February 8, 2021

Commissioner of Internal Revenue
Internal Revenue Service
Attn: CC:PA:LPD:PR (Reg-101657-20)
1111 Constitution Avenue, NW
Washington, D.C. 20224

Filed electronically

Re: Comments on Proposed Regulations under Sections 901 and 903
Reg-101657-20

Dear Sir:

On November 12, 2020, the Treasury Department and the Internal Revenue Service published in the Federal Register proposed regulations under sections 901 and 903 of the Internal Revenue Code ("Code"), with a request for comments from interested parties with respect to the proposed regulations. We are hereby submitting comments on behalf of our clients in response to the request for comments in the proposed regulations.

Summary of comments

1. Our first comment is to recommend that the new jurisdictional nexus requirement should be eliminated from the proposed regulations.

   A. Our primary recommendation is that the jurisdictional nexus requirement should be eliminated entirely from both the section 901 and section 903 proposed regulations.

   B. If that recommendation is rejected, then, in the alternative, we recommend that the jurisdictional nexus requirement should be eliminated just from the section 903 proposed regulations, but the requirement would remain in effect for purposes of section 901.

   C. Finally, if both of those recommendations are rejected, then, at a minimum, we recommend that the nexus requirement should be eliminated for "covered" foreign withholding taxes in the proposed regulations under section 903.

2. If the Treasury and Internal Revenue Service make the decision to retain the new jurisdictional nexus requirement in the proposed regulations, then, in the alternative, we

recommend that the jurisdictional nexus requirement should be regarded as satisfied in the case of taxes on digitally-provided services if the ultimate recipients of those services reside in the foreign jurisdiction that imposes the tax on digitally-provided services, provided the tax would be creditable under the existing regulations.

3. With respect to the issue of whether a tax on gross receipts or gross income can be considered to be creditable, we recommend that the rule in the present final regulations, under which foreign taxes on gross receipts are creditable provided the expenses associated with the gross receipts are not likely to be substantial, should be retained, because the rationale provided in the preamble to the proposed regulations for eliminating this rule is inadequate to justify eliminating this rule.

Detailed arguments

1. Elimination of nexus requirement from the proposed regulations.

As noted above, one of the most significant changes in the proposed regulations to the creditability of foreign taxes is the new requirement that a taxpayer must have a jurisdictional nexus with the taxing jurisdiction in order for the tax to be creditable. The proposed regulations make it clear that the fact that the taxpayer's customers are located within the taxing jurisdiction is not a sufficient nexus to satisfy the foregoing requirement.

The proposed regulations impose this new jurisdictional nexus requirement both under section 901 and under section 903. With respect to section 901, the preamble states:

> As a dollar-for-dollar credit against U.S. income tax, the foreign tax credit is intended to mitigate double taxation of foreign source income. This fundamental purpose is served most appropriately if there is substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax. This conformity extends not just to ascertaining whether the foreign tax base approximates U.S. taxable income determined on the basis of realized gross receipts reduced by allocable expenses, but also to whether there is a sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax. Although prior regulations under section 901 did contain jurisdictional limitations on the definition of an income tax, see §4.901-2(a)(1)(iii) (1980) (requiring that a foreign tax follow "reasonable rules regarding source of income, residence, or other bases for taxing jurisdiction"), the existing regulations do not contain such a rule.
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> In recent years, several foreign countries have adopted or are considering adopting a variety of novel extraterritorial taxes that diverge in significant respects

from traditional norms of international taxing jurisdiction as reflected in the Internal Revenue Code. In addition, the Treasury Department and the IRS have received requests for guidance on whether the definition of foreign income tax includes a jurisdictional limitation, and recommending that the regulations adopt a rule requiring that income subject to foreign tax bear an appropriate connection to a foreign country for a foreign tax to be eligible for the foreign tax credit. In light of these developments, the Treasury Department and the IRS have determined that it is appropriate to revisit the regulatory definition of a foreign income tax to ensure that to be creditable, foreign taxes in fact have a predominant character of "an income tax in the U.S. sense."

The Treasury Department and the IRS have determined that in order to qualify as a creditable income tax, the foreign tax law must require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. For example, a tax imposed by a foreign country on a taxpayer's income that lacks a sufficient nexus to such country (such as the lack of operations, employees, factors of production, or management in that foreign country) is not an income tax in the U.S. sense and should not be eligible for a foreign tax credit if paid or accrued by U.S. taxpayers. Such a nexus is required in order for persons and income to be subject to U.S. income tax, and so a similar nexus reflecting the foreign country's exercise of taxing jurisdiction consistent with Federal income tax principles should be required in order for foreign taxes to be eligible for a dollar-for-dollar credit against U.S. income tax.

The proposed regulations therefore require that for a foreign tax to qualify as an income tax, the tax must conform with established international norms, reflected in the Internal Revenue 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 "jurisdictional nexus requirement"). Proposed §1.901-2(c)(1)(i) generally provides that in the case of a foreign country imposing tax on nonresidents, the foreign tax law must determine the amount of income subject to tax based on the nonresident's activities located in the foreign country (including its functions, assets, and risks located in the foreign country).... [F]oreign countries that, for example, impose tax by using as a significant factor the location of customers, users, or any other similar destination-based criterion to allocate profit (for example, by deeming a taxable presence based on the existence of customers) will not satisfy the jurisdictional nexus requirement.

> If the foreign tax law imposes tax on a nonresident's income based on the income arising from sources in the foreign country (for example, tax imposed on interest, rents, or royalties sourced in the foreign country and paid to a nonresident), proposed §1.901-2(c)(1)(ii) requires the sourcing rules of the foreign tax law to be reasonably similar to the sourcing rules that apply for Federal income tax purposes. For the avoidance of doubt, the proposed regulations provide that in the case of income from services, the income must be sourced based on the place of performance of the services, not the location of the services recipient.

Id. at 72,088.

Likewise, the preamble to the proposed regulations explains that the proposed regulations would apply the same jurisdictional nexus requirement to "in lieu of" taxes under section 903. The preamble states:

> To qualify as a tax in lieu of a tax on income, war profits, or excess profits, a levy must satisfy the definition of a tax in § 1.901-2(a)(2).

Id. at 46,275.

We submit that the analysis by the Treasury and the IRS that leads to the imposition of a jurisdictional nexus requirement in the proposed regulations is flawed and should be rejected. Our reasoning is addressed below.

A. Eliminate jurisdictional nexus requirement from all sections of the proposed regulations.

Our primary recommendation is that the jurisdictional nexus requirement should be eliminated from the proposed regulations relating to both section 901 and section 903. This argument is based on the fact that a set of proposed regulations that was issued in 1980 contained a similar jurisdictional nexus requirement and a number of other requirements, all of which seemed designed to require that in order to be creditable for U.S. tax purposes, a foreign tax had to be a "mirror image" of the U.S. income tax. Temp. Treas. Reg. §4.901-2(a)(1)(iii) (1980) (requiring that the foreign tax must use "reasonable rules regarding source of income, residence, or other bases for taxing jurisdiction). However, this jurisdictional nexus requirement and the other "mirror image" requirements were not retained when these proposed regulations were finalized. The current final regulations under both sections 901 and 903 that eliminated these requirements that had been included in the proposed regulations were issued on October 12, 1983. T.D. 7918, 48 Fed. Reg. 46,272 (Oct. 12, 1983). Based on this history, we submit that the legislative reenactment doctrine strongly supports the elimination of the jurisdictional nexus requirement from both the section 901 and 903 current proposed regulations, since the current proposed regulations adopt the

same type of "mirror image" approach that was adopted in the 1980 proposed regulations and abandoned in the 1983 final regulations. Our position is explained below.

a. General explanation and scope of legislative reenactment doctrine

The legislative reenactment doctrine involves rules of statutory interpretation that derive most prominently from the 1938 Supreme Court decision in *Helvering v. Winmill*, 305 U.S. 79 (1938). At issue in this case were long-standing regulations. In explaining the relevance of the long-standing nature of the regulations, the Court noted:

> Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.

Id. at 83.

