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CHARTERED

April 12, 2022

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

Re: APA Petition for Review of Final Regulations under Sections 901 and 903 -- T.D. 9959

Dear Sir:

On December 28, 2021, the Treasury Department and the Internal Revenue Service ("IRS") (collectively, the "Treasury") published in the Federal Register final regulations under sections 901 and 903 of the Internal Revenue Code ("Code"), addressing the creditability of foreign taxes. T.D. 9959, 87 F.R. 276. On behalf of our clients, we hereby petition the Treasury, pursuant to section 553 of the Administrative Procedures Act ("APA"), to revise certain aspects of these regulations.

The APA provides that "[e]ach agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule." 5 USC § 553(e). The Internal Revenue Manual provides that any petition for rulemaking submitted to the IRS under section 553(e) of the APA will be considered during the Priority Guidance Plan process. IRM 32.1.1.4.1(2). Any failure of the Treasury to timely address such a petition gives rise to a right to judicial review under 5 USC § 702. Pursuant to these provisions, we request the Treasury to consider this petition for review in a timely manner.

While our clients have concerns about various aspects of the final foreign tax credit regulations, this petition for review is confined to the issue of the creditability of certain foreign withholding taxes imposed on royalties.

SUMMARY OF PETITION

On November 12, 2020, the Treasury published in the Federal Register proposed regulations under sections 901 and 903 of the Code. Those proposed regulations would have imposed a new jurisdictional nexus requirement as part of the determination whether a particular foreign tax is creditable for U.S. tax purposes. The proposed jurisdictional nexus requirement generally provided that "for a foreign tax to qualify as an income tax, the tax must conform with established international norms, reflected in the Code and related guidance, for allocating profit between associated enterprises, for allocating business profits of nonresidents to a taxable presence in the foreign country, and for taxing cross-border income based on source or the situs of property." 85 Fed. Reg. at 72088. As specifically relevant to foreign withholding taxes on royalties, the jurisdictional nexus requirement for taxes imposed based on the source of income would have

required that "the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply for Federal income tax purposes." Prop. Treas. Reg. § 1.901-2(c)(1)(ii) The proposed regulations left completely open the question of how this requirement would apply to withholding taxes imposed on royalties.

Our firm, as well as other commentators, submitted comments to the Treasury suggesting that the proposed jurisdictional nexus requirement be modified or eliminated. In the final regulations issued on December 28, 2021, the Treasury renamed the jurisdictional nexus requirement the "attribution" requirement and moved the requirement. The final regulations also, however, added a new rule taking an extremely narrow position on when a foreign withholding tax on royalties is "reasonably similar" to the U.S. source rule for royalties. The new rule provides that "[a] foreign tax on gross income from royalties must be sourced based on the place of use of, or the right to use, the intangible property."[1] Treas. Reg. § 1.901-2(b)(5)(i)(B)(2)) (the "Royalties Attribution Requirement").

We submit that the Treasury should modify the Royalties Attribution Requirement for three main reasons. The first reason is that the Royalties Attribution Requirement is overly restrictive *even by the Treasury's own standards.* The Treasury introduced the Royalties Attribution Requirement as part of a process of clarifying how the source-based attribution requirement applies to different types of income. As part of that process, the Treasury agreed with comments that it should not require foreign taxes to strictly conform with the Code to be creditable, and instead should allow some flexibility in the design of foreign tax laws, provided they are "consistent with the general principles of income taxation reflected in the Code." T.D. 9959, 87 F.R. 276, 287 (Dec. 28, 2021).

We respectfully submit that the Treasury misjudged where to draw that line with respect to foreign withholding taxes imposed on royalties, by failing to recognize that the U.S. place of use rule is an outlier rather than a norm, and that other source rules for royalties used by foreign countries are fundamentally similar to the U.S. place of use rule. In particular, the most common rule in use around the world is that the source of a royalty is based on the country of residence of the payor. The country of residence of the payor is a reasonable proxy for the place of use, or the right to use, licensed property. Sourcing based on the residence of the payor (as most of the world does) reaches the same result as sourcing based on the place of use (as the U.S. does) in most situations. Moreover, both rules treat the use of licensed property as the economic source of royalty income (rather than, for example, treating the development of the licensed property as its economic source). Payor residence sourcing is an easily administrable and enforceable way to source royalties based on where property is used and is therefore reasonably similar to the U.S. source rule.

[1] We note that the new rule contains a grammatical error that arguably renders it meaningless. The rule purports to require that *the foreign tax itself* "must be sourced based on the place of use . . ." For purposes of these comments, however, we assume that Treasury meant to provide that under the foreign tax law, *gross income from royalties* must be sourced based on the place of use . . . ."

Moreover, whatever differences there are between payor residence and place of use in theory, the two sourcing rules are virtually identical in practice. Parties to license agreements avoid subjecting royalties to withholding taxes sourced based on the residence of the payor except to the extent that the royalties are for use in the country of residence of the payor (*i.e.*, the payor's customers reside in the same country). This bolsters the conclusion that payor residence is a reasonable proxy for the place of use. It also demonstrates that in any event, the Royalties Attribution Requirement is a form over substance restriction.

The latter point is reason *by itself* for the Treasury to modify the Royalties Attribution Requirement to permit a credit for payor residence sourced withholding taxes on royalties. In the context of foreign income taxes generally, Treasury abandoned the predominant character test out of concern that the IRS and taxpayers lacked sufficient data to determine whether particular foreign taxes reached net gain "in the normal circumstances" in which they applied. That change in the regulations by itself does not mean, however, that *in drafting regulations in the first place*, Treasury should close its eyes to how foreign taxes apply in practice, including how common sense tells one that businesses with cross-border operations respond to foreign tax laws. The Treasury should not disallow foreign tax credits for foreign withholding taxes that apply almost identically to U.S. FDAP withholding, and that were creditable for over 50 years, on the sole grounds that *in theory* the foreign taxes could apply more broadly.

The second main reason why the Treasury should reconsider the Royalties Attribution Requirement is that it represents a major and consequential departure from settled law for which Treasury has provided no justification. The Treasury's stated reasons for proposing an attribution requirement in the first place clearly do not justify the way the Treasury has applied the requirement to royalties. First, unlike digital services taxes and diverted profits taxes, payor residence sourced withholding taxes are not novel or overreaching, and instead have been part of the international tax system for decades. Second, sourcing royalties based on the place of use of licensed property is not an international norm—if anything, sourcing based on payor residence is the international norm. Third, the Treasury's goal of ensuring that foreign countries only impose income and withholding taxes to the extent that a taxpayer has activities and assets in foreign countries is not furthered in any way by the Royalties Attribution Requirement. That is because place of use sourcing (the U.S. standard), just like payor residence sourcing, conveys jurisdiction to the jurisdiction where intellectual property facilitates consumption and not to the jurisdiction where the licensed property was developed.

