June 3, 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: Supplement to APA Petition for Review of Final Regulations under Sections 901 and 903 -- T.D. 9959

Dear Sir:

On April 12, 2022, we filed a petition under section 553 of the Administrative Procedures Act ("APA") for the Treasury and the Internal Revenue Service ("IRS") (collectively, the "Treasury") to modify the "Royalties Attribution Requirement" (Treas. Reg. § 1.901-2(b)(5)(i)(B)(2)) contained in 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.

We hereby submit this supplement to our petition, requesting the Treasury also to reconsider the "arm's length requirement" (Treas. Reg. § 1.901-2(b)(5)(ii)) in the same regulations. For the reasons set forth below, the arm's length requirement is grossly overbroad and inconsistent in its effects. The requirement is also unclear in its application and will be difficult for taxpayers to apply and for the IRS to administer. Therefore, the requirement should be withdrawn or modified in the manner suggested below.

BACKGROUND

On November 2, 2020, the Treasury proposed regulations under section 901 and 903 of the Code, including a new "jurisdictional nexus" requirement which would generally require that "for a foreign tax to qualify as an income tax, the tax must conform with established international norms, . . . , 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." REG-101657020, 85 F.R. 72078, 72088 (Nov. 12, 2020). The Treasury's primary stated justification for imposing such a requirement was 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 . . . .” *Id.*

The preamble to the proposed regulations explained the jurisdictional nexus requirement applicable to taxes imposed on *residents* of a foreign country (*i.e.*, the arm’s length requirement), in relevant part, as follows:

> A similar rule applies under proposed § 1.901-2(c)(2) with respect to determining the income of a resident taxpayer in cases where income of a related entity may be allocated under transfer pricing rules to the resident taxpayer. For the jurisdictional nexus requirement to be satisfied in such a case, the foreign tax law’s transfer pricing rules must be determined under arm’s length principles [*sic*]. Thus, for example, foreign tax laws that contain transfer pricing rules that are consistent with the arm’s length standard under the section 482 regulations, or with the arm’s length principle under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, will satisfy this requirement. However, foreign transfer pricing rules that allocate profits by taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion will not satisfy the jurisdictional nexus requirement. Comments are requested on whether special rules are needed to address foreign transfer pricing rules that allocate profits to a resident on a formulary basis (rather than on the basis of arm’s length prices), such as through the use of fixed margins in a manner that is not consistent with arm’s length principles. . . .

Id. The proposed arm’s length requirement itself provided as follows:

> (2) Tax on residents. A foreign tax imposed on residents of the foreign country imposing the foreign tax may be imposed on the worldwide income of the resident, but must provide that any allocation to or from the resident of income, gain, deduction, or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (that is, any allocation made pursuant to the foreign country’s transfer pricing rules) is determined under arm’s length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.

Prop. Treas. Reg. § 1.901-2(c)(2). The preamble’s statement that “foreign tax laws that contain transfer pricing rules that are *consistent with* the arm’s length standard . . .” is significant, because the proposed rule that a foreign tax must provide that any allocation is “*determined under*” arm’s length principles could otherwise be interpreted as more restrictive—*i.e.*, as requiring direct implementation of the arm’s length standard in the foreign country’s law (such in section 482).

Numerous comments on the proposed regulations argued that the proposed jurisdictional nexus requirement (as to both residents and non-residents) was invalid and ill-advised. The

Treasury generally rejected these arguments and finalized the regulations, without significant changes favorable to taxpayers. T.D. 9959, 87 F.R. 276 (Jan. 4, 2022). The Treasury renamed the jurisdictional nexus requirement the "attribution requirement" and included it in the existing net gain requirement, rather than issuing it as a separate rule.

The preamble to the final regulations discussed each of the three prongs of the attribution requirement for taxes imposed on non-residents in detail. *See* 87 F.R. at 288-290. By contrast, the preamble did not address *at all* the proposed arm's length requirement. No special rules were provided for foreign transfer pricing rules that adjust prices based on fixed margins. Instead, the Treasury finalized the arm's length requirement without material revisions from the proposed version, as follows:

> *(ii) Tax on residents*. The base of a foreign tax imposed on residents of the foreign country imposing the foreign tax may include all of the worldwide gross receipts of the resident, but must provide [*sic*] that any allocation to or from the resident of income, gain, deduction or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly by the same interests (that is, any allocation made pursuant to the foreign country's transfer pricing rules) is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.

Treas. Reg. § 1.901-2(b)(5)(ii) (the "arm's length requirement"). There are no examples in the final regulations illustrating how the arm's length requirement applies.

