Foreign Tax Credit Rules Spur Worries Beyond Technicalities , 2021 Law360 64-23

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Summary

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Body

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Under the proposed regulations (*2020 Law360 273-62*), which were issued in late September, offshore corporate income ***taxes*** aren't creditable unless they have the character of "an income ***tax*** in the U.S. sense." For U.S. companies that aren't physically present in countries where they pay ***taxes***, the term "in the U.S. sense" requires the ***foreign*** levies to reflect jurisdictional nexus, or sufficient nexus with the ***taxing*** jurisdictions — based on activities, income sources or property — to be creditable.

Treasury said in the regulations that it revisited the definition of ***foreign*** income ***tax*** due to offshore measures that "diverge in significant respects from traditional norms," including digital services levies. There's disagreement among practitioners, including those who wrote to Treasury (*2021 Law360 40-182*) in February, about whether the proposed ***rules*** change the definition of ***foreign*** income ***tax*** in a manner that should be reserved for Congress.

Beyond questions of regulatory boundaries, specialists have raised concerns about the range of ***foreign*** ***taxes*** that may no longer be creditable.

In the preamble to the proposed ***rules***, Treasury said the jurisdictional nexus requirement involves "clarifications and changes." But according to Larissa Neumann, a partner at Fenwick & West LLP, "it would be a monumental change to the creditability of ***foreign*** ***taxes***."

"It would narrow the definition of what is creditable and redefine it," she said. "It's much broader than just digital services ***taxes***."

Questions of Authority

As some see it, Treasury lacked legislative backing to take its proposed position on the creditability of ***foreign*** income ***taxes***.

Such a contention was made by Les Schneider and Patrick J. Smith, partners at Ivins Phillips & Barker Chtd., who said Congress was aware that Treasury in 1980 proposed ***rules*** similar to the jurisdictional nexus requirement. Those proposed regulations didn't make it into final guidance issued in 1983, and Congress took no subsequent steps to change what constitutes a creditable ***tax***, they wrote in a letter to Treasury last month.

Given the lack of congressional action, it follows that lawmakers must have agreed with Treasury's approach "and felt no need to make additional changes to the definition of what it means to be an income ***tax***," Schneider and Smith wrote. The same review of ***rules*** took place again in 2017 when Congress enacted the ***Tax*** Cuts and Jobs Act (115 P.L. 97) and adopted no "wholesale changes" to the definition of creditable ***foreign*** ***tax***, according to their letter.

Schneider told Law360 that the proposed jurisdictional nexus requirement should be withdrawn based on the legislative reenactment doctrine, which concerns ***rules*** of statutory interpretation that are in part based on whether legislation was enacted with the consideration of long-standing regulations.

If it can be shown that Congress thought about and agreed with those ***rules*** when they passed legislation, "then it really is up to Congress to change the ***rules*** and not the Treasury," he said.

For Treasury's part, the preamble to the proposed ***rules*** cites "novel extraterritorial ***taxes***" that depart from international norms, such as France's digital services levy and the U.K.'s diverted profits ***tax*** (*2020 Law360 27-137*). Shortly after Treasury proposed the jurisdictional nexus requirement, government officials commented on the ***rules***' connection to offshore measures (*2020 Law360 276-167*).

The requirement is "something that we have been thinking about for a long time," said Jason Yen, associate international ***tax*** counsel at Treasury, speaking in October during the American Bar Association Section of Taxation's fall meeting.

"We wanted to make clear the position that these ***taxes*** should not be creditable," he said.

John Merrick, senior-level counsel to the Internal Revenue Service's associate chief counsel, international, cited offshore digital ***taxes*** (*2020 Law360 316-18*) in November during the American Bar Association's Philadelphia ***Tax*** Conference. He noted that "we had to act to protect the [U.S.] fisc" because some countries had already enacted unilateral digital services ***taxes*** that would be subject to the proposed ***rule***.

A representative for Treasury didn't respond to a request for comment on this article.

There's a question of whether protecting the U.S. ***tax*** base is in Treasury's directive, according to Jamison Sites, a senior manager at RSM US LLP.

"They're tasked with enforcing and interpreting the existing ***tax*** law, not making new policy," he said. "It could be argued that it's a little bit outside their lane to go at something in this manner."

The proposed ***rules*** aren't tied to anything in the TCJA, but instead are related to actions by ***foreign*** nations — principally the digital services ***taxes*** throughout Europe, according to Sites. From a policy perspective, "I would say that it should fall on Congress to react to these kinds of actions by ***foreign*** nations," whether through treaties or actual legislation, he said.

Others believe Treasury was on sound footing, including David Hardy, counsel at McDermott Will & Emery LLP. He co-authored a report submitted to Treasury last month from the New York State Bar Association ***Tax*** Section, which acknowledged a potential toll on the U.S. ***tax*** base if companies get ***credits*** for ***taxes*** on offshore income that isn't significantly connected to the ***taxing*** jurisdiction.

