WRITTEN SUBMISSION OF THE NATIONAL FOREIGN TRADE COUNCIL
Comments Regarding Foreign Tax Credits REG-112096-22
CC:PA:LPD:PR
Room 5203
Internal Revenue Service
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Washington, DC 20044
January 23, 2023

The National Foreign Trade Council (the "NFTC") is writing to provide comments on the proposed regulations regarding Foreign Tax Credits ("FTCs") REG-112096-22 released by the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") on November 22, 2022.

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. Our members support establishing and maintaining international tax norms that provide certainty to enterprises conducting cross-border operations.

We welcome the corrections and clarifications to the new foreign tax credit regulations addressing: (1) the definition of a reattribution asset for purposes of allocating and apportioning foreign income taxes; (2) the application of the cost recovery requirement; and (3) the application of the source-based attribution requirement to withholding taxes on certain royalty payments. NFTC comments are limited to the cost recovery requirement and the attribution requirement as applied to withholding taxes on royalty payments. We also provide comments relating to Brazil and their potential adoption of the "arm's length standard."

Cost Recovery

NFTC requests additional guidance related to the cost recovery requirement. In seeking to clarify the cost recovery requirement, Proposed Treas. Reg. §1.901-2(b)(4)(i)(C)(1) provides that "whether a foreign tax permits recovery of substantially all of each item of significant cost or expense is determined based solely on the terms of the foreign tax law." Proposed Treas. Reg. §1.901-2(b)(4)(i)(C)(2) then provides safe harbor rules for disallowances that are based on a "stated portion" of an item of significant cost or a receipts-based or income-based measure. These two sections fail to clarify how to determine that a disallowance is not substantial "based solely on the terms of the foreign tax law" in circumstances where the safe harbor does not apply (i.e., in circumstances where the disallowance is not based on a "stated portion" of an item of significant costs or a receipts-based or income-based measure).

For example, a foreign tax law may generally allow the deduction of interest, but it may limit the deduction to an interest rate percentage set by the government or based on a specified debt-to-equity ratio. While such limitations do not fall under the safe harbor, they are limited disallowances similar to those in the safe harbor. NFTC requests that the regulations provide guidance allowing taxpayers to determine

when a foreign tax law allows substantially all of each item of significant cost or expense when such disallowances do not fall within the safe harbors provided.

In examining whether a foreign law disallowance meets the cost recovery requirement, Proposed Treas. Reg. §1.901-2(b)(4)(i)(F) provides that "a disallowance of all or a portion of an item of significant cost or expense does not prevent a foreign tax from satisfying the cost recovery requirement if such disallowance is consistent with any principle underlying the disallowances required under the income tax provisions of the Internal Revenue Code [("the Code")], including the principles of limiting base erosion or profit shifting and addressing non-tax public policy concerns similar to those reflected in the Internal Revenue Code."

NFTC requests guidance that a foreign disallowance should be allowed for any public policy reason reflected under the Code and not only public policies supporting disallowance of deductions. Tax policy can effectuate public policy and encourage certain behaviors through one of two mechanisms: (i) allowance of credits or additional deductions or (ii) disallowance of a deduction. For example, the public policy of encouraging domestic content is found in the Code but is, generally, promoted through the Code's credit mechanism (e.g., the domestic content requirement found in the newly enacted Inflation Reduction Act of 2022[1]). Foreign tax law may have the same public policy of promoting domestic content but lack the same credit mechanism and instead promote such public policy by limiting deductions for expenses incurred outside the country. The same public policy is affected regardless of the mechanism. Thus, the regulations should allow foreign disallowances for any public policy reason reflected under the Code and not be limited to public policies supporting disallowance of deductions.

Additionally, clarification is requested that when the principle or motivation for a disallowance under the foreign tax law is unclear (e.g., not articulated in the foreign tax law or evidenced by its legislative history), such disallowance is "consistent with" a U.S. principle if the disallowance has the same effect as a particular disallowance in the Code. For example, a foreign tax law may disallow payments to related parties outside of the country, but not provide a reason for such disallowance in its text or its legislative history. This disallowance should be allowable under the cost recovery requirement because its effect is consistent with the U.S. principle of limiting base erosion or profit shifting.