Finally, the Treasury should reconsider the Royalties Attribution Requirement because the Treasury violated the APA by adopting the Royalties Attribution Requirement for the first time in final regulations without notice and comment. The Royalties Attribution Requirement is a major addition to the regulations that was not reasonably signaled by the proposed jurisdictional nexus requirement and, as a result, took affected parties by surprise.

We note that when the new foreign tax credit regulations were proposed, we and other commentators argued against the jurisdictional nexus requirement generally, including arguing that the requirement violates the APA, and arguing that the Treasury lacked authority to issue the requirement because it purports to reverse decades of case law under the pretense of revising

regulations. While we maintain those positions, we do not repeat them here. We focus instead on the Royalties Attribution Requirement because it is new and should be revised even assuming that the broader attribution requirement is otherwise valid and good policy.

BACKGROUND

I. U.S. Source Rule for Withholding Tax on Royalties

Under the Code, royalties for the use of IP are sourced based on the country in which the IP is used, or the country in which the right to use the IP is protected. I.R.C. §§ 861(a)(4), 862(a)(4). Congress enacted these source rules in 1921 with the intent that the source of royalty income for tax purposes match its economic source. H.R. Rep. No. 67-350, at 24 (1921), as reprinted in 1939-1 CB 192 (explicitly allocating "certain important sources of income to the United States or to foreign countries" because current law was "both obscure and economically unsound").

One of the primary applications of this sourcing rule is that, in general, the U.S. imposes a 30% withholding tax on royalties paid (by a U.S. person or otherwise) for the use of IP in the U.S. Thus, the U.S. withholds on royalties for the use of patents, trademarks, copyrights, and other IP in the U.S., even if the IP was developed through investments and activities by a foreign person in a foreign country. In other words, the U.S. asserts jurisdiction to withhold on royalties based on where IP is used to sell to consumers (*i.e.*, the U.S.'s status as the market jurisdiction), and not where the activities giving rise to the IP occur. This contrasts with the U.S. source rule for services, which are treated as foreign source if the services are performed outside the U.S., and regardless of whether the customer is located in the U.S. *See* §§ 861(a)(3), 862(a)(3).

It is often unclear in what country IP is used or protected, and the place of use standard has given rise to numerous interpretative rulings and cases.[2] Disputes have also arisen as to how to allocate royalties for the use of IP that is protected or used in multiple jurisdictions.[3] The outcome of such disputes has often been the same as if the royalties at issue were sourced based on the country of residence of the payor. *See*, *e.g.*, *SDI Netherlands B.V. v. Comm'r*, 107 T.C. 161, 171-177 (1996) (rejecting IRS's position that Dutch corporation was liable for withholding taxes on royalties paid under head license to Bermuda corporation with respect to use of software in the U.S., because there was a sublicense with a U.S. payor); *Misbourne Pictures Ltd. v. Johnson*, 189 F.2d 774, 776 (2d Cir. 1951) (due to inability to allocate, U.S. movie producer correctly withheld on 100% of royalties paid, even though "only the income from sources within the United States is

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[2] *See, e.g.*, Rev. Rul. 84-78, 1984-1 CB 173; Rev. Rul. 80-362, 1980-2 CB 208; Rev. Rul. 72-232, 1972-1 CB 276; Rev. Rul. 68-443, 1968-2 CB 304; GCM 33711; *SDI Netherlands B.V. v. Comm'r*, 107 T.C. 161 (1996); Notice 2006-34; Rev. Proc. 2007-23.

[3] *See, e.g.*, *Estate of Marton v. Comm'r*, 47 B.T.A. 184 (1942), *aff'd* 156 F.2d 924 (2d Cir. 1946); *Rohmer v. Comm'r*, 8 T.C. 183 (1945), *aff'd*, 153 F.2d 61 (2d Cir. 1946); *Wodehouse v. Comm'r*, 8 T.C. 637 (1947), *acq.*, 1947-2 C.B. 5, *rev'd*, 166 F.2d 986 (4th Cir. 1948), *rev'd and rem'd*, 377 U.S. 369 (1949), *aff'd in part, rev'd in part and rem'd on issue of apportionment*, 178 F.2d 987 (4th Cir. 1949), *on remand*, 15 T.C. 799 (1950).

taxable and Goldwyn's license covered also other parts of the world"); *Molnar v. Comm'r*, 1945 Tax Ct. Memo LEXIS 59, 4 T.C.M. (CCH) 951 (1945) (royalties paid by U.S. motion picture companies for worldwide rights to use manuscripts were entirely U.S. source due to difficulty of allocating between U.S. and foreign use), *aff'd*, 156 F.2d 924 (2d Cir. 1946). The other challenge with the place of use standard is enforcement—one of the main purposes of FDAP withholding is to impose tax on persons within U.S. jurisdiction, and it is difficult for the IRS to enforce FDAP withholding tax on royalty payments solely between two foreign persons (with respect to the use of property in the U.S.). One practitioner and former Treasury official has observed that for these reasons, despite the text of sections 861(a)(4) and 862(a)(4), "[i]n practice, taxpayers and tax administrators have often assumed that the source of royalty income is determined by the residence of the payer." Charles I. Kingson, *The Source of Royalty Income*, 119 Tax Notes 499 (May 5, 2008) (arguing that the IRS does not, but should, enforce the text of sections 861(a)(4) and 862(a)(4)).

II. International Sourcing Rules for Withholding Taxes on Royalties

The U.S. source rule for royalties is unusual. The overwhelming majority of countries, including developed countries, impose withholding taxes on royalties paid by a resident of a country to a non-resident, based simply on the residence of the payor. The following table summarizes the withholding tax laws with respect to royalties of the 50 largest economies in the world by GDP, excluding the United States and Iran:[4]

[4] Our summary of these source rules is based on translations of foreign tax legislation where available, English-language guides provided by revenue authorities where available, and secondary sources prepared by local country practitioners.