Since the regulations were finalized, several commenters (including leading trade associations and members of Congress) have requested the Treasury to reconsider the regulations. The Treasury has stated publicly that it is considering revisions.

COMMENTS

The Treasury's concern that it should not subsidize foreign income taxes imposed on "improperly inflated" tax bases is understandable. However, the arm's length requirement is not an appropriate solution to the perceived problem of countries expanding their tax base by using transfer pricing rules that are not based on the arm's length standard.

The arm's length requirement, by itself, will cause double taxation that goes far beyond the level necessary to achieve the Treasury's policy objectives. Because of its "all-or-nothing" character, the arm's length requirement goes well beyond denying foreign tax credits to the extent that a foreign tax base has been expanded by transfer pricing rules inconsistent with arm's length principles. Instead, it treats income taxes as non-creditable *in their entirety*, with respect to *all*

resident taxpayers, and with respect to *all* transactions, *including those priced consistent with the arm's-length standard*.

Moreover, the government may interpret the "generally-imposed net income tax" requirement in the final section 903 regulations to mean that if a country's income tax on residents does not satisfy the arm's length requirement, the country's in-lieu of taxes are entirely non-creditable, even though they otherwise satisfy the substitution requirement in those regulations. Thus, while we would disagree with that interpretation, the arm's length requirement could have the effect of denying all foreign tax credits for a garden-variety withholding tax imposed on arm's length payments to U.S. taxpayers, based solely on the transfer pricing standard used by the country imposing the withholding tax in the net income taxation of its residents.

In addition, the imposition of an arm's length requirement 100 years after the enactment of the foreign tax credit is problematic *even assuming* that there should always have been such a requirement. Congress enacted the foreign tax credit to eliminate a disincentive to U.S. business operations in foreign jurisdictions. *See* 56 Cong. Rec. App., at 677 (statement of Rep. Kitchin) (1918) ("We would discourage men from going out after commerce and business in different countries or residing for such purposes in different countries if we maintained this double taxation."); *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 8-9 (1932) ("In the case of domestic corporations, the purpose is also disclosed to facilitate their foreign enterprises."); *Salem Fin., Inc. v. U.S.*, 786 F.3d 932, 954 (Fed. Cir. 2015) ("The foreign tax credit system aims to achieve 'capital export neutrality', thereby removing a possible disincentive to engage in foreign trades because of the burden of double taxation.") (citations omitted). As intended by that policy, U.S. taxpayers have invested in foreign countries with the reasonable expectation that their earnings would not be subject to double taxation. The new arm's length requirement has the effect, however, of imposing unlimited double taxation in some jurisdictions, with respect to investments made in reliance on the longstanding prior policy. This is patently unfair and violates the Administrative Procedures Act. *See Dep't of Homeland Security v. Regents of the Univ. of Cal.*, 140 S. Ct. 1891, 1913 (2020) (it is arbitrary and capricious to ignore reliance interests); *FCC v. Fox TV Stations, Inc.*, 556 U.S. 502, 515-16 (2009) (an agency changing a longstanding policy must address reliance interests "engendered by the prior policy").

Brazil is a prominent example of a foreign country in which U.S. companies have invested heavily based in part on the previously unquestioned creditability of its income tax, but whose income tax may no longer be creditable due to the new arm's length requirement. The Brazilian income tax imposed on legal entities has long been held creditable. *See, e.g.*, Rev. Rul. 74-58, 1974-1 C.B. 180. However, Brazil's transfer pricing rules rely in part on formulas that include fixed margins for certain transactions. Therefore, it is now questionable whether *any* component of the Brazilian income tax is creditable for U.S. tax purposes, for *any* taxpayer, including those whose intercompany pricing is not subject to a fixed margin method and otherwise satisfies the arm's length standard. If transfer pricing rules like Brazil's that rely in part on fixed margins were found to be inconsistent with the arm's length standard, the result could be that the entire Brazilian income tax went from being fully creditable (in tax years beginning before December 28, 2021),

to completely non-creditable in later taxable years. Such a sudden and complete reversal in treatment of the same foreign tax ignores taxpayers' reliance on historical U.S. policy.