Irrespective of whether the above clarifications are adopted, we believe that Treasury should clarify that all interest expense disallowances are permitted on public policy grounds. The precise rationale for interest expense limitations varies from jurisdiction to jurisdiction, but these sorts of limitations typically reflect a concern about the potential flexibility of interest as a tool for base erosion, as well as a concern about detrimental effects resulting from over-leverage (e.g., thin capitalization rules). Under the Code, for example, limitations exist on deductions where hybrid arrangements are involved, where interest expense exceeds a certain percentage of EBIT (or, prior to 2022, EBITDA), or where a debt instrument has certain equity-like features. Regulations disallow interest deductions on certain related-party debt instruments issued as dividends. Furthermore, interest expense limitations under the Code have evolved significantly over the years, with the most recent change made at the end of 2017. In other countries, there are many different approaches to limiting interest deductions, and the mechanism for such limitations varies from country to country. In Mexico, for example, in addition to a limitation based on a percentage of income, disallowance of interest expense includes a disallowance of interest expense with respect to certain demand loans and with respect to certain back-to-back financing arrangements, where Mexican tax law re-characterizes such interest as non-deductible dividends with respect to the debtor (but not with respect to the creditor). While the proposed regulations provide an exception for limitations based on principles of limiting base erosion and profit shifting, it remains unclear whether interest expense limitations that may differ substantially from the approaches adopted under the Code, such as the Mexican interest expense disallowances described here, would qualify for this exception. Thus, it is recommended that Treasury clarify in the final regulations that no limitations on interest deductions would prevent a foreign tax from satisfying the cost recovery requirement, because all disallowances of interest expense,

[1] Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818 (2022)

including, but not limited to, limitations under thin capitalization rules or limitations with respect to related-party interest expense (including interest paid through third-party conduits or intermediaries), are consistent with the principles (including non-tax public policy concerns) underlying the disallowances in the Code. A broad statement would be similar to the approach taken with respect to taxes paid to foreign taxing jurisdictions that do not allow any deductions for stock-based compensation in Proposed Treas. Reg. §1.901-2(b)(4)(iv)(J), Example 10.

In addition to providing clarity as described above, NFTC recommends that Treasury add the following example:

Interest Expense; no cost recovery allowed. Country X imposes a tax on the income of corporations that are resident in Country X. Under Country X tax law, full deductions are allowed for each item of significant cost or expense attributable to the gross receipts included in the Country X tax base, except that no deduction is permitted for any interest expense.

Analysis. Although the Country X tax law does not allow a deduction for any interest expense, because limitations on interest expense deductions are consistent with the principles underlying the limitations in the Internal Revenue Code, the Country X tax satisfies the cost recovery requirement.

In addition to the above clarifications, NFTC believes Treasury should clarify that all restrictions against cost recovery for purchased goodwill are permitted as consistent with the principles underlying the Code. Certain jurisdictions, including Mexico for example, do not permit deductions for any purchase price allocated to purchased goodwill and therefore, there cannot be any recovery of costs of purchased goodwill, including upon a subsequent disposition of the business. In the U.S., cost recovery of purchased goodwill through amortization is limited by the anti-churning rules. And prior to the enactment of the anti-churning rules (and §197 more generally) cost recovery associated with goodwill was a frequent subject of litigation between taxpayers and the IRS. Given the difficulties in determining the appropriate scope of cost recovery for purchased goodwill and the U.S.'s extensive history with this subject, any restriction against cost recovery for purchased goodwill imposed by other jurisdictions should be treated as consistent with the principles underlying the Code and therefore not cause a tax to become non-creditable. To make this point clear, Treasury should add an example to the final regulations such as the following:

Purchased Goodwill; no cost recovery allowed. Country X imposes a net income tax on corporations that are resident in Country X. Under Country X tax law, no portion of the purchase price of a business allocated to goodwill is deductible for tax purposes, and therefore there is no cost recovery with respect to purchased goodwill, including upon a subsequent disposition of the goodwill.

Analysis. Although the foreign tax law does not allow deductions for any portion of the costs of the purchase of a business to attributable purchased goodwill, because the disallowance is consistent with principles under the Code limiting cost recovery for purchased goodwill, Country X tax law satisfies the cost recovery requirement.

Attribution Requirement for Royalty Payments: Application of the Single-Country License Rule to Unrelated-Party Licenses

The NFTC welcomes the single-country license rule in the proposed foreign tax credit regulations. However, NFTC has some concerns regarding the rule.