Country	OECD Member	Treaty with the United States	Rate for U.S. Payees	Jurisdictional Basis
Argentina	No	No	28% or 31.5%	Unclear
Australia	Yes	Yes	5%	Payor Place of Business, and Connection of Royalty to Business
Austria	Yes	Yes	0% or 10%	Place of Use or Place of Registration
Bangladesh	No	Yes	10%	Place of Use
Belgium	Yes	Yes	0%	Payor Residence
Brazil	No	No	15%	Payor Residence
Canada	Yes	Yes	0%	Payor Residence
Chile	Yes	No	30%	Place of Use
China	No	Yes	10%	Unclear
Colombia	Yes	No	20%	Unclear
Czech Republic	Yes	Yes	0% or 10%	Payor Residence
Denmark	Yes	Yes	0%	Payor Residence
Egypt	No	Yes	15%	Payor Residence
Finland	Yes	Yes	0%	Payor Residence
France	Yes	Yes	0%	Payor Place of Business
Germany	Yes	Yes	0%	Place of Use or Place of Registration
Hong Kong	No	No	2.475% or 4.95%	Payor Residence, or Place of Use
India	No	Yes	10%	Place of Use
Indonesia	No	Yes	10%	Payor Residence
Ireland	Yes	Yes	N/A	N/A
Israel	Yes	Yes	10% or 15%	Payor Residence
Italy	Yes	Yes	0% or 5% or 8%	Payor Residence
Japan	Yes	Yes	0%	Payor Place of Business, and Connection of Royalty to Business
Malaysia	No	No	10%	Payor Residence
Mexico	Yes	Yes	10%	Payor Residence, or Place of Use
Netherlands	Yes	Yes	N/A	N/A
New Zeland	Yes	Yes	5%	Payor Residence
Nigeria	No	No	10%	Other
Norway	Yes	Yes	N/A	N/A
Pakistan	No	Yes	N/A	N/A
Phillipines	No	Yes	15% or 25%	Place of Use
Poland	Yes	Yes	10%	Payor Residence
Portugal	Yes	No	10%	Payor Residence
Romania	No	Yes	10% or 15%	Payor Residence
Russia	No	Yes	0%	Place of Use
Saudi Arabia	No	No	15%	Payor Residence, and Place of Use
Singapore	No	Yes	10%	Payor Residence
South Africa	No	Yes	0%	Payor Residence, or Place of Use
South Korea	Yes	Yes	10% or 15%	Payor Residence, or Place of Use
Spain	Yes	Yes	0%	Payor Residence, or Place of Use
Sweden	Yes	Yes	0%	N/A
Switzerland	Yes	Yes	0%	N/A
Taiwan	No	No	20%	Place of Use
Thailand	No	Yes	5%	Payor Residence
Turkey	Yes	Yes	10%	Payor Residence
United Arab Emirates	No	No	N/A	N/A
United Kingdom	Yes	Yes	0%	Payor Residence
Vietnam	No	No	10%	Other

Thus, payor residence is by far the most common basis on which countries, including OECD members and U.S. tax treaty partners, assert jurisdiction to impose withholding taxes on royalties.[5] Withholding based on the place of use of licensed property is unusual.

Specifically, the domestic laws of 20 major countries in the table above, including OECD members and treaty partners, impose a withholding tax on royalties based on the residence of the payor. By contrast, only 6 countries (other than the United States) impose their withholding tax on royalties based on the extent that IP is used in the country. Thus, over *three times* as many foreign countries with the largest economies in the world impose a withholding tax based on the residence of the payor as impose a withholding tax based on place of use. Of the 6 countries that impose a withholding tax based on the place of use, only Chile is an OECD member.

Income taxes withheld from royalty payments by a resident of a foreign country to a U.S. person, based on the payor's residence in that foreign country, have generally been allowed as a credit against the U.S. federal income tax for at least 50 years. *See, e.g.*, Rev. Rul. 59-70, 1959-1 CB 186 (Brazilian withholding tax on royalties paid by residents to non-residents creditable); Rev. Rul. 60-56, 1960-1 CB 274 (same); Rev. Rul. 73-106, 1973-1 CB 343 (Mexican withholding tax on royalties paid by residents to non-residents creditable because similar to U.S. FDAP withholding on royalties); Rev. Rul. 73-118, 1973-1 CB 345 (same with respect to Czechoslovakian withholding tax).

III. The Proposed Jurisdictional Nexus Rule

As noted above, on November 2, 2020, the Treasury proposed regulations under sections 901 and 903 of the Code. REG-101657020, 85 F.R. 72078 (Nov. 12, 2020). The proposed regulations proposed significant changes in the approach to assessing the creditability of foreign taxes. The first significant change relevant to the Royalties Attribution Requirement was to revise the test for whether a foreign tax is an income tax so that the question would no longer be whether, empirically, a foreign tax reaches net gain in the "normal circumstances" in which it applies, but whether the foreign tax law on its face is a tax on net gain. *See id.* at 72089. The preamble asserted that this change was motivated by the IRS's difficulty over the years in obtaining the data necessary to determine how foreign taxes in fact apply to taxpayers generally. *Id.*

The second major change relevant to the Royalties Attribution Requirement was the new jurisdictional nexus requirement, which generally required that "for a foreign tax to qualify as an income tax, the tax must conform with established international norms, reflected in the Code and

[5] Several of the countries that rely, in whole or in part, on payor residence also treat royalties paid by a permanent establishment ("PE") of a foreign resident as sourced in the country—*i.e.*, they treat royalties paid by a PE in the same manner as royalties paid by a resident. The specific countries that include this feature in their payor residence standard are: Belgium, the Czech Republic, Hong Kong, Indonesia, Italy, Malaysia, Mexico, New Zealand, Portugal, Romania, Saudi Arabia, Singapore, South Africa, South Korea, Spain, and the United Kingdom. Denmark treats royalties paid by a domestic agent of a foreign person (in addition to those paid by Danish residents) as Danish source.

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." *Id.* at 72088.

Treasury asserted that the purpose of the foreign tax credit in mitigating double taxation of income "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," including "whether there is a sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax." *Id.* The Treasury did not explain the basis for this policy conclusion, other to note that "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." *Id.* The Treasury summarized its response to such taxes as follows:

> 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.

Id. Thus, the Treasury's view is that by requiring that a foreign country's assertion of jurisdiction to tax be co-extensive with the U.S.'s assertion of jurisdiction to tax, the jurisdictional nexus requirement will ensure that foreign tax credits are only be available with respect to foreign taxes imposed based on a taxpayer's *activities and assets* in the foreign country imposing the tax.

There are three prongs to the proposed (and final) jurisdictional nexus requirement for taxes imposed on non-residents: "income attribution based on activities nexus"; "nexus based on source of income"; and "nexus based on situs of property". The second prong, nexus based on source of income, is directly relevant to the Royalties Attribution Requirement (and to foreign withholding taxes generally). The proposed version of the source-based nexus rule provided as follows:

> (ii) *Nexus based on source of income.* The amount of income (other than income from sales or other dispositions of property) that is taxable in the foreign country on the basis of source (instead of on the basis of activities as described in paragraph (c)(1)(i) of this section) is based on income arising from sources within the foreign country that imposes the tax, *but only if the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply for Federal income tax purposes. In particular, a foreign tax on income from services must be sourced*

> *based on where the services are performed, and not based on the location of the service recipient.*

Prop. Treas. Reg. § 1.901-2(c)(1)(ii) (emphasis added). The proposed regulations were silent on extent to which foreign sourcing rules for royalty income are "reasonably similar" to the U.S. source rules for royalty income, including whether sourcing based on the residence of the payor (as in many countries) is reasonably similar to sourcing based on place of use.