Not long after the decision in *Winmill*, the Supreme Court again relied on the legislative reenactment doctrine in *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939). The Court described and applied the legislative reenactment doctrine as follows:

> The administrative construction embodied in the [earlier] regulation has, since at least 1920, been uniform with respect to each of the revenue acts from that of 1913 to that of 1932, as evidenced by Treasury rulings and regulations, and decisions of the Board of Tax Appeals. In the meantime successive revenue acts have reenacted, without alteration, the definition of gross income as it stood in the Acts of 1913, 1916, and 1918. Under the established rule Congress must be taken to have approved the administrative construction and thereby to have given it the force of law.

Id. at 115 (footnotes omitted).

More recently, in *Lorillard v. Pons*, 434 U.S. 575 (1978), the Supreme Court explained the effect of the legislative reenactment doctrine as follows:

> [When] Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute.

Id. at 581.

In addition, in *Cottage Savings Ass'n. v. Commissioner*, 499 U.S. 554 (1991), the Supreme Court once again applied the legislative reenactment doctrine.

Based on this history of the legislative reenactment doctrine, we now turn to the application of the doctrine to the new section 901 and 903 proposed regulations.

b. Application of doctrine to section 901 regulations

In determining the applicability of the legislative reenactment to the new section 901 proposed regulations, it is necessary to review the history of the regulations under section 901, as well as the case law and administrative law that preceded the currently effective section 901 regulations. While the allowance of a credit against U.S. income taxes for foreign income taxes paid or accrued by a taxpayer has been part of the U.S. tax law since the earliest days of the federal income tax statutes, regulations dealing with the definition of a foreign income tax that is eligible for a credit against the U.S. income tax liability of a taxpayer were not promulgated until 1983. Prior to that time, the standards for determining the eligibility of a foreign tax for a credit against the U.S. income tax were derived from court decisions and lesser forms of administrative guidance, such as revenue rulings.

i. Early Case Law

One of the most significant early court decisions that addressed the eligibility of a tax for the foreign tax credit was *Keen v. Commissioner*, 15 B.T.A. 1243 (1929), a case that dealt with a French tax based on imputed rental income. Although a tax based on imputed rental income was not like any tax imposed in the U.S., the Board of Tax Appeals nevertheless applied a flexible approach and concluded that the tax was still imposed on net income. The Board noted that "[t]he fact that under the law the taxable income is determined in a manner different from the taxable income under the Revenue Act of 1921 does not change the nature of the tax."

A decade later, the Supreme Court held that whether a foreign tax is creditable depends on whether the foreign tax is an income tax in the U.S. sense. *Biddle v. Commissioner*, 302 U.S. 573 (1938). The Court relied on the principle that the determination whether a foreign tax is an income tax for purposes of the foreign tax credit in the Code must be based on the application of U.S. tax principles as to what constitutes an income tax imposed on a taxpayer. *Id.* at 578-579. However, *Biddle* did not change or overrule the flexible, practical approach that early Board of Tax Appeals courts like *Keen* used to determine whether a foreign tax was an income tax in the U.S. sense of the term.

ii. Cases involving foreign taxes on gross receipts

While our recommendation relates specifically to the jurisdictional nexus requirement in the proposed regulations, this requirement is part of a set of new requirements that together adopt the approach that in order for a foreign tax to be creditable for U.S. tax purposes, the foreign tax must be a "mirror image" of the U.S. income tax. Another new requirement that is part of this same overall approach is to provide that in no circumstances will a foreign tax imposed on gross receipts qualify as a creditable income tax under section 901, a reversal of the position taken in the current regulations.

However, even before the promulgation of the 1983 regulations, some courts allowed taxpayers to take a foreign tax credit for foreign taxes based on gross receipts if the court found

that the tax reached net income of taxpayers subject to the tax. In *Seatrain Lines, Inc. v. Commissioner*, 46 B.T.A. 1076 (1942), the Board of Tax Appeals held that a 3 percent tax that Cuba imposed on foreign shipping companies was a creditable tax. Before it enacted the three percent tax, Cuba had a similar tax that was imposed at a rate of six percent and allowed a taxpayer to take deductions in determining the amount of income subject to tax. The court reasoned that the three percent decrease in the tax rate approximated the deductions of foreign shipping companies. *Id.* at 1080. A year after *Seatrain*, the Tax Court applied the same approach in *Santa Eulalia Mining Co. v. Commissioner*, 2 T.C. 24 (1943).

Seatrain and *Santa Eulalia* are not inconsistent with two Court of Appeals cases that concluded a certain foreign tax on gross income was not a creditable tax under section 901. *See Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894 (3d Cir. 1943); *Commissioner v. American Metal Co.*, 221 F.2d 134 (2d Cir. 1955). Both cases were cited in the preamble to the 2020 proposed regulations for the proposition that a tax on gross receipts is not creditable unless the tax allows for deductions. Although there is dictum in *Keasbey* that may be close to the approach taken in the 2020 proposed regulations, nevertheless, the Court of Appeals cases are consistent with the *Seatrain* line of cases because each court determined that it was *not* virtually certain that the foreign tax at issue would reach net income, and thus it was not an income tax in the U.S. sense. *Keasbey*, 221 F.2d. at 898; *American Metal Co.* 221 F.2d. at 140.

The Court of Claims, in *Bank of America Nat'l Trust & Sav. Assn. v. United States*, 459 F.2d 513 (Ct. Cl. 1972), *cert. denied* 409 U.S. 949 (1972), synthesized the cases above and created a persuasive standard for how to determine whether a tax on gross receipts is creditable under section 901. Although the court held against the taxpayer, it rejected the government's contention that because the tax was on gross receipts, it could never be a creditable tax. The court explained that it did not:

> [C]onsider it all-decisive whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing the profit. *The important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives. In certain situations a levy can in reality be directed at net gain even though it is imposed squarely on gross income.* That would be the case if it were clear that the costs, expenses, or losses incurred in making the gain would, in all probability, always (or almost so) be the lesser part of the gross income. In that situation there would always (or almost so) be some net gain remaining, and the assessment would fall ultimately upon that profit.

Id. at 519 (emphasis added).

In the years before the 1983 regulations, two court cases adopted the rationale of the Court of Claims opinion in *Bank of America*. *See Inland Steel v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982); *Bank of America Nat'l Trust & Savings Ass'n v. Commissioner*, 61 T.C. 752, 759-760.

Thus, it is clear from the preceding discussion that the standard from these pre-1983 cases is that a foreign tax can be considered an income tax in the U.S. sense *even if* the foreign tax does not allow for deductions. The assertion in the preamble to the 2020 proposed regulations that "the base of a foreign tax should conform in essential respects to the determination of taxable income for Federal income tax purposes" is in conflict with all of the cases cited above.

iii. Change in IRS Policy

Beginning in the 1970s, the IRS radically shifted its policies on the creditability of foreign income taxes that did not provide for deductions in a way that was a "mirror image" of the U.S. code. This shift in policy is shown by the holdings in a trio of revenue rulings issued in 1978: Rev. Rul. 78-61, 1978-1 C.B. 221, Rev. Rul. 78-62, 1978-1 C.B. 226, and Rev. Rul. 78-63, 1978-1 C.B. 228.

With these rulings, the IRS reversed its position on the creditability of several foreign taxes that the IRS had previously held were creditable. In reaching these holdings, the IRS announced new principles for determining the creditability of a foreign tax. Most significantly, in Rev. Rul. 78-61, the IRS modified the standard in *Bank of America* that a tax on gross income will only be an income tax if it "was reasonably intended . . . to reach some net gain in the normal circumstances in which it applies" and put in its place a standard that a tax will only be an income tax if "its purpose is to reach net gain *and* it [is] structured as to be almost certain of doing so." In essence, this rule put a "mirror image" deduction requirement that prevented unconventional foreign taxes like the ones in *Keen* or *Seatrain* from being creditable.