In order to comply with the single-country use rule, licensors may have to amend license agreements, for example, to explicitly limit the territory of the license or to provide that a separately stated portion of the royalty is attributable to part of the territory of the license. If a licensor seeks to amend an agreement with an unrelated licensee, the licensee may either attempt to extract opportunistic concessions or refuse to amend the contract (for reasons wholly unrelated to U.S. tax). For example, the unrelated licensee may

demand a reduced royalty rate, which would likely lower the amount of income included in the U.S. base. In many circumstances, the jurisdiction in which the licensee is resident sources royalty income based on the residence of the payor (otherwise, the licensor would not be seeking to apply the single-country license rule in the first place) and so is indifferent to this contractual modification from a tax perspective.

The inclusion of a factual description of the underlying activity in a contract, on its face, reduces the burdens on taxpayers and the IRS. On the other hand, if parties apply §482- and §861-based sourcing principles to that factual description "behind the scenes" and then reflect it in the contract as an amount or formula, that lack of transparency will cause significant administrative burden on the IRS to audit these transactions and confirm that the legal analysis is reasonable.

NFTC recommends modifying the single-country license rule to eliminate this disadvantage. This change will reduce the administrative burden on the IRS and at the same time will not increase that burden on taxpayers as most taxpayers are already required to perform this analysis for the IRS to audit. For example, the single-country use exception could instead require that: (1) an agreement must include an adequate factual description of the relevant activity conducted by the licensee (*e.g.*, manufacturing and customer locations); and (2) the taxpayer must maintain in its books and records documentation that reflects the application of §482- and §861- based sourcing principles.[2]

The proposed regulations also impose limitations on the scope of the single-country license rule where the taxpayer "knows, or has reason to know," the agreement "misstates the territory" in which the intangible is used. The concern underlying this rule should be significantly lower in agreements with unrelated parties. However, the limitation applies equally in both the related and unrelated party contexts. The application of this limitation is likely intended to be different for related and unrelated party agreements. But, absent explicit language in the proposed regulations, the regulations do not provide enough certainty to taxpayers with unrelated party licenses. This is especially true where the penalty for failing to meet the requirements of this limitation is complete disallowance of any foreign tax credits related to the transaction.

The limitation on the single-country license rule should be modified in one of two ways, each of which would address the area of concern for related party agreements while also providing more certainty to taxpayers with unrelated party agreements. First, the limitation could be modified to include a limited presumption in favor of the taxpayer with respect to agreements with unrelated parties. Alternatively, or in addition, the consequences for not meeting the limitation's requirements could be modified to disallow only a portion of the foreign taxes.

Attribution Requirement for Royalty Payments: Application of the Single-Country License Rule to Agreements that Do Not Characterize Payments as Royalties

While the NFTC welcomes the single-country license rule, we believe that the requirement that the license agreement pursuant to which payments are made characterize the payments as royalties is not necessary. The rule should be clarified so that it applies to any agreement that provides for payments that are treated as royalties by the foreign country imposing the tested tax. Accordingly, the rule would apply to withholding taxes on payments pursuant to an agreement that in form is not a license, but which is recharacterized by the local jurisdiction as in substance to be a license of IP with payment of royalties.

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[2] NFTC highlights that the single country license exceptions requirement as written creates a "cliff effect" (i.e., the complete disallowance of an FTC) if the agreement overstates the amount of a royalty attributable to a jurisdiction under the principals of §§861 and 482. Considering the inconsistent and often conflicting interpretations of the "place of use" standard in case law, this rule could disallow the entire credit even in the event of an immaterial misstatement. Similarly, if the IRS redetermines a transfer price that is immaterially different than the amount utilized under the agreement, the taxpayer would not be able to credit any of the tax associated with the royalty payment. We recommend relaxing the requirement and only denying a credit for the amount attributable to the overstatement.

This modification would be consistent with the general structure of the regulations which do not require the foreign country to have the same conclusion on character as the U.S. (*See* Proposed Treas. Reg. §1.903-1(c)(2)(iii)(B) "whether the income is characterized as royalty income is determined under the foreign tax law"). Such a rule would not contradict the policy goals of the single-country license rule or the broader regulations. There is little to no risk of abuse both in theory or in practice as taxpayers must exhaust remedies and otherwise comply with U.S. tax rules addressing the character mismatch.