IV. The Royalties Attribution Requirement

Numerous commentators, including our firm, suggested that the proposed regulations, and particularly the jurisdictional nexus requirement, were invalid because they purported to overturn existing case law, and because they failed to comply with the APA. The Treasury generally rejected these suggestions and finalized the regulations, without significant changes favorable to taxpayers, on December 28, 2021. T.D. 9959, 87 F.R. 276. The Treasury renamed the jurisdictional nexus requirement the "attribution requirement" and tucked the requirement into the existing net gain requirement, rather than issuing it as a separate rule.

The Treasury did agree with one set of points made by commentators that are significant in the context of the Royalties Attribution Requirement, as follows:

> . . . [a comment] also asserted that defining what are acceptable standards of taxing jurisdiction based upon U.S. principles may be unduly restrictive and may result in non-creditability of foreign taxes even when the foreign tax law is mostly aligned with U.S. principles. [. . .]
>
> Comments also pointed out that the jurisdictional nexus requirement that was included in the 1980 temporary and proposed regulations at § 4.901–2(a)(1) (flush language) was a more flexible standard because it required only that the foreign tax follow reasonable rules regarding source of income, residence, or other bases for tax jurisdiction, and did not require specific rules that are similar to Federal income tax rules. In addition, one comment noted that the 1980 temporary regulations also provided that a foreign tax may satisfy the definition of an income tax even if the foreign tax law differs substantially from the income tax provisions of the Code. That comment recommended that the final regulations should provide flexibility to accommodate the continued evolution of international tax policy consensus, which may diverge from the U.S. view of traditional taxing norms.
>
> Comments also asserted that certain U.S. sourcing rules reflect domestic policies other than jurisdiction to tax. As an example, one comment noted that the title passage rule for inventory in sections 861(a)(6) and 862(a)(6) reflects administrative simplification concerns, and former section 863(b) served as an incentive for certain activities. The comments argued that foreign countries that adopt a rule different from U.S. source rules due to different choices among competing policies should not cause the foreign tax to be noncreditable. One

> comment argued that diverging views of taxing rights, especially as between developed and developing countries, have long existed outside the context of novel extraterritorial taxes. The comment asserted that diverging views on taxing rights is what makes relief from double taxation necessary; it is not a reason to deny creditability of a foreign tax.
>
> The Treasury Department and the IRS generally agree that different countries may diverge in their approach to asserting jurisdictional taxing rights, just as countries may have different approaches in determining the amounts of realized gross receipts and recoverable costs and expenses included in the foreign taxable base. As a result, the net gain requirement in existing § 1.901–2, as well as in these final regulations, does not require strict conformity between foreign and U.S. tax law. However, the final regulations do require that a foreign tax must be consistent with the general principles of income taxation reflected in the Code for it to be an ''income tax in the U.S. sense.'' These principles include not only those related to determining realization, gross receipts, and cost recovery, but also principles related to assertion of taxing rights. . . . However, the Treasury Department and the IRS agree with the comments asserting that certain aspects of the source requirement can appropriately be revised to be more flexible; [. . .].

87 F.R. at 287. Thus, the Treasury asserted that the approach it attempted to follow in drafting the final regulations was to insist that to be creditable, a foreign country's exercise of jurisdiction must be "consistent with the general principles of income taxation reflected in the Code," while providing sufficient flexibility to allow for reasonable divergence in different countries' tax policy decisions. The Treasury believed additional flexibility was appropriate to recognize both that "different countries may diverge in their approach to asserting jurisdictional taxing rights," and that "competing policies" other than jurisdictional rights including "administrative simplification concerns" play a role in international tax policy.

Despite these acknowledgments, and despite that the U.S. source rule for royalties is more of an outlier than a norm, the Treasury allowed almost no flexibility in the final regulations with respect to when a foreign withholding tax on royalties will be creditable against U.S. income tax. In general, the final regulations require that:

> in the case of gross income arising from royalties, the foreign tax law must impose tax on such royalties based on the place of use of, or the right to use, the intangible property. However, the final regulations do not require that the foreign law, in determining the place of use of an intangible in a particular transaction or fact pattern, reach the same conclusion as the IRS in a particular revenue ruling or a U.S. court in a particular case.

Id. at 288. Given the international landscape described above, the purported flexibility identified by the preamble with respect to royalties does not alleviate any of the concerns addressed by commentators, and agreed to by the Treasury, regarding divergent approaches to taxing jurisdiction—most countries have never even attempted to determine the place of use of IP on

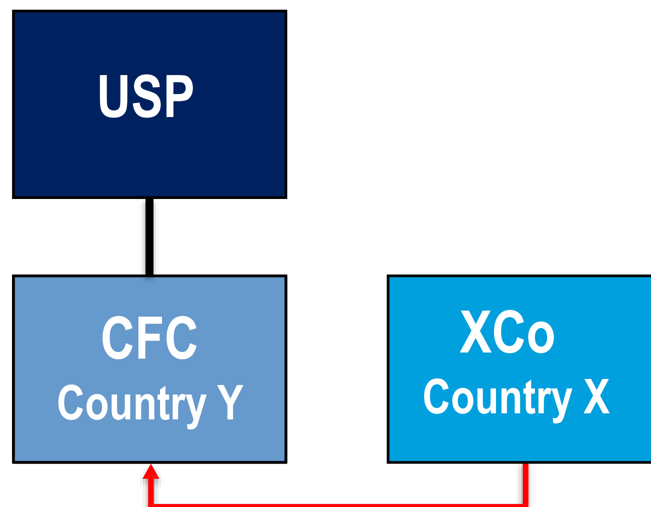
particular facts because hardly any of them assert jurisdiction based on the place of use in the first place.

Specifically, the final regulations included a new Royalties Attribution Requirement as subparagraph (2) of the following reworded source-based nexus requirement:

> *(B) Income attribution based on source*. The amount of gross income arising from gross receipts (other than gross receipts from sales or other dispositions of property) that is included in the base of the foreign tax on the basis of source (instead of on the basis of activities or the situs of property as described in paragraphs (b)(5)(i)(A) and (C) of this section) is limited to gross income arising from sources within the foreign country that imposes the tax, and the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply under the Internal Revenue Code. A foreign tax law's application of such sourcing rules need not conform in all respects to the application of those sourcing rules for Federal income tax purposes. For purposes of determining whether the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply under the Internal Revenue Code, the character of gross income arising from gross receipts is determined under the foreign tax law (except as provided in paragraph (b)(5)(i)(B)(3) of this section), and the following rules apply:
>
> > (1) Services. Under the foreign tax law, gross income from services must be sourced based on where the services are performed, as determined under reasonable principles (which do not include determining the place of performance of the services based on the location of the service recipient).
> >
> > *(2) Royalties. A foreign tax on gross income from royalties must be sourced based on the place of use of, or the right to use, the intangible property.*
> >
> > (3) Sales of property. . . .

