FTC Developments

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SJSU | LUCAS COLLEGE AND GRADUATE SCHOOL OF BUSINESS
MST Program

TAX EXECUTIVES INSTITUTE, INC.
Silicon Valley Chapter

Agenda

Topic
Foreign Tax Credits: Overview
Section 901: Income Taxes
Section 903: In Lieu of Taxes
Single Country License Exception
Interaction with Tax Treaties
Relief in the Form of Notice 2023-55
But wait, BEPS . . .
Foreign Tax Redeterminations, Contested Taxes, and Timing
Noncompulsory Payments
Selected Jurisdictional Considerations
Disregarded Payments and Treas. Reg. § 1.861-20

Panelists

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Foreign tax credits: Overview

Foreign tax credit– Timeline of guidance

Jan. 4, 2022

Final regulations
- Significantly tightened rules for determining when a foreign levy would be eligible to be treated as foreign income tax
- Applicable to foreign taxes paid or accrued in tax years beginning on or after December 28, 2021
- More objective cost recovery requirement
- Attribution requirements

July 26, 2022

Technical corrections
Some clarifying edits to "cost recovery" rules

Nov. 22, 2022

Proposed regulations
- Proposed changes to mitigate strict cost recovery rules
- Introduced single country license exception for royalties
- Allowed reliance on proposed changes

April 3, 2023

Notice 2023-31
Extended the time period for meeting the documentation requirement

July 21, 2023

Notice 2023-55
- For 2022 and 2023, allows taxpayers to apply certain modified rules instead of certain provisions under the final section 901 and section 903 regulations.

What is a creditable tax under Sections 901 and/or 903?

- Creditability analyzed in respect of each separate levy
- A foreign levy is creditable under section 901 if:
  - It is a "tax," defined as a *compulsory payment* pursuant to a foreign country's authority to levy taxes
  - It satisfies certain key requirements, namely:
    - realization, gross receipts, and cost recovery requirements that were substantially revised in 2021 Final Regulations under Reg. § 1.901-2, as well as a new attribution requirement (discussed in subsequent slides).
  - It is not a soak up tax:
    - A tax is a soak-up tax if liability for the tax is dependent on the availability of a credit for the tax against the payer's income tax liability to another country

Section 901: Income Taxes

Changes to creditable "net income taxes" in TD 9959 (2021 final FTC regulations)

- **The creditability of a given foreign levy is determined separately from the creditability of any other foreign levy**
  - Levies constitute separate levies if:
    - Imposed by different foreign tax authorities
    - Separate bases
    - Imposed on nonresidents versus imposed on residents
    - Withholding tax as applied to each separate class of income described in section 61, as well as certain *subsets* of income
    - Foreign levy as modified by a treaty or contract with the foreign country is separate from the general levy
- **In order for a levy to be a creditable foreign income tax, it must be a foreign tax and qualify as either a net income tax or an "in lieu of" tax in its *entirety* for all persons subject to the tax**
- **Applicability date – taxes paid or accrued in tax years beginning on or after December 28, 2021 (with a delayed effective date for certain taxes paid to Puerto Rico)**
- **Corrections to final Regulation (87 Fed. Reg. 45018) published on July 27, 2022 (the "Technical Corrections"), and proposed regulations in November 2022 (the "Proposed Regulations")**
- **For purposes of the corporate AMT, foreign taxes will need to satisfy these rules too**

Foreign income taxes – November 2022 proposed regulations

Proposed regulations would modify cost recovery requirement:

- To only require recovery of "substantially all" of each item of significant cost or expense.
- To add safe harbors that permit certain partial disallowances of significant costs.
- To continue to permit disallowances consistent with U.S. principles.
- To add examples regarding the application of cost recovery rules to better illustrate the cost recovery requirement added by the final regulations and revised by the technical corrections.
- To add a safe harbor to the source-based attribution rule for royalties that allows all or a portion of foreign withholding taxes on royalties to satisfy the attribution requirement if certain documentation requirements are met.