Many tax lawyers observed at the time that these revenue rulings imposed requirements on the foreign tax credit that conflicted with prior case law and prior IRS guidance. For example, the ABA made the following observation about the revenue rulings in a comment letter:

> The [Foreign Tax Credit Subcommittee] believes that the decided cases do not support Revenue Rulings 78-61, 78-62, or 78-63, which required that a foreign taxing system must bear such a substantial degree of similarity to the United States federal tax system as to constitute something akin to its 'mirror image.' As noted in [*Schering Corp v. Commissioner*, 69 T.C. 579, 792 (1978)], 'exact congruence between the foreign tax statute and American law is not necessary to establish that a tax is an 'income tax.'' The decided cases illustrated the basic principle that an income tax, within the meaning of section 901, is a tax that is designed to reach some net gain . . . .*Revenue Rulings 78-61, 78-62, and 78-62 misstate these concepts and thus do not reflect the current state of the law.*

ABA Tax Section, Foreign Tax Credit Subcommittee, *The Creditability of Foreign Income Taxes: A Critical Analysis of Revenue Rulings 78-61, 78-62 and 78-63*, 32 Tax Lawyer 33, 44-45 (1978) (emphasis added). Thus, the ABA concluded that the "mirror image" requirement in Rev. Rul. 78-61 "runs counter to the great weight of decided authority." *Id.* at 50.

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These 1978 rulings set the stage for the IRS's announcement in 1978 of a new regulations project designed to provide taxpayers with additional guidance with respect to the eligibility of foreign taxes for a foreign tax credit. Comments and recommendations from the public were solicited in this announcement. Numerous comments were received, and in response to these comments, proposed regulations were issued on June 20, 1979. These proposed regulations incorporated principles that were similar to those described in the three revenue rulings discussed above.

Numerous adverse comments from the public were received with respect to these proposed regulations. Two attorneys noted that the proposed regulations "produced an outpouring of criticism which was unprecedented in magnitude and tone." *See* Daniel Horowitz, et. al., *The Final Foreign Tax Credit Regulations: a Summary and Analysis*, Tax Notes (Oct. 17, 1983), https://www.taxnotes.com/tax-notes-federal/final-foreign-tax-credit-regulations-summary-and-analysis/1983/10/17/1yfkc.

In 1980, the foregoing proposed regulations were withdrawn, and new temporary and proposed regulations were issued. While these regulations adopted some of the requirements in the earlier proposed regulations, the new temporary and proposed regulations eliminated certain of the other requirements in the earlier proposed regulations and adopted different interpretations of certain of the requirements. Temp. Treas. Reg. §§ 1.901-2(c)(2), (3) & (4). In particular, the regulations provided that a foreign tax would satisfy the net income test only "if the base of the charge is computed, without significant deviation, by reducing" either costs "attributable under reasonable principles, to such gross receipts," or "costs computed under a method that is designed to produce an amount that is not less than costs attributable under reasonable principles . . .but only in the case of transactions with respect to which it is reasonable to believe that costs may not otherwise be clearly reflected." *Id.*

iv. 1983 Regulations

Final regulations were adopted in 1983. Those final regulations retained the three prerequisites for creditability that had been included in the temporary and proposed regulations, but the interpretations of each of the prerequisites were modified in several significant ways in comparison to the proposed regulations.

For example, the final regulations made certain clarifications to the net income test. In this regard, while a foreign tax must provide a reasonable opportunity to recover expenses in determining the base for the tax, the final regulations provided that in rare cases where the income to be taxed is such that there are not significant expenses, the tax might be creditable notwithstanding the lack of availability of deductions in computing the base for the tax. Treas. Reg. § 1.901-2(b)(4).

Thus, the IRS backed away from the strict "mirror image" requirement that had been applied in Rev. Rul. 78-61 and the 1979 proposed regulations and instead moved toward a standard more in line with past cases. It is notable that with the 2020 proposed regulations, the IRS is once

again heading in the direction of adopting a rule that functions like the mirror image rule when the mirror image rule in the 1979 proposed regulations was so maligned.

In general, it would be fair to characterize the provisions in these final 1983 regulations as being reasonably consistent with the principles previously espoused in most court decisions dealing with the creditability of foreign taxes that were decided prior to the 1978 – 1983 period. *See* T.D. 7918 (Oct. 12, 1983) ("Under these final regulations, the predominant character of a foreign tax is that of an income tax in the U.S. sense if the foreign tax is likely to reach net gain in the normal circumstances in which it applies. This standard, found in §1.901-2(a)(3)(i), adopts the criterion for creditability set forth in *Inland Steel Company v. U.S.*, 677 F.2d 72 (Ct. Cl. 1982), *Bank of America National Trust and Savings Association v. U.S.*, 459 F.2d 513 (Ct. Cl. 1972), and *Bank of America National Trust and Savings Association v. Commissioner*, 61 T.C. 752 (1974).").

The final regulations that were issued in 1983 have been retained in essentially the same form since their issuance. However, in October of 2020, new proposed regulations were issued that would deviate significantly from the provisions in the 1983 regulations that have now been in existence for almost 40 years.

v. Effect of 2020 proposed regulations under section 901

Notwithstanding the regulations governing the creditability of foreign taxes under section 901 have been outstanding in essentially the same form for over 25 years, on November 12, 2020, the IRS issued proposed regulations that would drastically alter the requirements for creditability of foreign taxes under section 901. One of the most significant changes proposed by the IRS is the addition of a jurisdictional nexus requirement for creditability. As noted above. after acknowledging that the existing regulations under section 901 do not contain a jurisdictional nexus requirement, the preamble to the proposed regulations describes this new requirement under section 901 and the reasons for this requirement. 85 Fed. Reg. 72,088 (Nov. 12, 2020).

Thus, under this new provision, a foreign country's tax on a non-resident's income that is earned in that foreign country, but that is not effectively connected to the conduct of a trade or business in the country or to a permanent establishment in the country, would not qualify for a foreign tax credit under section 901. The new proposed regulations also modify the interpretation of the net gain requirement in the existing regulations under section 901. After acknowledging that the existing regulations contemplate the use of an empirical analysis in determining whether this requirement is satisfied, the preamble to the proposed regulations describes this new approach as follows:

> The Treasury Department and the IRS have determined that, in some respects, the empirical analysis contemplated by the existing regulations is unnecessary to identify the essential elements of an income tax in the U.S. sense. In addition, in the absence of specific rules and thresholds in the regulations on how to evaluate empirical data (if even available), both taxpayers and the IRS have had difficulties in applying the existing regulations to foreign taxes in a consistent and

> predictable manner. In some cases, the reliance on empirical data to determine whether the requirements of the existing regulations are met creates uncertainty and undue burdens for taxpayers and the IRS, considering challenges in obtaining the necessary information. Therefore, the proposed regulations limit the relevance of the "normal circumstances" in which the tax applies, as well as the role of the predominant character analysis, in determining whether a tax meets the various components of the net gain requirement. These changes will lead to more accurate and consistent outcomes and reduce the compliance and administrative burdens of the existing law requirement that taxpayers and the IRS obtain from the foreign government empirical information, such as tax return information for persons subject to the tax, to determine the normal circumstances in which the tax applies.

Id. at 72,089.

Thus, as in the case of the new nexus requirement, this new approach to evaluating whether a foreign tax constitutes a tax on net income in a U.S. sense is a significant departure from the approach in the existing regulations. Finally, the new proposed regulations modify significantly the net income requirement for creditability, which requires that the foreign tax provide for reasonable recovery of costs. The preamble explains this new requirement as follows:

> Under the net income requirement in the existing regulations, foreign tax law must permit the recovery of the significant costs and expenses attributable, under reasonable principles, to gross receipts included in the taxable base. A foreign tax law permits the recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be under the Code, unless the time of recovery is such that under the circumstances there is effectively a denial of recovery. Under the "noncofiscatory gross basis tax" rule in § 1.901-2(b)(4) of the existing regulations, which reflects the standard described in *Bank of America I*, a foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the "rare situation" when the tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement in the existing regulations if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax).
>
> The Treasury Department and the IRS have determined that to constitute an income tax for U.S. tax purposes, that is, a tax on net gain, the base of a foreign tax should conform in essential respects to the determination of taxable income for Federal income tax purposes. See for example, *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 895 (3d Cir. 1943) (holding that the criteria prescribed

> by U.S. revenue laws are determinative of the meaning of the term "income taxes" in applying the former version of section 901); and *Comm'r v. American Metal Co.*, 221 F.2d 134, 137 (2d Cir. 1955) (providing that "the determinative question is 'whether the foreign tax is the substantial equivalent of an 'income tax' as that term is understood in the United States'"). The Treasury Department and the IRS have determined that any foreign tax imposed on a gross basis is by definition not an income tax in the U.S. sense, regardless of the rate at which it is imposed or the extent of the associated costs.