Treas. Reg. § 1.901-2(b)(5)(i)(B) (Emphasis added). The Treasury also clarified in the final regulations that a foreign tax that is treated as an income tax under the relief from double taxation article of a treaty with the U.S. is treated as an income tax for purposes of the foreign tax credit regulations. Treas. Reg. § 1.901-2(a)(1)(iii). Thus, the attribution requirement does not affect the creditability of foreign taxes that are expressly creditable under existing U.S. tax treaties.

The Treasury also included two new examples illustrating the application of this rule to deny foreign tax credits for withholding taxes on royalty payments. The facts of the Examples may be illustrated as follows:



100u Royalty for worldwide rights (including Country X rights)
30u Withholding tax

The examples are as follows:

> (3) *Example 3: Withholding tax on royalties; attribution requirement*—(i) *Facts*. YCo, a resident of Country Y, is a controlled foreign corporation wholly owned by USP, a domestic corporation. In Year 1, YCo grants a license to XCo, a resident of Country X unrelated to YCo or USP, for the right to use YCo's intangible property (IP) throughout the world, including in Country X. Under Country X's domestic tax law, all royalties paid by a resident of Country X to a nonresident are sourced in Country X and are subject to a 30% withholding tax on the gross income, regardless of whether the nonresident payee has a taxable presence in Country X. Country X's withholding tax on royalties is a separate levy under § 1.901–2(d)(1)(iii). In Year 1, XCo withholds 30u (units of Country X currency) tax from 100u of royalties owed and paid to YCo under the licensing arrangement, of which 50u is attributable to XCo's use of the YCo IP in Country X and 50u is attributable to use of the YCo IP outside Country X. The United States and Country X have an income tax treaty (U.S.-Country X treaty); under the royalties article of the treaty, Country X agreed to impose its withholding tax on royalties paid to a U.S. resident only on royalties paid for IP used in Country X. Country X and Country Y do not have an income tax treaty.
>
> (ii) *Analysis*. Under § 1.901– 2(d)(1)(iv), the Country X withholding tax on royalties, as modified by the U.S.-Country X treaty, is a separate levy from the unmodified Country X withholding tax to which YCo was subject (because YCo is not a U.S. resident eligible for benefits under the U.S.-Country X treaty). The Country X withholding tax on royalties, unmodified by the U.S.- Country X treaty, does not meet the attribution requirement in § 1.901– 2(b)(5)(i)(B) because Country X's source rule for royalties (based upon residence of the payor) is not reasonably similar to the sourcing rules that apply under the Internal Revenue Code. Thus,

> under paragraph (c)(2)(iii) of this section, the Country X withholding tax paid by YCo is not a covered withholding tax, and none of the 30u of Country X withholding tax paid by YCo with respect to the 100u of royalties for the use of the IP is a payment of foreign income tax.
>
> (4) *Example 4: Withholding tax on royalties; attribution requirement*—(i) *Facts*. The facts are the same as in paragraph (d)(3)(i) of this section (the facts of Example 3), except that XCo only uses the IP in Country X and the 100u of royalties paid to YCo in Year 1 is all attributable to XCo's use of the IP in Country X.
>
> (ii) *Analysis*. The result is the same as in paragraph (d)(3) of this section (the analysis of Example 3). Because Country X's source rule for royalties (based upon residence of the payor) is not reasonably similar to the sourcing rules that apply under the Internal Revenue Code, the withholding tax paid by YCo does not meet the attribution requirement in § 1.901–2(b)(5)(i)(B). Under paragraph (c)(2)(iii) of this section, the Country X withholding tax paid by YCo is not a covered withholding tax, and none of the 30u of Country X withholding tax paid by YCo with respect to the 100u of royalties for IP used in Country X is a payment of foreign income tax.

Treas. Reg. § 1.903-1(d)(3) and (4). Thus, the examples specifically confirm, among other things, that a withholding tax asserted based on the residence of the payor does not meet the Royalties Attribution Requirement, and that such a withholding tax is not creditable irrespective of whether in a particular case the royalty is solely for use of property in the country of residence of the payor. (The result would be the same under the final regulations even if YCo had only licensed to XCo the Country X rights (as opposed to the worldwide rights) to use YCo's IP.)

The Royalties Attribution Requirement and Examples 3 and 4 took tax practitioners and U.S. multinationals by surprise, in light of the prevalence of payor residence sourced withholding taxes on royalties, the longstanding and previously unquestioned creditability of those taxes, and the fact that sourcing royalties based on the residence of the payor *is* reasonably similar to sourcing based on the place of use, particularly in practice. *See*, *e.g.*, Michael Smith, *New Attribution Rule is FTC Pitfall, Practitioners Say*, 105 Tax Notes International 466 (Jan. 24, 2022) (noting that U.S. multinationals are surprised by the degree of conformity required by the final regulations, "particularly in the areas of royalties and intellectual property"); Gary Sprague, *Application of Treasury's New 'Reasonably Similar' Source Rule Requirement to Claim Foreign Tax Credits for Royalty Withholding Taxes*, 51 Tax Management International Journal 1 (BNA Jan. 7, 2022) ("There is nothing in the policy underlying the foreign tax credit, the campaign against offensive unilateral measures, or even the attribution nexus rules generally (to the extent the point is to limit creditable taxes to those imposed consistently with 'international norms') that suggests that such taxes should not remain creditable."); Michael Smith, *Final FTC Regs Raise Questions About Royalties and IP*, 2022 Tax Notes Today International 8-1 (Jan. 12, 2022); Michael Smith, *FTC Regs' Attribution Requirement Raises Administrability Issues*, 2022 Tax Notes Today International 7-1 (January 11, 2022) (quoting practitioner comment predicting that many taxpayers

would be caught by surprise by the non-creditability of many foreign withholding taxes on royalties).

COMMENTS

I. Introduction

The first argument advanced in the comments below is that in applying the source-based attribution requirement to gross income from royalties, the Treasury should find that, as a matter of the exercise of taxing jurisdiction, sourcing royalties based on the residence of the payor is reasonably similar to sourcing royalties based on the place of use, or right to use, IP and other property. If the Treasury agrees with that position, the Treasury should simply amend the Royalties Attribution Requirement to read as follows:

> (2) Royalties. *Under the foreign tax law,* gross income from royalties must be sourced based on the place of use of, or the right to use, the intangible property, *or based on the residence of the payor of the royalty.*

The argument in support of this suggested modification is set forth in the next section II. of the letter, and is supported by the remaining arguments in this letter.