Applicability date for the proposed regulations:

Cost recovery and single-country license changes: Proposed to apply to foreign taxes paid in taxable years ending on or after November 22, 2022. Once finalized, taxpayers may choose to apply the regulations to foreign taxes paid in taxable years beginning on or after December 28, 2021, and ending before November 22, 2022, provided that they consistently apply those rules to such taxable years.

General reliance rule: Taxpayers may rely on one or more of the three changes made by the proposed regulations before the effective date of such regulations if the taxpayer and its related parties, within the meaning of sections 267(b) (determined without regard to sections 267(c)(3)) and 707(b)(1)), consistently follow all proposed regulations with respect to the change or changes in the proposed regulations relied upon for all relevant years until the effective date of the final regulations adopting the rules.

Per se significant costs and expenses – Proposed regulations

- **First safe harbor**: A disallowance is permitted if it is of a <u>stated portion of an item</u> (or multiple items), and the total portion of the item (or items) that is disallowed does not exceed <u>25 percent of the item</u>.
- **Second safe harbor**: A limitation caps the recovery of an item, or multiple items that relate to a single category of significant costs and expenses, is permitted if the cap is:
  - A <u>stated portion of gross receipts, gross income</u>, or a similar measure, that is not less than <u>15 percent</u> of such measure, or
  - A <u>stated portion of taxable income</u> (determined without regard to the item at issue) or a similar measure that is not less than <u>30 percent</u> of such measure.

Attribution requirement in final FTC regulations (TD 9959)

- Separate attribution requirements apply to nonresident taxes and resident taxes.
- **Nonresident taxes**
  - **Activities based nexus**
    - Tax based on ECI-type or PE-type principles
    - No destination-based criterion
    - Cannot attribute activities or income of an affiliate or other nonagent third person
  - **Sourced based nexus**
    - Sourcing rules must be similar to U.S. sourcing rules (specific rule for services and royalties)
      - Services income must be sourced based on place where the services are performed, NOT location of the payor
      - Royalty income must be sourced based on place of use or right to use
    - Foreign law characterization of income generally controls (exception for sales of copyrighted articles as determined under rules similar to Reg. section 1.861-18)
    - Does not apply to sales or dispositions of property

Attribution requirement in final FTC regulations (TD 9959)

- **Situs-based nexus (nonresident taxes continued)**
  - Applies with respect to taxes imposed based on situs of real property or business property of a taxable presence
  - Sale or disposition of stock satisfies situs-based nexus only under a FIRPTA-type regime
  - Gross receipts from the sale or disposition of property, other than stock, that are attributable to business property of a taxable presence under rules reasonably similar to section 864(c) (including section 864(c)(8))

- **Resident taxes**
  - Foreign tax imposed on a ***resident*** may be on worldwide income
  - Must incorporate arm's length transfer pricing principles and cannot take into account destination-based criterion as a significant factor
    - Uncertainty as to how the IRS would determine if a foreign country's tax laws allocate income using the arm's length standard, with the consequence of an adverse conclusion being that ALL taxes imposed on residents of that country would be noncreditable

Section 903: In Lieu of Taxes

U.S. FTC considerations: Section 903 taxes

Section 903 ("in lieu of taxes") creditability requirements:

- A good **generally imposed net income tax ("GINIT")** creditable under Section 901
- **Non-duplication**: No net income tax in the country applies to the same base
- **Close connection**: GINIT would have applied to that base if "in lieu of" tax didn't apply
- **Attribution**: If the GINIT, or a hypothetical new separate levy with respect to the GINIT, were applied to the tax base of this levy, such GINIT or separate levy would meet the attribution requirements
- Immaterial whether the base bears any relation to net gain

"Covered WHTs" imposed on non-residents need to satisfy only non-duplication and source-based attribution requirements

- Existence of a good GINIT
- Must be imposed on non-residents
- Non-duplication requirements
- Source-based attribution requirements
- Note: WHT with respect to each class of income (or certain subsets thereof) tested as separate levies