Id. at 72,090.

The proposed regulations also contain a number of additional rules that were not included in the existing regulations. This reversal of a number of the significant provisions in the existing regulations is particularly relevant when assessing the applicability of the statutory reenactment doctrine based on Congressional consideration of the foreign tax credit provisions in the existing regulations when Congress undertook legislative action in 1986 and 2017.

vi. Subsequent Legislation

Nevertheless, in order for the doctrine of legislative reenactment to apply, it is not enough to show that the IRS's position, as reflected either in regulations or in other administrative pronouncements, has been outstanding for an extended period of time and has been substantially reversed by subsequent regulations. It must also be demonstrated that Congress took the position reflected in the earlier regulations or other administrative pronouncements into account when Congress enacted legislation subsequent to the time that the regulations or other administrative pronouncements were issued. Accordingly, in the present context of the 1983 version of the foreign tax credit regulations, it is necessary to consider whether any Congressional actions between 1983 and the present time took into account the positions set forth in the 1983 regulations.

In the case of the regulations under section 901, Congress enacted two separate sets of legislation that implicitly approved the rules for determining the creditability of a foreign tax in the 1983 regulations and prior case law consistent with those regulations. First, in 1986, Congress made several statutory changes in the rules governing international taxation, including certain of the rules governing the foreign tax credit. In developing this legislation, Congress was fully aware of the position adopted in the 1983 regulations on what constitutes a creditable tax. However, Congress took no action to change those rules, despite being fully aware of those rules. In this regard, in the legislative history of the Tax Reform Act of 1986, the Senate Committee Report provides:

> **Creditability rules and withholding taxes on interest.** The foreign tax credit is available only for income, war profits, and excess profits taxes paid to a foreign country or a U.S. possession and for certain taxes imposed in lieu of them (Code secs. 901 and 903). Other foreign levies generally are treated as deductible expenses only. To be creditable, a foreign levy must be the substantial equivalent

> of an income tax in the U.S. sense, whatever the foreign government that imposes it may call it. To be considered an income tax, a foreign levy must be directed at the taxpayer's net gain. Treasury regulations promulgated under Code sections 901 and 903 provide detailed rules for determining whether a foreign levy is creditable (Treas. Reg. secs. 1.901-1 through 1.901-4 and 1.903-1). In general, a foreign levy is creditable only if the levy is a tax and its predominant character is that of an income tax in the U.S. sense. A levy is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country such as the right to extract petroleum owned by the foreign country. The predominant character of a levy is that of an income tax in the U.S. sense if the levy is likely to reach net gain in the normal circumstances in which it applies and the levy is not conditioned on the availability of a foreign tax credit in another country (a levy that is so conditioned is referred to as a "soak-up" tax).

S. Rep. 99-313, p. 293.

The fact that Congress took no action at this time to modify or question the rules in the 1983 foreign tax credit regulations, although fully aware of those rules, bolsters the argument that Congress implicitly blessed those rules in enacting this legislation. This argument is further strengthened by the fact that in the period leading up to the 1986 Act, which was relatively soon after the 1983 foreign tax credit regulations were adopted, Congress conducted hearings about the 1979 proposed regulations and closely examined the way those regulations provisions were being interpreted.

For example, the Ways and Means Committee held multiple hearings about proposed changes to the foreign tax credit, including a 1979 hearing specifically on how proposed legislation and the 1979 proposed regulations to the foreign tax credit would affect oil companies. *See* Proposed Amendments to the Foreign Tax Credit Limitation for Oil and Gas Extraction Taxes: Hearings Before the House Comm. on Ways and Means, 96th Cong., 1st Sess. 1 (1979).

Many witnesses discussed or referenced the 1979 proposed regulations and most of them expressed doubt that the regulations reflected sound policy. *See, e.g., id.* at 101 (statement of Edwin S. Cohen & Joseph H. Guttentag, Chamber of Commerce).

Even the then-Chairman of the Ways and Means Committee made the following observation about the need to consider the proposed regulations *before considering the proposed legislation*:

> It is my judgment that we can't make an intelligent decision on the President's foreign tax recommendations unless we relate them to the regulations. One of the problems with the regulations is that in the first place there undoubtedly will be court action, legal action to test those regulations which create a great deal of uncertainty.

Id. at 179.

Thus, it is quite apparent that in the years leading up to the Tax Reform Act of 1986, Congress both knew *and considered* the effect of the proposed regulations dealing with the definition of income tax under section 901. Given the lack of congressional action after the 1983 regulations were finalized, it follows that Congress must have agreed with the approach taken by the IRS and Treasury Department in these final regulations and felt no need to make additional changes to the definition of what it means to be an income tax.

The same type of reappraisal of the rules for taxing foreign source income and the availability of foreign tax credits with respect to such income took place again in 2017, in connection with Congress's enactment of the TCJA. As part of the TCJA, Congress adopted a new participation exemption system for taxing foreign source income, eliminating the need for a foreign tax credit with respect to foreign taxes paid on most foreign source income earned by controlled foreign corporations. Also, special transition rules were provided in new section 965, which treated pre-effective date earnings and profits as subpart F income that is includible in the U.S. shareholder's taxable income, subject to the availability of a foreign tax credit with respect to foreign taxes imposed on such income. Nevertheless, after the TCJA. the foreign tax credit remains relevant for domestic corporations who have GILTI or Subpart F income.

All of these legislative changes in the TCJA relied heavily on the foreign tax credit regime that was in existence when the TCJA was enacted. If wholesale changes in the definition of a creditable foreign tax were contemplated at that time, Congress would certainly have wanted to be involved and would have passed judgment on the merits of any such changes. Given that no such changes were proposed by the Treasury and none were adopted by Congress, the adoption of regulations implementing such wholesale changes in the definition of a creditable foreign tax so soon after the enactment of the TCJA strongly calls for the invocation of the legislative reenactment doctrine.

c. Application of Doctrine to Section 903 Proposed Regulations

As in the case of the new section 901 proposed regulations, understanding the applicability of the legislative reenactment doctrine in evaluating the new section 903 proposed regulations requires a review of the history of the regulations under section 903, as well as the case law and administrative law that preceded the promulgation of the current final section 903 regulations.

As background for this discussion, it is helpful to identify aspects of the proposed regulations under section 903 that are most directly implicated in the application of the legislative reenactment doctrine. In particular, a new requirement would be added by the proposed regulations under section 903 providing that if the type of income that is subject to the "in lieu of" tax was subject to tax under the foreign country's general income tax, that tax would be creditable under section 901, taking into account the new jurisdictional nexus requirement.

i. Early case law

Prior to 1942, there was no separate section of the Code dealing with the creditability of a foreign tax that was imposed in lieu of a general income tax in the foreign jurisdiction. Instead, the creditability of such taxes was analyzed under the general provisions of the foreign tax credit, which were embodied in section 131 of the Revenue Act of 1931, the predecessor to section 901 of the Code. The creditability of foreign taxes under this predecessor statutory provision depended on a determination that the foreign tax was an income tax, as that concept is applied under US tax law principles. *Biddle v. Commissioner, supra*.

ii. 1942 legislation

In response to this trend in the case law, Congress held hearings on the creditability of foreign taxes, and taxpayers testified that Congress should permit a credit for a foreign tax despite the fact that the tax was imposed on gross income, provided the tax was a substitute for a creditable foreign income tax. Hearings Before the Committee on Finance on H.R. 7378, 77th Cong., 2d Sess. 217 (1942). In follow-up to these hearings, Congress decided to act legislatively and adopted many of the suggestions made by taxpayers at the Hearings.