Crediting a ***tax*** on that kind of unconnected income, including U.S.-sourced earnings, "could effectively convert the [***foreign tax credit***] regime into a means of subsidizing ***foreign*** jurisdictions at the expense of the U.S. fisc," according to the report.

As Hardy saw it, the proposed jurisdictional nexus requirement is "technically flawed" in how it cuts out ***foreign*** ***taxes*** that were previously creditable, but it doesn't exceed Treasury's authority.

"It doesn't exceed their authority because it is a logical component of what is a creditable ***foreign*** ***tax*** for an income ***tax***," he said.

'Reasonably Similar' to U.S. ***Rules***

While the proposed jurisdictional nexus requirement has largely been discussed in the context of digital services ***taxes***, specialists have noted that other ***foreign*** measures could be affected too, including withholding ***taxes***.

The impact on withholding ***taxes*** stems from one of the ways nonresident companies can meet the jurisdictional nexus requirement: earning income arising from sources in a ***foreign*** country with sourcing ***rules*** that are "reasonably similar" to those in the U.S. When it comes to income from services, the income must be sourced "based on the place of performance of the services, not the location of the services recipient," according to the proposed ***rules***.

A source-based jurisdictional nexus requirement could be a big change for withholding ***taxes*** on services, according to Neumann at Fenwick & West.

"Most companies realize that digital service ***taxes*** could be an issue, but I am not sure everyone realizes that these regulations would also affect withholding ***taxes*** and whether regular withholding ***taxes*** are going to be creditable or not," she said.

For withholding ***taxes***, Hardy gave the example of a company that provides access to software and receives payments from ***foreign*** users. That payment may be regarded as a royalty — and ***foreign*** ***tax*** on the payment would be creditable because it arises from sources within the country — or it may be regarded as a payment for services, he said.

Under U.S. ***rules***, sourcing is based on the provider of services, including services that may be on servers run by companies in the U.S. or elsewhere, Hardy said. In that case, "it wouldn't be from sources within the jurisdiction of the consumer, and the same ***tax*** imposed would not be creditable," he said.

Meanwhile, Yen at Treasury said in January the department is considering how to flesh out the source-based nexus requirement (*2021 Law360 13-125*), including "what particular details or safe harbor or contours we need … to provide more certainty in the gray area." Speaking during a webinar hosted by the D.C. Bar, he noted that there's "a lot of gray area" when it comes to U.S. sourcing ***rules*** — particularly for royalties.

Looking to the OECD

The future of the proposed jurisdictional nexus requirement remains uncertain, in part due to ongoing negotiations at the Organization for Economic Cooperation and Development to rewrite international corporate ***tax*** ***rules***.

The Paris-based organization's project would give countries some ability to ***tax*** all companies — digital or nondigital — that use their markets, regardless of whether they are physically present. If an agreement is reached that includes the U.S. government, Treasury "recognizes that changes to the ***foreign tax credit*** system may be required at that time," according to the preamble to the proposed jurisdictional nexus requirement.

Talks at the OECD were at a near standstill (*2021 Law360 14-171*) after late 2019, when Steven Mnuchin, the Treasury secretary in the Trump administration, said the revamp should only be implemented as an optional safe harbor. Signs of a thaw emerged recently, when Treasury Secretary Janet Yellen said in late February that the U.S. government would stop advocating (*2021 Law360 57-112*) for the opt-out provision.

As Hardy saw it, Yellen's statement is "the first possible indication" that Treasury could separate the jurisdictional nexus requirement from the rest of the guidance and leave it in proposed form.

"That strikes me as a very serious statement that the United States would like to be constructively engaged in the OECD deliberations," he said.

In a similar vein, Sites at RSM said he could see Treasury moving forward with other parts of the proposed ***foreign tax credit*** ***rules*** that provide "much-needed clarity and guidance." Treasury could divide the regulations to allow for those proposed ***rules*** to advance with "further debate on more controversial items such as the jurisdictional nexus," he said.

Following Yellen's announcement, several government officials have said the U.S. decision to drop the safe harbor provision signals progress in the negotiations, which face a mid-2021 deadline (*2021 Law360 56-12*). Meanwhile, the OECD recently issued a report that reiterated warnings about how the absence of a global agreement would likely lead to "a proliferation of unilateral and uncoordinated ***tax*** measures, retaliatory trade sanctions and an undermining of ***tax*** certainty and investment."

According to Smith at Ivins Phillips & Barker, the U.S. government's abandonment of the safe harbor stance "makes it much more likely that the U.S. will sign on to whatever the OECD eventually adopts."

Citing the preamble, where Treasury said it might need to revisit the ***foreign tax credit*** regime, he said "the fact that a new administration has come in and seems to have a different attitude is clearly a very major development here."

--Additional reporting by Alex M. Parker. Editing by Robert Rudinger and Vincent Sherry.