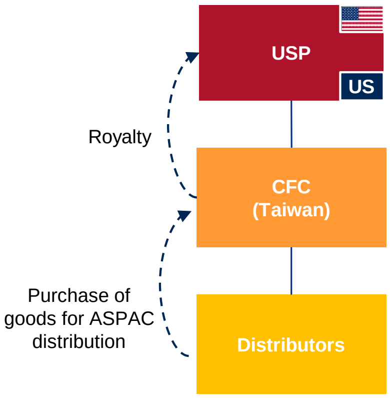
Single Country License Exception

Single country license (SCL) exception for royalty WHTs—Proposed regulations

Special relief for royalty WHTs

- "Place of use or right to use" in the U.S. vs. residence of payor or location of registration in many other jurisdictions
- Proposed FTC regulations introduced the "single-country license" exception:
  - License should limit the use of the IP to the territory of the country imposing the tax.
  - Portion of the royalty WHT may satisfy if underlying agreement delineates the portion related to in-country use (whether via a specified amount or a formula).
  - License agreements to be provided within 30 days of request and must generally be executed no later than the date of royalty payment.
    - Grace period provided until 180 days after the Proposed FTC regs are finalized and filed with the federal register to execute amended agreements to satisfy single country license exception (**Notice 2023-31, April 2023**).

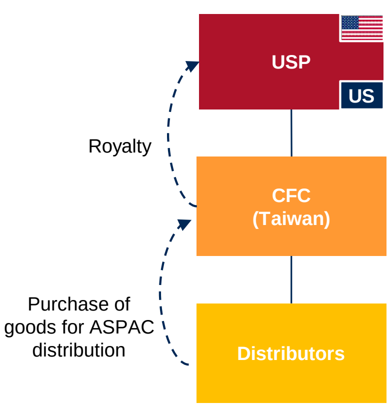
Example – Separately stated portion



- Taiwan imposes a 20% withholding tax on royalties paid to non-residents because the royalty is paid by a resident of Taiwan.
- There is no income tax treaty between the U.S. and Taiwan.

- **Facts:**
  - CFC enters into a written agreement with USP for the right to use USP's IP in the ASPAC region.
  - USP's IP includes all of the rights to make and sell products, including product and process patents, manufacturing know how, and trademarks.
  - CFC manufactures the products in Taiwan using the IP. CFC sells finished goods to customers in Taiwan and to distributors to sell the products throughout the rest of the ASPAC region.
- **Discussion:**
  - Separately value the rights to manufacture vs. the rights to sell. The rights to manufacture are likely used in Taiwan, and the rights to sell are likely used in the countries where the products are ultimately sold.
  - IP used in the manufacturing process (e.g., manufacturing knowhow) is likely used in Taiwan.
  - Marketing IP (e.g., trademark and brand IP) is likely used at the place of sale (i.e., throughout the ASPAC region).
  - Product IP (e.g., IP related to the design of the product or specific features of the product) may be used partly at the location of manufacturing and partly at the location of sale, depending on the facts.

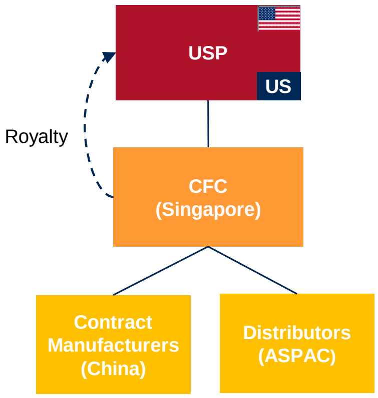
Example – Separately stated portion (cont'd)



- Taiwan imposes a 20% withholding tax on royalties paid to non-residents because the royalty is paid by a resident of Taiwan.
- There is no income tax treaty between the U.S. and Taiwan.