Accordingly, in the Revenue Act of 1942, Congress enacted the predecessor to current section 903. In the 1942 Act, the approach Congress adopted was not to broaden the definition of a creditable income tax under the general foreign tax credit provisions, but instead to add a separate section to the 1939 Code that provided an independent basis for creditability of a foreign tax that would not otherwise be creditable as an income tax under the general foreign tax credit provisions, where that tax was enacted as a substitute for the foreign jurisdiction's general income tax.

This new Code section, the predecessor to section 903 of the 1954 Code, permitted a foreign tax credit to be claimed for foreign taxes that were imposed in lieu of a jurisdiction's regular income tax. In explaining its reasons for broadening the scope of the foreign tax credit provisions to cover these "in lieu of" taxes, the Senate Finance Committee Report to the 1942 Act stated:

> Your committee believes further amendments should be made in section 131. Under that section as it now stands, a credit is allowed against United States tax for income, war profits or excess profits taxes paid or accrued to any foreign country or to any possession of the United States. In the interpretation of the term "income tax," the Commissioner, the Board, and the courts have consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income it was not recognized as a basis for such credit. Thus if a foreign country in imposing income taxation authorized, for reasons growing out of the administrative difficulties of determining net income or taxable basis within that country, a United States domestic corporation doing business in such country to pay a tax in lieu of such income tax but measured, for example, by gross income, gross sales or a number of

> units produced within the country, such tax has not heretofore been recognized as a basis for a credit. Your committee has deemed it desirable to extend the scope of this section. Accordingly, subsection (f) of section 160 provides that the term "income, war profits and excess profits taxes" shall, for the purposes of sections 131 and 23(c)(1), include a tax paid by a domestic taxpayer in lieu of the tax upon income, war profits and excess profits taxes which would otherwise be imposed upon such taxpayer by any foreign country or by any possession of the United States.

S. Rep. No. 1631, 77th Cong., 2d Sess.131 (1942).

The 1943 regulations under section 131(h), the predecessor statute to section 903, provided that a tax would be creditable as an in lieu of tax if

1) the foreign country has in force a general income tax law;

2) the taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax; and

3) such general income tax is not imposed upon the taxpayer thus subject to such substituted tax.

These regulations also contained a single example that illustrated these requirements. That example dealt with a case where a foreign country that has a general income tax found that for particular taxpayers the imposition of that general income tax would be administratively difficult. Accordingly, the foreign country imposed a tax on the gross income of such taxpayers in lieu of the general income tax. The example concludes that such a tax would be creditable under the in lieu of provisions. Treas. Reg. § 19.131-2.

iii. 1954 Code regulations

There were no substantive changes in the "in lieu of" foreign tax credit provisions in the 1954 Code. Section 131(h) was renumbered as section 903 and became the operative Code section for determining the creditability of a foreign tax under the "in lieu of" provisions. Proposed regulations were issued in 1956 (21 Fed. Reg. 4407), and final regulations were issued in 1957. T.D. 6275, 22 Fed. Reg. 9657 (Dec. 8, 1957). These regulations did not contain any substantive changes from the regulations issued under the 1939 Code.

Following enactment of the 1954 Code and regulations thereunder, a few early cases adopted a restrictive view of the scope of section 903. However, in general, the courts "significantly 'softened'" the interpretation of the "in lieu of" regulations, often holding that a taxpayer was eligible for an "in lieu of" credit "so long as the taxpayer is not subject to the 'underlying' tax." ABA Tax Section, Foreign Tax Credit Subcommittee, *The Creditability of Foreign Income Taxes: A Critical Analysis of Revenue Rulings 78-61, 78-62 and 78-63*, 32 Tax Lawyer 33, 64 and 65 (1978).

Most significantly, the requirements in the regulations were interpreted in a taxpayer-favorable manner in four cases in the Court of Claims, each of which held that a taxpayer was eligible for an "in lieu of" tax credit for a Canadian premium tax. *See Prudential Ins. Co. v. United States,* 319 F.2d 161 (1963) ("*Prudential I*"); *Prudential Ins. Co. v. United States*, 337 F.2d 651 (1964) ("*Prudential II*"); *Equitable Life Assurance Soc'y v. United States*, 366 F.2d 967 (1966); *Metro. Life Ins. Co. v. United States*, 375 F.2d 835 (1967). There are three important ways in which these cases softened the regulations.

First, the Court of Claims unequivocally stated that the congressional intent behind section 903 was to increase the number of instances in which a taxpayer could take a foreign tax credit. In *Prudential I*, the Court of Claims concluded that, in enacting the predecessor statute to section 903, Congress made a "clear expression of intent to widen the judicial interpretation that had previously been given to the term 'income taxes' in subsection (a) of section 131 as being limited to foreign taxes based on net income, (i.e. on gain or profit), in order to include a tax measured by gross income or gross sales as a basis for tax credit." *Id.* at 162.

Second, the Court of Claims dismissed the government's attempts to narrow the types of taxes that would be eligible for an "in lieu of" tax credit. For example, in *Metropolitan Life*, the Court of Claims said that it was irrelevant whether a foreign country enacted a tax "because of administrative or computation or 'empirical' difficulties" or whether the United States thought that the tax "was considered bad policy or inconsistent with the country's legal theory to levy the normal income tax upon a particular class of company." 375 F.2d at 838.

Third, the Court of Claims adopted a very broad and flexible standard in evaluating whether a tax could be creditable under section 903. In *Metropolitan Life,* the court provided the following standard for what type of tax will qualify as an in lieu of tax:

> There need be no functional connection between the foreign income tax and the 'in lieu' tax; no coordination of rates; no effort to approximate the amount of the general income tax or to reach the same subject matter or to replace the normal formula for computing income by a special formula designed to achieve the same or roughly the same amount.

Id. at 838.

iv. Change in IRS policy

The next significant development with respect to creditability of foreign taxes did not occur until 1978, when, as discussed in the preceding section of this comment letter dealing with the new proposed regulations under section 901, a trio of revenue rulings were issued reversing the IRS position on the creditability of a number of particular foreign taxes, followed by an IRS announcement that it was opening a regulations project to update the rules relating to the creditability of foreign taxes. As discussed in the preceding section of this memorandum, this IRS

study culminated in the issuance in 1979 of proposed regulations covering the creditability of foreign taxes under both sections 901 and 903. 44 Fed. Reg. 36,071 (June 20, 1979).

At a Ways and Means hearing in 1979, Donald C. Lubick, who was the Assistant Secretary for Tax Policy in the Department of Treasury in 1979, noted that he expected challenges to the 1979 proposed regulations. Proposed Amendments to the Foreign Tax Credit Limitation for Oil and Gas Extraction Taxes: Hearings Before the House Comm. on Ways and Means, 96th Cong., 1st Sess. 196 (1979).

In response to the comments received, in 1980, temporary and proposed regulations were issued under section 903, as well as under section 901. 45 Fed. Reg. 75,695 (Nov. 27, 1980). With respect to the portion of the temporary regulations relating to section 903, these temporary and proposed regulations added a new requirement -- a jurisdictional nexus requirement. These regulations required that an "in lieu of" tax follow "reasonable rules of taxing jurisdiction within the meaning of §4.901-2(a)(1)(iii)." Temp. Treas. Reg. § 4.903-1(a)(4)(1980).

