifying financial services income. In addition, we respectfully urge Treasury to permit taxpayers to rely on current-law definitions with respect to any pre-existing attributes such as qualified deficits that were generated in the years before the definition change, so that future income that could be offset with a qualified deficit under the current, long-standing regulations can continue to be offset (as if there were no definition change).

Prop. Treas. Reg. section 1.905-1 when credit for foreign income taxes may be taken

The 2020 FTC proposed regulations provide as a general rule that contested foreign taxes cannot be claimed as foreign tax credits until the contest is resolved, but provide an election to claim a "provisional credit for contested foreign taxes." A taxpayer making the election must comply with certain requirements, including filing an amended return for the year at issue, making an annual certification each year until the contest is resolved and extending the statute of limitations until 3 years after the contest is resolved. If a taxpayer fails to file any annual certification, it is treated as receiving a refund of the amount of the contested foreign income tax liability on the date the annual certification is required to be filed, resulting in a redetermination of the taxpayer's U.S. tax liability pursuant to Prop. Treas. Reg. section1.905-3(b). This penalty for failure to file the annual certification is unduly harsh. Extension of the statute preserves the IRS's ability to challenge the taxpayer for any failure to exhaust all practical remedies.

With the increased complexity and volume of foreign tax audits and tax disputes, this new annual certificate requirement substantially increases administrative burden for taxpayers to access foreign tax credits, which is intended by Congress to reduce (tax) burdens of conducting business in a foreign jurisdiction. Under section 905, taxpayers are already required to file an amended return in order to claim foreign tax credits for **amounts** which are not reflected on the original local tax return. If there is a further need to notify the IRS when the contest is resolved or if there is a need to extend the statute of limitations, either can be adequately achieved without requiring annual certifications.

USCIB recommends that no annual certification be required for contested liabilities if the taxpayer elects to claim the provisional foreign tax credit. The taxpayer should notify the IRS by filing the amended tax return(s) for the year(s) the contested liability is related to and at the time of resolution. At a minimum, if taxpayers were to be required to file an annual certification for a contested liability, there should be available means for them to cure any inadvertent failure to file or delays in filing without the harsh penalty of being treated as a deemed refund.

Sincerely,

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