March 3, 2022

The Honorable Janet L. Yellen
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3058
Washington, D.C. 20220

Re: Foreign Tax Credit Regulations (T.D. 9957)

Dear Secretary Yellen:

On behalf of the National Foreign Trade Council ("NFTC"), I would like to express our concerns regarding the final foreign tax credit regulations (T.D. 9959, 87 Fed. Reg. 276) filed in the Federal Register on December 28, 2021 and published on January 4, 2022. We request that Treasury reconsider several aspects of the regulations that will result in double taxation on the international operations of U.S. companies in circumstances that seem unintended or underappreciated by the regulation drafters, and will further destabilize the fundamental international tax rules that apply to U.S. companies and jeopardize the ability of U.S. companies to compete with multinationals based in other countries.

To permit a reasoned reconsideration to take place, we urge Treasury as a first step to delay the applicability date of the regulations by at least one year. A delay in applicability date would have at least two positive effects:

- Most immediately, a delay would prevent an unnecessarily chaotic first quarter filing season for publicly traded U.S. companies, which will otherwise be required to take the final regulations into account on their first quarter 2022 financial statements.

- A delay would also allow for any reasoned reconsideration of these regulations to include much greater clarity on how they might interact with new foreign taxes being contemplated as part of the OECD Inclusive Framework's Pillar One and Pillar Two work, permitting Treasury to assess the advisability of the regulations in that context. Further, it will allow the tax-writing committees in Congress to better understand how the U.S. foreign tax credit system might interact with this work as they consider proposed changes.

The NFTC, organized in 1914, is an association of U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial and service activities and, therefore, the NFTC seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment and through direct investment in facilities abroad. Foreign trade is fundamental to the economic growth of U.S. companies.

Introduction

The NFTC and its members have many technical and procedural concerns regarding the regulations. The purpose of this letter is to outline the most significant aspects of the regulations that will result in double taxation in circumstances that seem unintended or underappreciated, and provide recommendations with respect to each aspect. We urge Treasury as a first step to delay the applicability date of the regulations for at least one year while these and other items are reconsidered. These key items include:[1]

- The source-based attribution rules for withholding taxes on royalties, service fees, and capital gains

- The attribution rules for taxes imposed on residents, particularly the reference to arm's length principles

- The cost recovery rules for income taxes, particularly the *per se* list of significant costs and expenses

As described in the NFTC's comment letter to the proposed regulations, as well as many other comment letters, sections 901 and 903 unambiguously provide a credit for any income tax paid or accrued to any foreign country, or any tax imposed in lieu of such an income tax, subject only to the specific limitations under section 904. These basic statutory rules have been in place for decades. Under these rules, longstanding and traditional foreign income and withholding taxes were creditable. This treatment was clear, noncontroversial, and consistent with the policies underlying the statute and the U.S. tax treaties that permit the imposition of such taxes.

The preamble to the final regulations explains that the impetus for the new rules is the proliferation of digital services and similar novel extraterritorial taxes, which can apply to U.S. companies with no physical presence in the country imposing the tax. Many of these novel taxes have been imposed by U.S. tax treaty partners in contravention of the spirit, if not the letter, of their treaty obligations.

While the NFTC has concerns regarding these taxes and the targeting of large U.S. digital and technology companies, such concerns do not justify upending by regulatory fiat the treatment of longstanding, traditional income and withholding taxes. The NFTC believes that regulations can be drafted to address concerns regarding existing and future novel extraterritorial taxes without upending the treatment of longstanding, traditional income and withholding taxes.

[1] While this letter is focused on the sections of the final regulations addressing whether foreign taxes are creditable income taxes under sections 901 and 903, NFTC members have significant concerns with the substance and applicability dates of other provisions of the final regulations. In particular, NFTC members are concerned with the retroactive application of new Treas. Reg. § 1.861-20.