- As noted above, product IP (e.g., IP related to the design of the product or specific features of the product) may be used partly at the location of manufacturing and partly at the location of sale, depending on the facts.
  - Facts indicating a higher value in manufacturing activities:
    - Manufactured goods are non-branded goods, components, or commodities
    - The quality or price of manufacturing is of particular importance
  - Facts indicating a higher value in selling activities:
    - Manufactured goods are branded goods
    - The design of the product is a market differentiator
    - The effectiveness of the product (e.g., pharma products) is a market differentiator

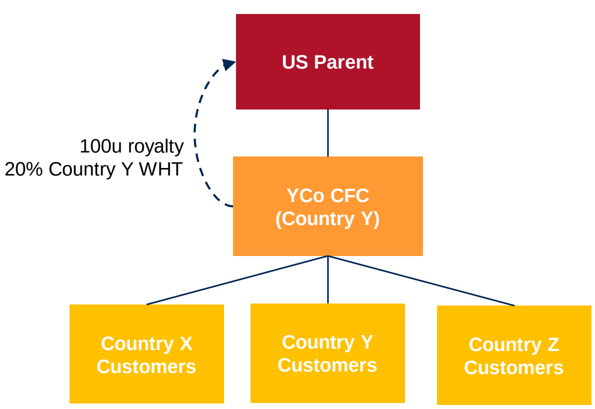
Example – IP hub



- Singapore imposes a 10% withholding tax on royalties paid to non-residents because the royalty is paid by a resident of Singapore.
- There is no income tax treaty between the U.S. and Singapore.

- **Facts:**
  - CFC enters into a written agreement with USP for the right to use USP's IP in the ASPAC region.
  - USP's IP includes all of the rights to make and sell products, including product and process patents, manufacturing know how, and trademarks.
  - CFC hires Contract Manufacturers in China to manufacture the products.
  - CFC sells finished goods to Distributors in ASPAC.
  - CFC gives the Contract Manufacturers and Distributors a royalty-free right to use the IP.
- **Discussion:**
  - Economically, most of the profit resulting from making and selling the products using the IP will be earned in Singapore.
  - However, use of a royalty (unlike a service fee) does not depend on where the licensee conducts activities, but rather where the IP is exploited.
  - Because no manufacturing or selling activities occur in Singapore, is the IP "used" in Singapore?

Example – Master software license



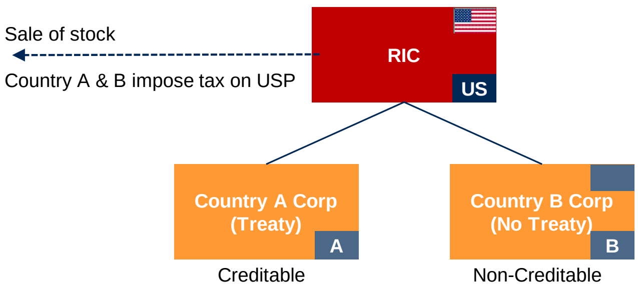
- **Facts:**
  - US Parent licenses software to YCo CFC to provide services for customers in Countries X, Y and Z.
  - Under Country Y's domestic tax law, all royalties paid by a resident of Country Y to a nonresident are sourced in Country Y and are subject to a twenty-percent (20%) withholding tax.
- **Discussion:**
  - How do we determine where YCo is using the IP?

Interaction with Tax Treaties

Creditability of foreign taxes under an income tax treaty

- Foreign taxes that would not be creditable under the 2022 Final FTC Regulations *may* nonetheless be creditable under the relief from double taxation article of a US income tax treaty (see Reg. § 1.901-2(a)(1)(iii))
    - The relevant foreign tax must be treated as an income tax under the treaty
    - The foreign tax must be paid or accrued by an eligible US resident or citizen that elects to claim the benefit
    - Some treaties may contain a "resourcing" provision that treats income that is otherwise US source income (e.g., stock gains recognized by a US resident, such as a RIC) as foreign source, subject to limitations under the Internal Revenue Code
        - Code provisions such as sections 865(h) and 904(d)(6) may require separate "basketing" of resourced income and associated taxes for FTC limitation purposes
    - Reporting of treaty-based return positions on IRS Form 8833 is generally required under section 6114