If the Treasury disagrees with that initial argument, however, Treasury should *make an exception* to the application of the source-based attribution requirement for foreign tax laws that source royalties based on the residence of the payor (in the same manner that Treasury excepted taxes covered by treaties from application of the new attribution requirement). The reasons why the Treasury should make such an exception are set forth in sections III.-VI. of this letter, below. Those sections show that the stated premises behind the Royalties Attribution Requirement are demonstrably wrong. Thus, the Treasury has failed to carry its burden to explain why it introduced a new rule, for the first time in final regulations, providing that no foreign tax credits are allowed for certain foreign taxes that have been creditable for decades. There is no reason to change the law in this area, and in the alternative to the modification suggested above, Treasury should make the following exception to the attribution requirement:

> The attribution requirement shall not apply to any foreign tax on gross income from royalties if under the foreign tax law, gross income from royalties is sourced based on the country of residence of the payor of the royalty.

Before proceeding with the arguments for such an exception, however, we begin by explaining why such an exception should be unnecessary.

II. Sourcing Royalty Income Based on Payor Residence is Reasonably Similar to Sourcing Based on the Place of Use

Sourcing royalties based on the residence of the payor is reasonably similar to sourcing based on the place of use of licensed IP, from a jurisdictional perspective, because the residence

of the payor is a reasonable proxy, or *per se* rule, for place of use, and its adoption instead of place of use is far more administrable and enforceable. Both types of source rule assert jurisdiction based on where IP is used (or presumed to be used), and not where it was developed. The only difference is that payor residence assumes (reasonably) that licensed IP is used in the payor's jurisdiction. Contrary to the assertions in the preamble, *neither* source rule requires the payee to have a taxable presence (*i.e.*, "operations, employees, factors of production, or management") in the foreign country imposing the withholding tax—unlike the U.S. source rule for services, both source rules for royalties are instead destination/market based. *Neither* jurisdictional standard is inherently more expansive than the other—in situations where the payor of a royalty resides in whole or in part outside the country of use of licensed property, a payor residence jurisdiction *loses revenue* to the extent it is in fact the country of use, and only gains to the extent it is not the country of use (which as noted below, hardly ever happens in any event).

Thus, the final regulations should have gone much further than allowing foreign countries to determine the place of use in particular situations without adhering to U.S. cases and rulings, by allowing countries to rely on payor residence as a proxy for place of use. In concluding instead that place of use is the *only* reasonable assertion of taxing jurisdiction, the Treasury paid only lip service to requiring consistency with the "general principles . . . reflected in" the Code, and not strict conformity with the Code. The Treasury failed to recognize that payor residence sourcing is fundamentally similar to place of use, and represents a reasonable "choice among competing policies"—*i.e.*. theoretical perfection on the one hand, and ease of administration and enforcement on the other.

This argument is strongly supported by the U.S. experience with its place of use standard, which has given rise to interpretive challenges and disputes to the point where "[i]n practice, taxpayers and tax administrators have often assumed that the source of royalty income is determined by the residence of the payer." Kingson, *The Source of Royalty Income*, *supra*.

The following arguments also strongly support a finding that sourcing based on payor residence in the context of royalties is fundamentally consistent with sourcing based on place of use. In addition, they support the position that *even if the Treasury concludes otherwise* (*i.e.*, even if the Treasury continues to believe that payor residence sourcing is fundamentally different from the place of use sourcing for royalties), the Treasury should *make an exception* to the attribution requirement for withholding taxes on royalties sourced based on the residence of the payor.

III. In the Withholding Tax Context, Sourcing Royalties Based on Payor Residence Almost Always Reaches the Same Result as Sourcing Based on Place of Use

The Treasury should recognize that withholding taxes imposed by foreign countries based on the residence of the payor almost always reach the same result as if they were imposed based on the place of use of licensed property because *the imposition of a withholding tax* based on the residence of the licensee, regardless of the actual place of use, virtually guarantees that licensors

only license IP into that jurisdiction *for use in that jurisdiction*. For example, *even under prior law under which withholding taxes on royalties were generally creditable,* no U.S. multinational would grant a worldwide or regional license to use IP to a licensee in a jurisdiction that imposes withholding tax on the payor with respect to the entire royalty payment. Examples 3 and 4 from the new section 903 regulations are unrealistic in this regard—in the real world, YCo and XCo would not structure their transaction as a worldwide license for XCo to use YCo's IP, precisely because Country X would impose withholding tax on the entire royalty payment even if the IP were sublicensed or used elsewhere. Such withholding could easily be avoided, for example, by licensing the IP to a separate XCo affiliate formed in each country of use.

In other settings, such as a manufacturer resident in a country with a withholding tax on royalties based on the residence of the payor, using licensed IP from third parties in connection with the sale of its manufactured products, the manufacturer sets up a foreign resale structure in which royalties tied to foreign sales are paid by the foreign reseller in a jurisdiction that does not impose any withholding tax.

Meanwhile, on the U.S. side, there is a serious question, as noted above, of the extent to which the IRS enforces the place of use sourcing in the real world, rather than using the residence of the payor as the *de facto* rule. One can make up situations like Example 3 in which the country imposing the withholding tax has arguably collected more than its fair share, but they do not happen in practice because they can easily be avoided. Thus, the Royalties Attribution Rule is a meaningless form-over-substance limitation.

We recognize that Treasury may be reluctant to consider this argument because of the Treasury's deliberate move away from the predominant character test, which focused on how foreign taxes apply in practice, and because it would be impossible to empirically establish on a worldwide basis. We submit, however, that there is a difference between a regulation that itself requires a country-by-country consideration of how foreign tax laws apply in practice, and simply considering how foreign tax laws apply in practice when drafting a new rule. Moreover, considering how taxpayers would logically behave in response to tax laws is a common and entirely necessary element of tax policy making. It is both feasible and desirable for the Treasury, in weighing whether to make an amendment or exception to the Royalties Attribution Requirement, to consider how U.S. taxpayers with cross-border operations structure their IP licensing arrangements (as well as the extent to which the U.S. actually enforces its place of use standard). The Treasury should recognize as a matter of common sense and economic logic that (1) parties to license agreements prefer to avoid the cascading or otherwise overbroad application of payor residence-sourced withholding taxes, and (2) they can usually avoid it. There is simply no problem for the Royalties Attribution Requirement to solve.