Many commentators criticized the 1980 regulations for the same reasons that they criticized the 1979 regulations. Commentators noted that Congress would have enacted legislation under sections 901 and 903 if Congress had wanted to redefine the rules for foreign income taxes. See John L. Kramer, *Proposed Changes in Federal Income Tax Credits for Foreign Oil and Gas Payments*, 12 Case W. Res. J. Int'l L. 97, 119 (1980). ("A change of this magnitude appears to be of the nature that requires a legislative reappraisal of the entire foreign tax credit system, including its purposes and its current operating rules. As part of this examination, reasonable guidelines should be given to the IRS as to the congressional intent regarding the creditability of the levies . . .").

v. 1983 regulations

Due to the significant criticism of the 1980 regulations, these regulations were withdrawn, and final regulations under both sections 901 and 903 were issued to replace the prior temporary regulations on October 12, 1983. T.D. 7918, 48 Fed. Reg. 46,272 (Oct. 12, 1983). The preamble to the section 903 portion of these final regulations summarizes the provisions in these final regulations as follows:

> Creditability under § 1.903-1 is not dependent on administrative difficulty in applying the generally imposed income tax. The base of the tax need not bear any relation to realized net income; a section 903 tax may be imposed on gross receipts, gross income, or a base that bears no resemblance to income. A taxpayer may be entitled to credit under section 903 for a tax with respect to certain of its activities, even though the taxpayer is also subject to a generally imposed income tax on its income from other activities. As under section 901, each separate levy is evaluated in its entirety for all persons subject to the tax, and the rules of § 1.901-2A apply to dual capacity taxpayers.

Id. at 46,275.

These final regulations also eliminated the jurisdictional nexus requirement that had been included in the temporary and proposed regulations. Instead, several examples were added that, although nominally described as illustrating the substitution requirement in the regulations, in fact demonstrate the absence of a nexus requirement. In this regard, Treas. Reg. § 1.903-1(b)(1) notes that a foreign tax must satisfy a substitution requirement in order to be creditable as an "in lieu of" tax. This regulations provision indicates that the substitution requirement is satisfied if the foreign tax operates in a manner so that the foreign tax is in substitution for, not in addition to, a country's generally-imposed income tax. However, to illustrate this requirement, Treas. Reg. § 1.903-1(b)(3) Examples (1)-(3) provides:

> (b)(3) Examples. The provisions of this paragraph (b) may be illustrated by the following examples:
>
> Example (1). Country X has a tax on realized net income that is generally imposed except that nonresidents are not subject to that tax. Nonresidents are subject to a gross income tax on income from country X that is not attributable to a trade or business carried on in country X. The gross income tax imposed on nonresidents satisfies the substitution requirement set forth in this paragraph (b). See also examples (1) and (2) of § 1.901-2(b)(4)(iv).
>
> Example (2). The facts are the same as in example (1), with the additional fact that payors located in country X are required by country X law to withhold the gross income tax from payments they make to nonresidents, and to remit such withheld tax to the government of country X. The result is the same as in example (1).
>
> Example (3). The facts are the same as in example (2), with the additional fact that the gross income tax on nonresidents applies to payments for technical services performed by them outside of country X. The result is the same as in example (2).

The relevance of these examples to the newly-added nexus requirement in the new proposed regulations is addressed below.

These final regulations remain essentially unchanged from the date of their original promulgation in 1983 until the present time, when new proposed regulations under section 903 were issued by the IRS and Treasury.

vi. Effect of 2020 proposed regulations under section 903

Notwithstanding the long-standing provisions dealing with the credit for "in lieu of" foreign taxes in the 1983 regulations, the new proposed regulations would drastically alter the

requirements for creditability of "in lieu of" taxes under section 903. One of the most significant changes is the addition of a jurisdictional nexus requirement for creditability through the substitution requirement. The preamble to the proposed regulations describes this new requirement as follows:

> The proposed regulations revise the substitution requirement by more specifically defining the circumstances in which a foreign tax is considered "in lieu of" a generally-imposed income tax, consistent with the interpretation of the substitution requirement in prior judicial decisions. See, for example, *Metro. Life Ins. Co. v. United States*, 375 F.2d 835, 838-40 (Ct. Cl. 1967). In addition the proposed regulations provide that an in lieu of tax under section 903, by virtue of the substitution requirement, must also satisfy the jurisdictional nexus requirement described in proposed § 1.901-2(c). Although prior regulations under section 903 did contain a jurisdictional limitation with respect to in lieu of taxes, see § 4.903-1(a)(4) (1980) (requiring that an in lieu of tax follow "reasonable rules of taxing jurisdiction within the meaning of § 4.901-2(a)(1)(iii)"), the existing regulations do not contain such a rule.

85 Fed. Reg. 72,095 (Nov. 12, 2020).

Thus, under this new provision, a foreign country's tax on a non-resident's income that is earned in that foreign country, but that is not effectively connected to the conduct of a trade or business in the country or to a permanent establishment in the country, would not qualify for a foreign tax credit under section 903. That is in marked contrast to the current final regulations, where the examples in the current final regulations make it absolutely clear that no such nexus is a requirement for creditability under section 903.

In this regard, example (1) in Treas. Reg. § 1.903-1(b)(3) deals with a fact pattern where a foreign country exempts non-residents from a generally-imposed income tax on realized net income. However, in the facts of the example, the foreign country imposes as a substitute for this generally-imposed income tax a tax on gross income earned in the country, although that income is not attributable to a trade or business carried on in the country. The example concludes that the tax satisfies the substitution requirement in the section 903 regulations, and, thus, by implication, the tax is creditable. A similar conclusion may be reached from examples (2) and (3) in the current final regulations under section 903.

Under the proposed regulations, in order for a tax to qualify as a creditable "in lieu of" tax, it must be demonstrated that if the income on which the "in lieu of" tax was imposed was instead subject to the foreign country's generally-imposed income tax, that tax would be creditable under section 901. It is through this new aspect of the substitution requirement that the jurisdictional nexus requirement is introduced into section 903. The preamble explains this new requirement as follows:

> Fourth, proposed § 1.903-1(c)(1)(iv) requires that, 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 foreign net income tax, or would itself constitute a separate levy that is a foreign net income tax. This rule is intended to ensure that a foreign tax can qualify as an in lieu of tax only if the foreign country imposing the tax could instead have subjected the excluded income to a tax on net gain that would satisfy the jurisdictional nexus requirement in § 1.901-2(c).

85 Fed. Reg. 72,096 (Nov. 12, 2020).

As discussed above, examples (1) through (3) of the current regulations make it clear that no such jurisdictional nexus requirement applies under the current regulations under section 903.

This analysis of the new proposed regulations is especially relevant when evaluating the applicability of the statutory reenactment doctrine based on Congressional consideration of the foreign tax credit provisions in the existing regulations when Congress undertook legislative action in 1986 and 2017.

vii. Intervening legislation

As noted in the preceding section of this comment letter dealing with the new proposed regulations under section 901, in order for the doctrine of legislative reenactment to apply, it must be demonstrated that Congress took the position reflected in the 1983 final regulations under section 903 into account when Congress enacted legislation subsequent to the time that these regulations were issued. Accordingly, in the context of the 1983 version of the foreign tax credit regulations under section 903, it is necessary to consider two items of Congressional action between 1983 and the present time that took into account the positions set forth in the 1983 regulations.

First, as discussed in the preceding section of this comment letter relating to section 901, in 1986 Congress made several statutory changes in the rules governing international taxation, including certain of the rules governing the foreign tax credit. In developing this legislation, Congress was fully aware of the position adopted in the 1983 regulations on what constitutes a creditable "in lieu of" tax. However, Congress took no action to change those rules, despite being fully aware of those rules.

The fact that Congress took no action at that time to modify or question the rules in the 1983 foreign tax credit regulations under section 903, although fully aware of those rules, bolsters our contention that Congress implicitly blessed the existing provisions in those regulations when Congress enacted the Tax Reform Act of 1986. Past court decisions addressing the legislative reenactment doctrine have noted that the application of the doctrine in a particular situation is strengthened where it is shown that Congressional knowledge of positions adopted in the then existing regulations are not merely presumed, but those regulations provisions are specifically

addressed during Congressional consideration of subsequent legislation on the topics addressed in those prior regulations.

In the case of the section 903 regulations, Congressional knowledge of the positions adopted in the prior section 903 regulations goes beyond mere mention of those provisions in the 1986 Committee reports. Instead, as discussed above, Congress conducted hearings about the provisions in the 1979 proposed regulations and closely examined the way those regulations provisions were being interpreted.