Attribution Rules for Withholding Taxes on Royalties, Service Fees, and Capital Gains

The final regulations would not permit a credit for withholding taxes on royalties and service fees unless such taxes are imposed under sourcing rules “reasonably similar” to those of U.S. law, and would not permit a credit for a tax on gains from the sale of property unless the tax is imposed under rules “reasonably similar” to section 897 (which applies to the disposition of U.S. real property interests). The source-based attribution rule is satisfied with respect to royalties only where foreign law imposes tax based on place of use of the underlying intangible property, and for services only where foreign law imposes tax based on where the services are performed. Contrary to the statements in the preamble of the final regulations, these standards are not aligned with international norms for imposing such taxes. U.S. sourcing rules are not the norm but in many ways are the outlier. Internationally, the residence or place of business of the payor is more often the standard, even if used as a proxy for place of use which is difficult to determine from an administrative standpoint. The final regulations throw the creditability of most withholding taxes on royalties into doubt, and eliminate the creditability of longstanding withholding taxes on services fees.

The final regulations provide a treaty coordination rule, under which a credit is provided for taxes treated as covered taxes under the relief from double taxation article of a U.S. tax treaty and paid by a U.S. resident that elects benefits under that treaty. Many U.S. tax treaties permit the imposition of withholding tax on royalties and related technical services, and one major treaty – the treaty with India – permits the imposition of withholding tax on technical or consulting services more generally. Many of these treaties provide a source rule that looks at least in part to the country of residence of the payor or permanent establishment bearing the royalty or service fee, consistent with the longstanding source rules in the U.N. Model Convention. The OECD Model Convention does not specify a sourcing rule; however, a number of OECD members including France and Canada have reserved on this omission and have proposed a source rule for royalties similar to the source rule for interest (that is, to the place of payor). Since most Latin America and African countries, and many countries in Asia, are outside the U.S. treaty network, this new treaty coordination rule penalizes U.S. companies with operations and customers in those countries even though the taxes imposed by those countries may be identical to the taxes imposed by treaty partners and permitted under U.S. tax treaties.[2] Last, the final regulations apply different treaty rules for taxes paid by foreign subsidiaries of U.S. companies, leading to incongruous results for the same U.S. taxpayer on income included under the GILTI rules as compared to income earned directly. To take one example, the royalty withholding tax imposed by Mexico on a U.S. company will be creditable under the U.S.-Mexico treaty, while the same royalty withholding tax imposed by Mexico on a CFC of that U.S. company may not be creditable. The same incongruous results arise in the case of India’s withholding tax on technical and consulting services. These changes would be a drastic change from longstanding U.S. rules and practice and provide a competitive disadvantage for U.S. companies compared to companies headquartered in other countries.

[2] This result is inconsistent with decades of U.S. tax treaty and foreign tax credit policy, under which credits for foreign taxes are permitted by treaty only if U.S. treaty negotiators determined that such taxes were creditable under U.S. domestic law. To the extent the United States has obligated itself to credit foreign taxes by treaty, it is because U.S. treaty negotiators viewed such taxes (and similar taxes imposed by countries outside the U.S. tax treaty network) as creditable under U.S. domestic law.

The rules applicable to withholding taxes on services and royalties create a further perverse incentive on U.S. companies to locate jobs outside the United States. A fee for technical or engineering services provided by U.S. personnel of a U.S. company to an affiliate or other resident of a foreign country may be subject to withholding tax imposed by that country, which generally would not be creditable under the final regulations. If those U.S. jobs were moved to the country of the recipient, however, profits from the function likely would be subject to local income tax, which might be creditable. Similarly, U.S. companies may also consider moving their intangible property – or the R&D functions that generate intangible property – outside the United States so that royalty income or other returns to intangible property are not subject to double taxation due to non-creditability of withholding taxes. These perverse incentives will adversely affect the competitiveness of the United States as a location for technical, engineering, and R&D.

Recommendation: Traditional withholding taxes imposed on royalties and service fees paid by residents of the country imposing the tax and deductible against the income tax imposed by that country should remain creditable. In addition, withholding taxes permitted and treated as covered taxes under a U.S. tax treaty should be *per se* creditable regardless of whether they are paid by a U.S. company or a foreign subsidiary thereof.