IV. Withholding Income Tax on Royalties Based on Payor Residence is a Longstanding International Norm

A major premise of the Treasury's decision to require conformity with the U.S. source rule for royalties is that by doing so, the final regulations require withholding taxes to "conform to traditional international norms of taxing jurisdiction as reflected in the Internal Revenue Code." 85 F.R. at 72087. In reality, however, imposing withholding taxes on royalties based on payor residence is a longstanding international norm, and the U.S. approach is an outlier.

As noted above, the domestic laws of 20 countries with some of the largest economies in the world, including OECD members and U.S. treaty partners, impose a withholding tax on royalties based on the residence of the payor. By contrast, only 6 countries (other than the United States) among the largest 50 countries by economy impose a withholding tax on royalties based on the extent that IP is used in the country. Of the 6 countries that impose a withholding tax based on the place of use, only Chile is an OECD member.

If the Treasury's goal in promulgating the regulations was to ensure conformity with international norms, it obviously made a mistake by treating withholding taxes on royalties based on payor residence as non-creditable. If instead the Treasury's goal was to require conformity with every U.S. sourcing rule *regardless of how out of step the U.S. rule is with the rest of the world*, the Treasury was obviously using an arbitrary and capricious basis for determining the creditability of foreign taxes.

We note that the Royalties Attribution Requirement is invalid under the APA based on its erroneous assumption that place of use sourcing is an international norm. An agency determination based on a factual error is arbitrary and capricious. *Green v. Nat'l Archives & Records Admin.*, 992 F. Supp. 811 (E.D. Va. 1998) (agency decision to destroy film based on a factual error of the film's timespan, 1944-61 instead of 1945-72, is arbitrary and capricious); *Horizon Lines, LLC v. U.S.*, 414 F. Supp 2d 46, 56-58 (D.D.C. 2006). Agency decisions cannot be "clearly at variance with established facts." *U.S. v. F/V Alice Amanda*, 987 F.2d 1078, 1087 (4th Cir. 1993). The Treasury's position that the U.S. source rules are an international norm in every respect is demonstrably wrong, and its policy choice based on that position is therefore arbitrary and capricious.

V. Treasury Provided No Reasoned Justification for Changing the Creditability of Foreign Withholding Taxes on Royalties

Based on the background discussed above, including the international prevalence of countries asserting taxing jurisdiction over royalties based on the residence of the payor, and the longstanding creditability of those taxes, the Treasury had a heavy burden to justify its change of position. "Agencies are free to change their existing policies as long as they provide a reasoned explanation for the change." *Encino Motorcars, LLC v. Navarro*, 579 U.S. 211 (2016). However, an agency many not "depart from a prior policy *sub silentio* or simply disregard rules that are still on the books." *Id.* An agency changing a longstanding policy must (1) "display awareness that it

is changing its position," (2) "show that there are good reasons for the new policy," (3) show the agency believes the policy is better, and (4) address reliance interests "engendered by the prior policy." *FCC v. Fox TV Stations, Inc.*, 556 U.S. 502, 515-16 (2009). It is arbitrary and capricious to ignore reliance interests. *Dep't of Homeland Security v. Regents of the Univ. of Cal.*, 140 S. Ct. 1891, 1913 (2020).

Here, the Treasury's purported justifications for its change in position are entirely unpersuasive. First, as previously demonstrated, the withholding taxes at issue are quite obviously *the opposite of* "novel extraterritorial taxes that diverge in significant respects from traditional norms of international taxing jurisdiction . . . ."

Second, the Treasury's notion that asserting jurisdiction based on place of use is more appropriate than asserting jurisdiction based on payor residence, because place of use requires a taxable presence of the licensor in the country of use, is wrong. Conformity with the U.S. place of use rule would *not* ensure "a sufficient nexus between the foreign country and the taxpayer's activities or other assets that give rise to the income being taxed." 85 F.R. at 72088. Place of use, like payor residence, is simply not a presence-based jurisdictional rule, it is destination or market based. The Treasury complains in Examples 3 that Country X sources all royalties paid by a resident of country X in Country X "regardless of whether the nonresident payee has a taxable presence in Country X." But if Country X sourced based on place of use, it would also do so regardless of whether the nonresident payee has a taxable presence in Country X—just as the U.S. imposes FDAP withholding on royalties paid to nonresidents that do not have a taxable presence in the U.S. The Treasury's conflation of the place of use source rule for royalties with a taxable presence standard is another erroneous premise, just like the premise that place of use is an international norm.

The Treasury provided no justifications for the attribution requirement, or for the Royalties Attribution Requirement, other than those stated and refuted in this letter., *Every one* of the government's stated justifications for the attribution rule is inconsistent with applying the rule to withholding taxes on royalties, and woefully inadequate to justify the Treasury's major change to the creditability of those taxes.

VI. Violation of Notice and Comment Requirement

Regulations that are issued in violation of violates the procedural requirements of the APA do not receive *Chevron* deference if the regulations are procedurally defective. *Encino Motorcars, Ltd. v. Navarro*, 579 U.S. 211, 219 (2016). The inclusion of the Royalties Attribution Requirement, and Examples 3 and 4 identified above, without first exposing them to notice and comment in the form of new proposed regulations, violates the notice and comment requirement in the APA.

Under the APA, a regulatory agency must offer parties affected by a rule notice and the opportunity to comment before the rule takes effect in final regulations. 5 U.S.C. § 553(b)-(c). While the notice and comment requirement is very strict in the case of new regulations, we recognize that the requirement is more flexible in situations where a provision is added to final regulations that first went through went through a notice and comment procedure as proposed

regulations. Thus, not *every change* to proposed regulations that is adopted in final regulations need undergo a new notice and comment period. Final regulations can vary substantially from proposed regulations and still be valid. *Hodge v. Dalton*, 107 F.3d 705, 712 (9th Cir. 1997).

Judicial decisions have applied a so-called "logical outgrowth" test to determine whether a new notice-and-comment period is necessary when new provisions not previously contained in proposed regulations are for the first time promulgated in final regulations. *Nat'l Exch. Carrier Ass'n v. FCC*, 253 F.3d 1, 4 (D.C. Cir. 2001); *AMA v. U.S.*, 887 F.2d 760 (7th Cir. 1989) (applying the logical outgrowth test to Treasury regulations). Under that test, if the provisions at issue in final regulations are a logical outgrowth of provisions that were contained in proposed regulations that preceded the final regulations, a regulatory agency promulgating the final regulations may avoid providing a new notice-and-comment period when including the new provisions in the final regulations. *Rybachek v. U.S.*, 904 F.2d 1276, 1287-88 (9th Cir. 1990).