At the same time, NFTC recommends that the withholding tax exception of Proposed Treas. Reg. §1.903-1(c)(2)(iii)(B) be amended to delete the second sentence thereof so that even if a sale of software is treated as a sale of a copyrighted article under Treas. Reg. §1.861-18 for U.S. Federal income tax purposes, foreign withholding tax imposed on the amount considered a royalty under local foreign law would nevertheless qualify for the single-country license exception of Proposed Treas. Reg. §1.903-1(c)(2)(iii)(A). In software transactions that are treated as sales of copyrighted articles under §1.861-18, some foreign countries regard some or all payments by their resident taxpayers for software copies as royalties, and accordingly, impose a royalty withholding tax on those payments. In the event that the United States does not have an income tax treaty with that foreign country, the U.S. taxpayer who suffers the withholding tax has no reasonable means to challenge the royalty characterization and resulting withholding tax. Disallowing a foreign tax credit to such a U.S. taxpayer places such U.S. taxpayer at a competitive disadvantage in exporting software to these countries and punishes the US taxpayer for the objectionable policies of the foreign country.

Attribution Requirements for Withholding Taxes on Service Fees

While the NFTC appreciates the inclusion of the single-country license rule for royalties, we believe that a similar rule should be provided for service fees where services are actually performed in the country, imposing the withholding tax. In such a case, while the withholding tax may be imposed under a foreign law sourcing rule that looks to the residence of the payor, the foreign country has the primary right to tax under U.S. principles as well because the services are performed within the country imposing the tax. In other words, there is a complete overlap between the local country's primary right to tax, under U.S. principles, and the actual exercise of that primary right. Accordingly, withholding taxes imposed on service fees paid for services performed in the country imposing the tax, or on the separately stated portion of service fees attributable to services performed in that country, should be deemed to meet the attribution requirement without regard to the sourcing rule applied by the country imposing the tax.

More generally, NFTC reiterates our prior comments with respect to the attribution requirement and traditional withholding taxes on service fees that have been imposed by foreign countries for decades. While we appreciate the policy concerns expressed with respect to novel extraterritorial taxes on digital and similar services, we recommend that consideration be given to modifying the attribution requirement with respect to withholding taxes on services in cases where (1) the services primarily benefit the recipient of the services in the country imposing the tax, and (2) the services do not consist of services delivered primarily over the internet or an electronic network.

Attribution Requirement for Tax on Residents – Two-year delay of the implementation of the attribution requirement for taxes on residents with respect to Brazil

The Final Regulations in § 1.901-2(b)(5)(ii) provide any allocation to or from the resident of income, gain, deduction, or loss with respect to transactions with commonly controlled parties "is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion." As we understand it, this provision was intended to motivate Brazil to adopt an arm's length standard. Recent legislative developments in Brazil suggest that the country is seeking alignment with the OECD by adopting the arm's length standard under transfer pricing rules.

U.S. companies have invested heavily in Brazil based on the previously unquestioned creditability of its income tax. However, given that Brazilian income tax may no longer be creditable due to the new arm's length requirement, U.S. companies investing in Brazil will be at a competitive disadvantage with respect to their foreign counterparts that are not subject to double taxation on their operations in Brazil. For the reasons above, we, therefore, request that Treasury delay implementation of the attribution requirement for taxes on residents with respect to Brazil for a 2-year period. Concurrently, we recommend that Treasury and the IRS issue interim guidance stating that taxpayers' position with respect to the creditability of Brazilian income and withholding taxes will not be challenged during the suspension period, similar to what was done in Notice 2011-29 with respect to the creditability of the Puerto Rico Excise Tax.

If a delay is not adopted, we request a transition rule to determine when income taxes in Brazil would be eligible for FTCs. The law signed by the President in late December gives the Brazilian legislature up to 120 days to enact the provision into law. If the effective date is either December 2022 (when the bill was signed) or April 2023 (the end of the 120 period), it leaves an open question on how to determine when taxes paid (or accrued) in Brazil would be eligible for FTCs. NFTC recommends that the entire year (i.e., January 1, 2022, for a December 2022 effective date or January 1, 2023, for an April 2023 effective date.) be eligible for credits and that a similar transition rule is promulgated for fiscal year taxpayers.