Corporate Income Taxes Imposed on Residents – Attribution and Cost Recovery Rules

Attribution Rules for Income Taxes Imposed on Residents – Arm's Length Standard

The final regulations would not permit a credit for corporate income taxes that rely on non-arm's-length principles to determine the allocation of income or deductions to its residents. The final regulations throw into doubt the creditability of longstanding income taxes that rely on fixed margins or other criteria to determine taxable income, such as the income tax of the largest trading partner of the United States in South America, Brazil. Further, because withholding and other taxes in lieu of income taxes are creditable only if they are imposed in substitution for a creditable income tax, the creditability of longstanding withholding taxes imposed by Brazil and other countries may be in doubt even where such taxes are imposed on the same basis as U.S. withholding taxes.

Surprisingly, the treaty coordination rule may provide little relief even for income taxes permitted under U.S. tax treaties. Virtually all U.S. tax treaties provide for an "indirect" tax credit for income taxes covered by the treaty and imposed on profits out of which dividends are paid to U.S. companies. The final regulations do not directly address the application of these provisions on the operation of the GILTI foreign tax credit rules, remarkably throwing into doubt the creditability of corporate income taxes imposed by U.S. treaty partners and permitted under U.S. tax treaties. It appears possible that a U.S. company operating through a disregarded entity in a treaty country would be able to credit income taxes imposed on that entity, but may not be able to credit the same income tax imposed on a subsidiary. This incongruity is difficult to defend.

Cost Recovery Requirement – *Per Se* List of Significant Expenses

The final regulations would not permit a credit for corporate income taxes unless a strict new cost recovery requirement is satisfied. This strict new cost recovery requirement is satisfied only if foreign law permits the taxpayer to recover the following significant expenses: capital expenses, interest, rent, royalties, wages and other payments for services, and research and experimentation expense. Expense limitation rules "consistent with the principles underlying the disallowances required" under U.S. law, such as the expense limitation rules in sections 163(j) and 267A, may be taken into account in this regard.

This strict new cost recovery requirement represents a significant departure from the prior law net gain requirement, which required that foreign law permit a reduction in gross income by significant costs and expenses or by an approximation that was likely to reach net gain in normal circumstances. The new cost recovery requirement will require a close examination of the specific rules of income taxes imposed by each country in which U.S. companies operate, and an evaluation of the extent to which expense disallowance rules are consistent with those provided under U.S. law. This cumbersome and uncertain analysis is required even for U.S. companies that do not incur any expenses subject to local expense disallowance rules. For example, some foreign income taxes deny deductions for certain types of executive compensation, amortization of goodwill, or payments to related parties. It will be difficult to determine the extent to which these limitations are consistent with limitations on similar deductions under U.S. law. Further, as discussed above, the treaty coordination rule appears to provide little relief because it does not clearly address indirect tax credits.

Recommendation: Corporate income taxes imposed on residents should remain creditable regardless of conformity with the arm's length standard, and the prior law cost recovery rules should be reinstated. To the extent Treasury wishes to discourage profit allocations that exceed the allocations resulting from an application of the arm's length standard, regulations could provide that any tax on income in excess of the income that would result from an application of the arm's length standard be treated as a separate levy that is not creditable. To the extent the prior law cost recovery rules were perceived as difficult for the IRS to administer, consider: (1) treating income taxes treated as covered taxes under U.S. tax treaties as *per se* creditable regardless of whether they are paid by a U.S. company or a foreign subsidiary thereof, and (2) adopting the definition of "taxes on income" in the OECD's Pillar Two work and adding to that definition top-up taxes permitted under the Pillar Two work. Regardless of other changes, taxes imposed under international initiatives to which the United States has committed clearly should be creditable.

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In conclusion, we request that Treasury reconsider several aspects of the regulations that will result in double taxation. To permit a reasoned reconsideration to take place, we urge Treasury as a first step to delay the applicability date of the regulations by at least one year. We would be very pleased to discuss these matters with you or your staff.

Sincerely,

Jake Colvin
President

Cc:

Ms. Lily Batchelder, Assistant Secretary (Tax Policy), U.S. Department of the Treasury
Mr. Jose E. Murillo, Deputy Assistant Secretary for International Tax Affairs, Office of Tax Policy, U.S. Department of the Treasury
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