There is no precise standard for determining when a newly-added provision constitutes a "logical outgrowth" of previous provisions that were included in earlier proposed regulations. *Nat'l Mining Ass'n v. MSHA*, 116 F.3d 520, 531 (D.C. Cir. 1997). The test applied by most courts is "whether the agency's notice would fairly apprise interested persons" of the position ultimately adopted in final regulations. *Nat'l Black Media Coal. v. FCC*, 791 F.2d 1016, 1022 (2d Cir. 1986). Most courts have framed the issue in terms of whether the final rule was "reasonably foreseeable" when the prior proposed regulations were issued. *Long Island Care at Home, Ltd. v. Coke*, 511 U.S. 158, 174-75 (2007); *Allina Health Servs. v. Sebelius*, 746 F.3d 1102, 1109 (D.C. Cir. 2014); *Owner-Operator Indep. Drivers Ass'n v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188, 210 fn 7 (D.C. Cir. 2007) (stating that the "crux of the logical outgrowth test" is what is "reasonably foreseeable") (quoting *Long Island Care at Home, Ltd.*, 511 U.S. at 175). In addition, a new notice and comment period is required "when the changes are so major that the original notice did not adequately frame the subjects for discussion." *Conn. Light & Power Co. v. Nuclear Reg. Comm'n*, 673 F.2d 525, 533 (D.C. Cir. 1982).

Moreover, comments from interested parties are not a substitute for the notice and comment requirement. *Nat'l Black Media Coal.*, 791 F.2d at 1023. Adequate notice must come from the agency itself that is promulgating the new rules. *AFL-CIO v. Donovan*, 757 F.2d 330, 340 (D.C. Cir. 1985).

When provisions of the type in final regulations were included in proposed regulations, but the issue posed is whether it could have been anticipated that the particular provisions included in proposed regulations apply to certain types of transactions or to particular parties, some courts have focused on whether the specific transactions or parties affected by the final rule were mentioned in the prior proposed rules. *Chocolate Mfrs, Assoc. v. Block*, 755 F.2d 1098, 1106-07 (4th Cir. 1985). In that case, manufacturers of sweetened milk were able to block the application of a regulation designed to regulate excess sugar in sweetened milk. The Fourth Circuit held that because the USDA's earlier request for comments with respect to proposed restrictions on sugar intake in food focused solely on the sugar content in juice and cereal, but did not mention a concern about the sugar content in sweetened milk, the plaintiff did not receive adequate notice from the proposed regulations that the restrictions in those proposed regulations might apply to the

plaintiff's sweetened milk business. As a result, the Fourth Circuit held that the regulatory provision as applied to sweetened milk was invalid by reason of the failure of the USDA to provide reasonable notice and comment to businesses such as that of the plaintiff.

That reasoning applies in the present case, where the proposed regulations discussed the applicability of the new foreign tax credit rules to income from the provision of services, but not to withholding taxes imposed on the payment of royalties, particularly where the latter type of tax had previously been expressly ruled by the IRS to be creditable for decades in the past.

The Treasury may believe that the provisions dealing with foreign withholding taxes imposed on royalty payments, as well as the conclusions reached in Examples (3) and (4) in Treas. Reg. § 1.903-1(d), are a logical outgrowth of the jurisdictional nexus principles contained in the proposed regulations, even though the proposed regulations did not explicitly address the creditability of foreign taxes imposed on payments of royalties and provided no examples of that type of withholding tax in the proposed regulations. However, any such argument is significantly undercut by the tax community's surprised reaction to the Royalties Attribution Requirement, described above, and by all of the reasons discussed above as to why the Treasury's interpretation of how the attribution requirement should apply to withholding taxes on royalties is misguided.

One additional basis for the assertion of a lack of notice with respect to the provisions added to the final regulations is that as noted above there are rulings in which foreign withholding taxes on royalty payments were imposed on the basis of the residence of the payor of the royalties, yet the withholding taxes were treated as creditable by the IRS. Nevertheless, there was not a single mention of the IRS's change in position as to the creditability of the type of tax covered in the rulings either in the preamble to the proposed regulations or in the proposed regulations themselves. It flies in the face of the notice and comment requirement for the Treasury to contend that there was adequate notice to taxpayers that the proposed regulations were intended to reverse of 50 years of precedents dealing with withholding taxes imposed on royalty payments.

It is also noteworthy that the new sourcing provisions with respect to royalty payments contained in Treas. Reg. § 1.901-2(b)(5)(i)(B) are described as a "rule" in the final regulations and not merely as an illustration of the application of the general principle that the foreign country's sourcing rules must be reasonably similar to the U.S. source rules.

CONCLUSION

Treasury's interpretation of how its new attribution requirement should apply to foreign withholding taxes on royalties is fundamentally flawed.

First, the Treasury failed to recognize that imposing a withholding tax based on the residence of the payor is reasonably similar to imposing a withholding tax based on the place of use. The residence of the payor of a royalty for the use of licensed IP is a reasonable proxy for the place of use of the IP. This is particularly true when the imposition of a withholding tax based on the residence of the payor virtually guarantees that licenses into the jurisdiction of the payor's residence only permit use in that jurisdiction—taxpayers with cross-border operations can avoid

cascading or otherwise overbroad withholding taxes as part of their basic planning. Even to the extent that payor residence is not as theoretically sound as place of use sourcing, it has advantages over place of use sourcing in terms of administrability and enforceability.

Second, the Treasury failed to recognize that the U.S. sourcing rule for royalties does not reflect an international norm. Instead, far more foreign countries impose withholding taxes on royalties based on the residence of the payor than based on the place of use of IP. There is no rational policy basis to condition the creditability of foreign taxes on their conformity with a U.S. jurisdictional standard different from the standard followed by most of the world. This is particularly true when the U.S. standard is unworkable and continues to be subject to varying interpretations, and in any event the jurisdictional standard used by most of the world is no broader than the U.S. standard (and in any event reaches the same result in almost every real-world situation).

Third, the Treasury made an erroneous assumption that the U.S. source rule ensures that the U.S. only withholds on royalties paid to a foreign person to the extent that the foreign person has a taxable presence in the U.S. Regardless whether a withholding tax on royalties is based on the place of use or the residence of the payor, the focus is on where the payor of the royalty monetizes the licensed property, not where the investments and activities that created the IP occurred.

Fourth, the issuance of the Royalties Attribution Requirement for the first time in final regulations obviously violated the APA's notice and comment requirement because it was an unreasonable and unexpected application of the proposed jurisdictional nexus requirement.

For these reasons, the Treasury should amend the Royalties Attribution Requirement to provide as follows:

> (2) Royalties. *Under the foreign tax law,* gross income from royalties must be sourced based on the place of use of, or the right to use, the intangible property, *or based on the residence of the payor of the royalty.*

In the alternative, the Treasury should except payor residence sourced withholding taxes on royalties from application of the attribution requirement.

Respectfully submitted,

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