The all-or-nothing arm's length requirement under the attribution requirement in Treas. Reg. § 1.901-2 is also fundamentally inconsistent with the Treasury's much more measured approach to the problem of excess foreign taxes incurred due to pricing that does not comply with the arm's length standard, in the noncompulsory payment rules of the very same regulation. In Treas. Reg. § 1.901-2(e)(5) (governing noncompulsory amounts), amounts of foreign income tax paid are not creditable *to the extent* that they are due to intercompany pricing that does not comply with the arm's length standard, and that increases the taxpayer's liability for foreign income tax, *unless* the taxpayer reasonably applies the foreign tax law and exhausts all practical remedies to reduce its foreign tax. *See* Treas. Reg. § 1.901-2(e)(5)(vi), Examples 1-4. Nevertheless, (1) the remainder of the foreign income tax (*i.e.*, the amount of tax that would have been paid if the arm's length standard were applied) remains creditable, and (2) even the resulting increase is creditable if there was no practical way for the taxpayer to avoid it. *Id.*

This long-standing rule never suggested that a taxpayer could potentially lose all foreign tax credits for the entire amount of foreign tax paid on its income. The new arm's length requirement, however, adopts that extraordinarily harsh position. The result is a schizophrenic set of rules under which taxpayers subject to excess foreign tax as a result of non-arm's length pricing in some countries (*i.e.*, treaty countries and countries that follow the arm's length standard) are denied foreign tax credits *only to the extent of any avoidable excess*, whereas taxpayers operating in other foreign countries are denied foreign tax credits *entirely*, in some cases *even when the taxpayer at issue incurred zero excess foreign tax* as a result of non-arm's length pricing. The historical policy reflected in the -2(e)(5) regulations is reasonable and targeted, whereas the results under the new -2(b)(5) regulations are grossly overbroad.

For these reasons, the Treasury should withdraw or modify the arm's length requirement. There is an additional problem with the arm's length requirement that could likely only be remedied by full withdrawal—the requirement is difficult for taxpayers and the IRS to apply. It will often be unclear and debatable whether a foreign country's transfer pricing rules are consistent with the arm's length standard, and whether they impermissibly rely on "destination-based criterion." For example, are transfer pricing rules that rely in whole or in part on formulas to allocate profits to a resident, to avoid the uncertainty and costs of administration inherent in use of the arm's length standard, nevertheless "consistent with" the arm's length standard? The results under such rules are arguably consistent with applying the arm's length standard directly. The Treasury has left its position on such rules open by requesting comments on them, but then saying nothing about them in the final regulations. Notably, the starting point for applying the arm's length requirement is to fully understand a foreign country's transfer pricing rules, which are complex and largely written in foreign languages. Moreover, the applicable standards (*i.e.*, "consistent with arm's length principles" "without taking into account as a significant factor . . . destination-based criterion") are exceedingly vague. To avoid these uncertainties, it would be preferable for the Treasury to withdraw the arm's length requirement rather than retain it in some form.

Nevertheless, and in response to the Treasury's original request for comments on whether "special rules are needed to address foreign transfer pricing rules that allocate profits to a resident on a formulary basis" we suggest that, if the Treasury does not withdraw the arm's length requirement, the Treasury should modify it to make it clear that any denial of foreign tax credits is limited to the portion of the foreign tax that is attributable to non-arm's length pricing.

Specifically, the Treasury could provide that a foreign tax does not satisfy the attribution requirement if and *to the extent* that it results in additional tax attributable to the foreign country's use of transfer pricing rules that do not comply with the arm's length standard. For example, the arm's length requirement could provide as follows:

> A foreign tax imposed on residents of the foreign country satisfies the attribution requirement if it provides that any allocation to or from the resident of income, gain, deduction or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly by the same interests (that is, any allocation made pursuant to the foreign country's transfer pricing rules) is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.
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> If a foreign tax provides otherwise, it does not satisfy the attribution requirement, and thus is not an income tax, to the extent that the amount of foreign tax paid by a taxpayer exceeds the amount of foreign tax that would be imposed if the foreign country's transfer pricing rules were consistent with arm's length principles. Thus, for example, if a foreign tax uses transfer pricing rules that allocate profits to a resident on a formulary basis (rather than on the basis of arm's length prices), such as through the use of fixed margins in a manner that is not consistent with arm's length principles, the foreign tax imposed on residents is not an income tax to the extent that the foreign country's transfer pricing rules require allocations inconsistent with the allocations, if any, that would be determined under arm's length principles, and the foreign country's allocations thereby increase foreign tax.

Such an arm's length requirement could be illustrated by an example such as the following:

> A, a corporation organized in the United States, owns all of the stock of B, a corporation organized in Country X. A produces medical devices. In Year 1, A sells medical devices to B for a total price of $850,000. A sells the same medical devices to unrelated distributors in other countries for the same prices per unit charged to B. Later in Year 1, B resells the medical devices to unrelated parties in Country X for $1,000,000. Country X imposes a tax on corporations organized in Country X equal to 25 percent of their net income. Country X relies in part on fixed margins, on a transaction-by-transaction basis, to make transfer pricing adjustments in a manner that is not consistent with arm's length principles.

