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IRS Foreign Tax Credit Pause Is Welcome Course Correction

By **Lucas Giardelli, Juan Lopez Valek and Michael Lebovitz** (August 15, 2023, 3:41 PM EDT)


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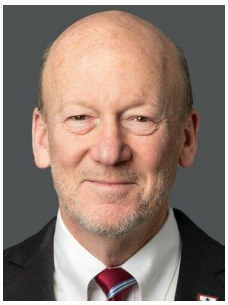
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On July 21, the Internal Revenue Service released Notice 2023-55 providing temporary relief from the final foreign tax credit regulations issued in 2022.[1]

Commentators have been mostly critical of the stance taken by the IRS throughout the regulation-writing process which resulted in the 2022 final regulations. It would appear that the IRS has finally recognized the numerous challenges the new rules would create and the need to take a fresh look at the standards for creditability of foreign taxes.

The notice generally allows taxpayers to apply the previous rules reflected in regulations promulgated in 1983, as in effect prior to the modifications introduced in the 2022 final regulations, for their 2022 and 2023 taxable years.[2] This is welcome news for U.S. taxpayers as the strict rules introduced by the 2022 final regulations had threatened the creditability of many foreign taxes that were historically considered creditable.

However, no relief is provided for so-called digital services taxes imposed on tech companies.

Background

U.S. taxpayers are generally subject to U.S. federal income tax on their worldwide income. Moreover, U.S. taxpayers that own a 10% or greater interest in a controlled foreign corporation are generally subject to U.S. federal income tax on the earnings of the CFC.

To alleviate the double taxation that could result in these situations, Section 901 of the Internal Revenue Code allows a credit for foreign income, war profits and excess profits taxes, and Section 903 provides that such taxes also include a tax paid in lieu of a generally imposed foreign income, war profits or excess profits tax.[3]

The requirements that a foreign tax must satisfy to be considered an income tax, or a tax in lieu of an income tax, were fairly well-settled for many decades under criteria first set forth in court cases and administrative guidance, and ultimately incorporated into the 1983 regulations.

Those rules had remained mostly unchanged until the 2022 final regulations added several stringent requirements for a foreign tax to qualify as a creditable income tax, notably including:

- The introduction of a new "attribution requirement." In the case of a foreign tax imposed on residents of the foreign country, this requires that the pricing of related party transactions be determined under arm's length principles. In the case of a foreign tax imposed on non-residents of the foreign country, this requires that gross receipts and costs be attributed based on one of three principles:

    - The activities of the non-resident in the foreign country, using "reasonable principles" such as the rules under the IRC for determining "effectively connected income," and not based on the mere location of customers or other destination-based criteria;

    - The source of the income, using sourcing rules that are "reasonably similar" to the sourcing rules that apply under the IRC; or

    - The situs of the property in case of gains from disposition of property, using rules consistent with the taxation of nonresident's capital gains under U.S. tax law — i.e., gains from disposition of in-country real property interests and gains from disposition of property forming part of the business property of an in-country taxable presence.

- The introduction of a requirement that a foreign tax must permit recovery of significant costs and expenses — which are expansively defined — and that any disallowance of recovery of such costs and expenses must be consistent with any principle underlying the disallowances required under the IRC.[4]

As reflected in the numerous comment letters submitted to U.S. Department of the Treasury and the IRS, taxpayers raised concerns that many foreign taxes that had been considered creditable would fail to satisfy the revised creditability requirements under the 2022 final regulations.

The 2022 final regulations would have far-reaching effects on routine international transactions that have long been considered uncontroversial by taxpayers and the IRS. For example, many foreign countries source royalty or services income based on the residence of the payor for purposes of applying their withholding taxes.

However, the IRC sources services income based on where the services are performed, and royalty income based on the place of use of the intangible. Thus, withholding taxes on royalties and services imposed by such foreign countries would generally not be creditable under the 2022 final regulations.[5]

As another example of their dramatic impact, the 2022 final regulations would prevent creditability of the Brazilian corporate income tax given that, for tax years prior to 2024, Brazilian transfer pricing rules do not generally follow the arm's-length principle, thus failing the attribution requirement.[6]

In addition, taxpayers and their advisers have struggled to assess whether many other specific foreign taxes would satisfy the cost recovery requirement, and especially to substantiate that a given foreign-expense disallowance rule is consistent with a principle underlying the disallowances under the IRC.