Thus, it is quite apparent that in the years leading up to the Tax Reform Act of 1986, Congress both knew *and considered* the effect of the existing regulations on the definition of income tax under sections 901 and 903. Given the lack of congressional action after the 1983 regulations were finalized, it follows that Congress must have agreed with the approach taken by the IRS and Treasury Department in these final regulations and felt no need to make additional changes to the definition of what it means to be an income tax when the 1986 Code was enacted.

The same type of reappraisal of the rules for taxing foreign source income and the availability of foreign tax credits with respect to such income took place again in 2017, in connection with Congress's enactment of the TCJA. As noted in the preceding section of this memorandum dealing with the new proposed section 901 regulations, as part of the TCJA, Congress made a number of changes to the taxation of foreign source income, but the foreign tax credit provisions remained unchanged. All of these legislative changes in the TCJA relied heavily on the foreign tax credit regime that was in existence when the TCJA was enacted. Thus, Congress must have relied on the definition of income tax as articulated in the 1983 final regulations.

With respect to the application of the legislative reenactment doctrine, it is clear that if wholesale changes in the definition of a creditable foreign tax in the 1983 regulations had been contemplated in 1986 and again in 2017 when Congressional action with respect to the foreign tax credit took place, Congress would certainly have wanted to be involved in those changes and would have passed judgment on the merits of any such changes. Given that no such changes were proposed by the IRS at those times, and none were adopted by Congress in its legislation on those two occasions, the promulgation of regulations in 2020 that would result in wholesale changes in the definition of a creditable "in lieu of" foreign tax so soon after the enactment of the TCJA is unwarranted.

B. Eliminate jurisdictional nexus requirement only from the section 903 proposed regulations.

If the foregoing recommendation regarding the complete elimination of the jurisdictional nexus requirement from the proposed regulations under section 901 and 903 were rejected, then it is our recommendation that this requirement should, at a minimum, be removed from the section 903 proposed regulations.

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As noted above, the current final regulations do not contain any form of jurisdictional nexus requirement. Moreover, the current final regulations go further and illustrate the lack of any jurisdictional nexus requirement through several examples. Furthermore, as noted above, while those examples are nominally described as illustrating the substitution requirement in the regulations, in fact, these examples demonstrate the complete absence of a jurisdictional nexus requirement.

In conclusion, the imposition of a jurisdictional nexus requirement under the proposed regulations makes those proposed regulations a departure from the current final regulations. However, without any sort of legislative backing, we submit that there is no basis for such a radical change in the requirements for creditability of a foreign tax. Accordingly, a jurisdictional nexus requirement in the foreign tax credit regulations is not justified.

In addition to the arguments against the inclusion of a jurisdictional nexus requirement in any section of the proposed regulations, there is an especially strong argument for the elimination of this requirement in the section 903 regulations. The difference in the strength of the argument for exclusion of a jurisdictional nexus requirement in the case of section 903, in comparison to section 901, is based on the fact that the legislative history of section 903 and the background surrounding the enactment of that section offer a persuasive argument that Congress intended this section to be more expansive than section 901 and apply to foreign taxes that would not qualify for a credit under section 901. In this regard, the Senate Finance Committee Report on the Revenue Act of 1942, which first enacted the "in lieu of" provisions for creditability of foreign taxes, provided:

> Your committee believes further amendments should be made in section 131. Under that section as it now stands, a credit is allowed against United States tax for income, war profits or excess profits taxes paid or accrued to any foreign country or to any possession of the United States. In the interpretation of the term "income tax," the Commissioner, the Board, and the courts have consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income it was not recognized as a basis for such credit. Thus if a foreign country in imposing income taxation authorized, for reasons growing out of the administrative difficulties of determining net income or taxable basis within that country, a United States domestic corporation doing business in such country to pay a tax in lieu of such income tax but measured, for example, by gross income, gross sales or a number of units produced within the country, such tax has not heretofore been recognized as a basis for a credit. Your committee has deemed it desirable to extend the scope of this section. Accordingly, subsection (f) of section 160 provides that the term "income, war profits and excess profits taxes" shall, for the purposes of sections 131 and 23(c)(1), include a tax paid by a domestic taxpayer in lieu of the tax upon

> income, war profits and excess profits taxes which would otherwise be imposed upon such taxpayer by any foreign country or by any possession of the United States.

S. Rep. No. 1631, 77th Cong., 2d Sess.131 (1942).

The original regulations under section 131(h), the predecessor to section 903, contained very limited restrictions on the creditability of a foreign tax under the "in lieu of" provisions. The final regulations broadened these rules somewhat, but continued to exclude a jurisdictional nexus requirement from the rules for determining eligibility for a foreign tax credit.

The decision to exclude a jurisdictional nexus requirement from the section 903 rules is also supported by the fact that three examples of creditable taxes, as "in lieu of" taxes, were added to the regulations in circumstances where those taxes would fail the test for creditability if the new proposed jurisdictional nexus requirement had been applicable to those types of taxes.

In the final analysis, even if the Treasury and IRS decline to accept our recommendation that the jurisdictional nexus requirement be completely eliminated, we submit that there is a very persuasive case for eliminating that requirement in the section 903 proposed regulations.

C. Eliminate jurisdictional nexus requirement from the "covered" withholding tax provisions in the section 903 proposed regulations.

Finally, even if both of our recommendations with respect to the elimination of the jurisdictional nexus requirement from the section 901 and 903 proposed regulations are rejected, at a minimum, the new jurisdictional nexus requirement should be eliminated from the section of the proposed regulations dealing with "covered" withholding taxes.

This recommendation is based on the fact that Treasury and IRS have drafted the rules in the proposed regulations in a manner so that the rules for creditability are less stringent with respect to withholding taxes. However, that difference in the rules should go further and eliminate the jurisdictional nexus requirement for withholding taxes under section 903.

The argument for more liberal treatment of foreign withholding taxes is that under the U.S. income tax system, withholding taxes are imposed on foreign corporations (and individuals) that earn certain types of fixed and determinable income in the U.S., even where there is no jurisdictional nexus between the taxpayer and the U.S. Section 881(a)(1) imposes a flat 30 percent tax on the gross amount of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, renumerations, emoluments, and other fixed or determinable annual periodical gains, profits, and income from U.S. sources, if not effectively connected with the conduct of a trade or business within the U.S. Section 871 imposes a similar tax on foreign individuals.

Sections 1442 and 1441 impose a withholding obligation on payors of such amounts to insure the collection of the tax.

In *Biddle*, the Supreme Court expressed the view that the creditability of a foreign income tax is based on its similarity with that of the U.S. income tax. If under the U.S. income tax system, gross basis withholding taxes are imposed on certain types of U.S. source income earned by foreign corporations and individuals not effectively connected with the conduct of a U.S. trade or business, then similar foreign withholding taxes ought to be creditable without violating *Biddle*.

While it must be acknowledged that U.S. withholding taxes apply only to certain types of fixed and determinable income and do not apply to services rendered by a foreign corporation with no contacts in the U.S. except for the location of the customers, that historically narrow structure for U.S. withholding taxes is undoubtedly due to the limitations in technology that existed when the withholding tax rules were enacted. At that time, it's hard to conceive of the types of services that could have been rendered to U.S. consumers by a foreign corporation located outside the U.S. and without a physical presence in the U.S. Accordingly, it is doubtful that a jurisdictional nexus requirement would have been imposed on withholding taxes at the time the current final regulations were issued.

2. Satisfaction of jurisdictional nexus requirement.

An alternative position that the Treasury and IRS could adopt with respect to the jurisdictional nexus requirement would be to accept the premise that the requirement is deemed satisfied in a case where the ultimate consumers of digitally-provided services reside in the jurisdiction where the tax is imposed, provided the taxes would be creditable under the current regulations. There are numerous developments both with respect to technology and with respect to tax systems in the U.S. that support the conclusion that a jurisdictional nexus requirement is satisfied in those circumstances.