> For tax purposes, B is required, under one of Country X's fixed margin methods for imports, to adjust the price it paid for the medical devices to equal the resale price of the devices sold to unrelated parties in Country X, minus a 30% profit margin. Thus, in computing its Year 1 Country X income tax liability, B reports that its cost of acquiring the devices was $700,000 ($1,000,000 - $300,000), such that B had $300,000 of profit from the purchase and resale of the devices. When it computes its Country X tax liability, B is aware that $700,000 is not an arm's length price (by section 482 or OECD standards). Accordingly, $37,500 (25 percent of $150,000 ($850,000-$700,000)), the amount of Country X income tax remitted by B to Country X that is attributable to the deemed purchase of the devices from A at less than an arm's length price, is not an amount of foreign income tax paid.

The foregoing suggested example is based in part on, and consistent with, Treas. Reg. § 1.901-2(e)(5)(vi), Example 1.

The foregoing limited exception to the "all-or-nothing" rule that otherwise applies under section 901 would be appropriate. The all-or-nothing rule is a policy choice that the Treasury has historically made. However, there is nothing in the text of section 901 that says that in all cases, a foreign levy either is or is not an income tax, in its entirety, for all persons subject to the tax. The Treasury asserts that "[t]he all-or-nothing rule ensures consistent outcomes for taxpayers and minimizes the administrative burdens on the IRS that would result if the creditability of a foreign tax instead varied depending on each taxpayer's particular facts." 85 F.R. at 72087. However, the all-or-nothing rules does not serve those policy objectives particularly well in the context of the arm's length requirement. First, as noted above, an all-or-nothing arm's length requirement creates highly *inconsistent* outcomes depending on which country is being analyzed, and how different taxpayers interpret the requirement to apply to any given country's transfer pricing rules. Second, the administrative burden on the IRS to enforce a more targeted arm's length requirement is mitigated by the fact that most affected taxpayers can be expected to reasonably self-apply the arm's length standard. Most multinational groups apply the arm's length standard routinely and are aware of when foreign law requires them to report transaction prices for particular purposes differently than they would be priced at arm's length. Moreover, in many cases divisions of multinational groups are in competition with each other. Therefore, under a requirement such as suggested above, taxpayers can be expected to reduce their foreign tax credits to a significant extent on their returns. Example 1 from the non-compulsory payment rules implicitly recognizes taxpayers' knowledge of their own business, and their resulting capacity to self-apply the arm's length standard. *See* Treas. Reg. § 1.901-2(e)(5)(vi), Example 1 ("When it computes it Country X liability B is aware that $600,000 is not an arm's length price (. . .)"). In any event, a limited exception to the all-or-nothing principle is simply necessary if the Treasury seeks to address the problem of non-arm's length transfer pricing rules, for the first time, using regulations under section 901, in a targeted and reasonable way.

As an alternative to making a limited exception to the all-or-nothing rule, the Treasury could reach the same result by providing a special rule, in Treas. Reg. § 1.901-2(d), under which

the portion of a foreign tax on residents attributable to the foreign tax's use of transfer pricing rules that are inconsistent with the arm's length standard is a separate levy from the remainder of the foreign tax. Specifically, the regulations could provide that in the case of a foreign country whose transfer pricing rules are inconsistent with arm's length principles, the excess of the amount of foreign tax calculated under the foreign country's transfer pricing rules, over the amount of foreign tax that would be calculated under the arm's length standard, is a separate levy from the remainder of the foreign tax. The separate levy represented by the excess amount of foreign tax would not satisfy the attribution requirement. The separate levy represented by the remaining foreign tax (*i.e.*, the foreign tax on residents that would be computed under the arm's length standard) would satisfy the attribution requirement.

This approach would be similar to the existing rule that "[w]here foreign tax law imposes a levy that is the sum of two or more separately computed amounts of tax, and each such amount is computed by reference to a different base, separate levies are considered to be imposed." *See* Treas. Reg. § 1.901-2(d)(1)(ii), and -2(d)(3), Examples 3 and 4. A foreign tax would be *deemed* to be the sum of two separately computed amounts of tax, one computed solely by reference to the base of net income determined under the arm's length standard, and the other computed also by reference to the base of net income determined under the foreign country's transfer pricing rules inconsistent with the arm's length standard. Such an extension of the separate levy rules to achieve a specific policy objective would be consistent with the policy reflected in the expanded separate levy rules that treat a tax imposed on residents as a separate levy from the same tax imposed on non-residents.

Thank you for your consideration. If you have any questions about our petition or would like to discuss it with us, please contact either of the undersigned at (202) 393-7600.

Respectfully submitted,

Leslie J. Schneider

James E. Brown