Commentators have surmised a variety of reasons why the Treasury and IRS saw fit to change long-standing rules with respect to creditability of foreign taxes. Many have suggested that they simply went too far as part of an attempt to provide guidance on creditability for digital services taxes and similar levies.

Moreover, it should be noted that some commentators have expressed the concern that the Treasury

may not have had the authority to introduce some of the new requirements included in the 2022 final regulations.

In response to the comments, the IRS issued a handful of technical corrections to the 2022 final regulations in July 2022,[7] as well as a set of proposed regulations in November 2022.[8] However, the targeted relief provided by the technical corrections and the proposed regulations did not address several issues that the 2022 final regulations raised.

The Notice

Taxpayers may elect to apply the relief provided by the notice in determining whether foreign taxes — paid or accrued during a relief period that includes taxable years beginning on or after Dec. 28, 2021, and ending on or before Dec. 31, 2023 — are foreign income taxes for purposes of the foreign tax credit regulations.

Specifically, for foreign taxes paid or accrued during the relief period, taxpayers may elect to apply Treasury Regulations Sections 1.901-2(a) and (b) as written before the modifications introduced by the 2022 final regulations, and Treasury Regulation Section 1.901-3 without the attribution requirement.

In practice, this means that for taxable years in the relief period, taxpayers may elect to claim a credit for foreign taxes that would otherwise fail the attribution requirement or the strict cost recovery requirement under the 2022 final regulations — including foreign taxes directly paid by a U.S. person or by a CFC of which the taxpayer is the U.S. shareholder.[9]

However, even for taxpayers that elect to apply the temporary relief, the notice includes a special rule providing that foreign taxes whose base is gross receipts or gross income fail the net-income requirement, and are thus noncreditable — except in the case of a foreign tax whose base consists solely of investment income that is not derived from a trade or business. This is intended to prevent the creditability of digital service taxes imposed on tech companies.

A taxpayer that elects to apply the temporary relief offered under the notice must apply it to all foreign taxes paid or accrued by the taxpayer and, as applicable, by the taxpayer's CFCs in the relief year.

All members of a consolidated group must consistently apply the temporary relief to the relief year.

Takeaway

The notice provides welcome temporary relief for the many U.S. multinational companies and other taxpayers that face the risk of significant double taxation in their international operations as a result of the application of the 2022 final regulations.

As explained above, the relief period does not extend beyond December 31. That said, the notice indicates that the Treasury and IRS are considering amendments to the 2022 final regulations and whether to provide additional temporary relief beyond 2023.

As such, we can expect future guidance on the issue of creditability of foreign taxes. Taxpayers may want to take this opportunity to further advocate for changes they think should be included in any such guidance.

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[1] The 2022 final regulations were published in Treasury Decision 9959, 87 Fed. Reg. 276 (Jan. 4, 2022).

[2] T.D. 7918, 48 Fed. Reg. 46,272 (Oct. 12, 1983).

[3] Unless otherwise noted, all "Section" references are to the Internal Revenue Code.

[4] While the 1983 regulations included a net income requirement, they relied on the more flexible "predominant character" standard, did not have the expansive definition of "significant cost and expenses" included in the 2022 final regulations and, importantly, did not require a justification for the disallowance of a cost or expense under foreign tax law.

[5] It should be noted that, even under the 2022 final regulations, these taxes may remain creditable if imposed on a U.S. taxpayer by a country that has a tax treaty with the U.S.

[6] Legislation has been passed in Brazil to align the transfer pricing rules with the arm's length standard effective as of 2024, with an option for taxpayers to adopt the rules in 2023. https://www.mayerbrown.com/en/perspectives-events/publications/2023/01/brazil-and-the-international-transfer-pricing-standards-provisional-measure-11522022.

[7] 87 FR 45018 and 87 FR 45021 (July 27, 2022).

[8] REG-112096-22, 87 Fed. Reg. 71,271 (Nov. 22, 2022). These proposed regulations provided limited relief to the attribution requirement for royalty withholding taxes in single-country licenses and certain safe harbors to ameliorate the impact of the cost-recovery requirement.

[9] The relief granted in the notice is also relevant for purposes of calculating whether income of a CFC may benefit from the high-tax exception to global intangible low-taxed income or Subpart F income, and for purposes of determining the creditability of foreign taxes under the corporate alternative minimum tax.