The new proposed regulations adopt a very narrow interpretation of the nexus requirement. That narrow interpretation relies on such factors as the location of a taxpayer's operations, the location of its employees, factors of production, or management of the foreign corporation. Where such factors are absent from the taxing jurisdiction, such other factors as the location of a taxpayer's customer, users, or similar destination-based criteria are an insufficient basis on which to predicate the satisfaction of a jurisdictional nexus requirement. 85 Fed. Reg. 72,088.

While that narrow interpretation of jurisdictional nexus may have been appropriate when the U.S. income tax system was first designed, based on the limits of technology at that point in time, the rationale in the preamble to the proposed regulations ignores the evolutionary changes that have occurred in technology and in taxing jurisdictions' responses to these technological changes. When the U.S. income tax system was first designed, the only types of income that

foreign non-resident corporations were likely to be able to earn absent a physical presence and an active trade or business in the U.S. were the types of fixed and determinable income that are subject to the withholding taxes imposed by current sections 881 and 871. However, the development of the internet has dramatically changed that situation.

In response to these technological changes, taxing jurisdictions both in the U.S. and outside the U.S. have changed their income tax regimes. For example, many of the states within the U.S. have broadened their states' tax regimes to include income earned by out-of-state providers of goods and services through the mechanism of the internet to consumers located in the taxing jurisdiction, where the out-of-state provider has no physical presence in the taxing jurisdiction.

The Supreme Court's recent decision in *South Dakota v. Wayfair, Inc*., 138 S. Ct. 2080 (2018), is an illustration of how U.S. courts deal with the issue of nexus in the context of the income tax regime adopted by states within the U.S. This case involved the issue of what degree of nexus is required in order for one U.S. state to impose sales taxes made to residents of that state by a retailer located in another U.S. state with no physical presence in the state into which the sales were made.

Prior Supreme Court decisions had held that an out-of-state retailer was required to have some degree of physical presence in the state into which the sales were made in order for that state to validly be able to require the retailer to collect sales taxes on the sales. However, the Court held in *Wayfair* that because of developments in digital communications and commerce, this physical presence test for nexus is no longer realistic:

> .... For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers' computers. A website may leave cookies saved to the customers' hard drives, or customers may download the company's app onto their phones....
>
> .... Between targeted advertising and instant access to most consumers via any internet-enabled device, "a business may be present in a State in a meaningful way without" that presence "being physical in the traditional sense of the term.".... This Court should not maintain a rule that ignores these substantial virtual connections to the State.

Id. at 2095.

While *Wayfair* involved actual sales of physical products that were shipped to customers' locations, and digital services do not involve this type of physical contact, nevertheless, for businesses that are engaged solely in providing digital services, a "jurisdictional nexus requirement" that is based purely on a physical presence test for nexus was repudiated in *Wayfair*.

Thus, the preamble's interpretation of jurisdictional nexus is clearly inadequate in light of the reality of current business practices in an age of digital commerce and communications that was recognized and applied by the Supreme Court in *Wayfair*.

Furthermore, the physical presence and permanent establishment standard is not something inherent to our tax system that was established to ensure that a source country is able to tax net income; rather, the permanent establishment standard was a "political invention" in the 1920s that was a result of bargaining between the U.S. and our tax treaty partners. *See* Ruth Mason, *The Transformation of International Tax,* 114 A.J.I.L. 353, 393 (2020). The preamble's approach to physical presence, a standard that is rooted in political bargaining, disregards the economic realities of digital companies today and lacks the reasoned decision-making that is an essential requirement under the arbitrary and capricious standard.

Based on the foregoing rationale, there are strong policy reasons for treating a jurisdictional nexus requirement with respect to a foreign tax as being satisfied where the consumers of a service rendered by a foreign non-resident corporation are located in the taxing jurisdiction.

3. The new rule requiring the allowance of deductions in order for a foreign tax to be creditable should be abandoned.

Another area in the proposed regulations that we recommend should be revised is the definition of the "net gain" requirement, as it relates to the new requirement that in order for a foreign tax to be creditable, the tax must allow deductions in computing the basis of the tax.

Current regulation § 1.901-2(b)(4)(i) states that a levy meets the net income test if "the base of the tax is computed by reducing gross receipts" to allow "[r]ecovery of significant costs and expenses" either (A) "attributable, under reasonable principles, to such gross receipts;" or (B) "under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses." The regulations continue by noting as follows:

> A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement *except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively,* and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. *Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax).*

(Emphasis added.). The current section 901 regulations are consistent with several cases that concluded that a tax on gross receipts can be a creditable tax so long as the tax reaches net income. *See, e.g., Seatrain Lines, Inc. v. Commissioner*, 46 B.T.A. 1076 (1942); *Santa Eulalia Mining Co.*

v. Commissioner, 2 T.C. 24 (1943); *Bank of America Nat'l Trust and Sav. Assn. v. United States*, 459 F.2d 513 (Ct. Cl. 1972).

It is the foregoing provision in the current regulations that clearly permits digital services taxes to be creditable for U.S. income tax purposes, because the costs and expenses that are associated with the type of gross receipts that are subject to the digital services taxes will "never be so high as to offset gross receipts or gross income," and accordingly "businesses subject to the tax are almost certain never to incur a loss (after payment of the tax)."

The preamble to the proposed regulations explains the change to the proposed regulations with respect to this issue as follows:

> The Treasury Department and the IRS have determined that, in some respects, the empirical analysis contemplated by the existing regulations is unnecessary to identify the essential elements of an income tax in the U.S. sense. In addition, in the absence of specific rules and thresholds in the regulations on how to evaluate empirical data (if even available), both taxpayers and the IRS have had difficulties in applying the existing regulations to foreign taxes in a consistent and predictable manner.

85 Fed. Reg. at 72,087.

The preamble later provides:

> . . . . The Treasury Department and the IRS have determined that any foreign tax imposed on a gross basis is by definition not an income tax in the U.S. sense, regardless of the rate at which it is imposed or the extent of the associated costs.
>
> In addition, the Treasury Department and the IRS have determined that the empirical standards contained in Bank of America I and that are contemplated by the nonconfiscatory gross basis tax rule in the existing regulations create substantial compliance and administrative burdens for taxpayers and the IRS when evaluating whether a foreign tax is an income tax in the U.S. sense. . . .
>
> Therefore, the proposed regulations remove the nonconfiscatory gross basis tax rule. . . . Under proposed §1.901-2(b)(4)(i)(A), a tax that is imposed on gross receipts or gross income, without reduction for any costs or expenses attributable to earning that income, cannot qualify as a net income tax, without regard to whether the empirical impact of the tax is confiscatory, and even if in practice there are no or few costs and expenses attributable to all or particular types of gross receipts included in the foreign tax base.

Id. at 72,090-91.

The treatment of the net gain requirement had been the subject of considerable controversy prior to the enactment of section 131(h) (the predecessor to section 903) and is probably the issue most responsible for the enactment of the "in lieu of" tax provisions. However, the interpretation of the "net gain" requirement in the 1983 version of the foreign tax credit regulations that allowed a credit for gross basis taxes where expenses are not likely to be significant has been uniformly followed since the promulgation of those regulations.

The assertion in the preamble that there is an objection to the long-standing interpretation of the "net gain" requirement based on perceived administrative difficulties with the empirical analysis that is supposedly needed to apply this rule is unwarranted. None of the court decisions in this area reflect any such administrative difficulties. Instead, the focus has been on the nature of the income that is the subject of the tax and whether that type of income is likely to involve significant expenses that could result in a net loss being realized from the activity being taxed.

In the case of digital services taxes, for example, it is obvious based on the nature of the services that it is unlikely that there would be significant expenses associated with digital services revenue, and that accordingly it is unlikely that failure to allow for such expenses would result in a net loss. Contrary to the contention in the preamble to the proposed regulations, reaching this conclusion regarding digital services taxes does not require any burdensome empirical analysis.

In conclusion, the argument to abandon the rule permitting creditability of a foreign tax that does not allow for deductions in cases where expenses are not likely to be significant, based on supposed administrative difficulty, is unjustified, and accordingly we recommend that the existing rule should be retained.

Respectfully submitted,

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