Interaction of 2022 final FTC regulations with tax treaties



- **Example:**
  - Countries A and B impose nonresident capital gains taxes on sales of corporate stock and those taxes do not satisfy the attribution requirement; the Country A and Country B taxes therefore would not creditable under the final regulations
  - US has an income tax treaty in effect with Country A, but not Country B. The US-Country A treaty treats the tax imposed on the gain as an income tax, and USP elects to credit the taxes pursuant to the double taxation article of the treaty
  - Under the final regulations, Country A taxes would be creditable (subject to applicable limitations); Country B taxes would not be creditable

Relief in the form of Notice 2023-55

Notice 2023-55

- Temporary relief under Notice 2023-55 issued on July 21, 2023 ("Relief Notice")
    - The IRS issued the Relief Notice announcing temporary relief for taxpayers determining whether a foreign tax is eligible for a foreign tax credit under sections 901 and 903
    - For foreign taxes paid during 2022 and 2023, taxpayers may apply:
        - Former § 1.901-2(a) and (b), before it was amended by the 2022 FTC final regulations, but subject to a modification to the non-confiscatory gross basis tax rule as described in the notice.
        - Existing § 1.903-1 without the attribution requirement
- Definition of "Relief Period" in Notice 2023-55
    - For **calendar year taxpayers** – from 1/1/22, through 12/31/23 (i.e., TY22 and TY23);
    - **For fiscal year taxpayers** – for tax years beginning after 1/1/22, and ending before 12/31/23 i.e., fiscal year ending in 2023 (unless there is a short period)
    - The Notice indicates that the Government is considering whether to provide additional temporary relief and the Government has indicated informally that it intends to extend the Notice's relief period for another year
- Additionally, Notice 2023-55 specifically addresses the creditability of DSTs noting that:
    - DSTs do not satisfy the net income requirement under former Section 1.901-2(b)(4)(i) for CITs, and
    - DSTs that impose tax on a base that is otherwise subject to that foreign country's net income tax do not meet the non-duplication requirement for in lieu of taxes.
        - Need to evaluate these types of tax provisions closely to see if they could meet section 903 to be treated as an lieu of tax.

Digital Service Taxes (DSTs)

- **DSTs generally seek to tax revenue earned by foreign corporations that access a country's market without having physical presence there**
    - A substantial proportion of the corporations that meet this description are US-headquartered, creating tension between the US and the countries implementing DSTs
- **DSTs are a tax on gross revenue derived from a variety of digital services**
    - Taxes on gross receipts or income generally don't qualify for foreign tax credits.
    - Treasury's position is that DSTs are non-creditable, and the attribution requirement was designed to address DSTs and similar taxes by classifying as noncreditable foreign taxes that don't require enough nexus between the foreign country and the taxpayer's activities upon which the foreign tax was imposed
- **OECD's Pillar 1 aims to abolish such taxes, but there are significant obstacles to Pillar 1 enactment**
    - US and several countries agreed to a compromise for the period prior to Pillar 1's enactment, but the timeline for enactment has drifted
    - Not all countries are willing to wait. In July of 2023, Canada rejects OECD's DST moratorium extension, plans new DST in 2024.

Selected Digital Service Taxes

Country	Status	Effective Date	Rate	Notes
Austria	Enacted	Jan 2020	5.0%	Agreed to unilateral measures compromise
Belgium	Proposed	TBD	3.0%	Development on hold pending Pillar 1 outcome
Canada	Proposed	Jan 2024[1]	3.0%	**Will enact without further delay**
Croatia	Proposed	TBD	7.0%	
France	Enacted	Jan 2019	3.0%	Agreed to unilateral measures compromise
Italy	Enacted	Jan 2020	3.0%	Agreed to unilateral measures compromise
India	Enacted			Agreed to unilateral measures compromise
Kenya	Enacted	Jan 2021	1.5%	
Mexico	Proposed	TBD	2.0%	
New Zealand	Proposed	Jan 2025*	3.0%	
Poland	Proposed	TBD	7.0%	Development on hold pending Pillar 1 outcome
Slovakia	Proposed	TBD	TBD	
Spain	Enacted	Jan 2020	3.0%	Agreed to unilateral measures compromise
Tunisia	Enacted	Jan 2020	3.0%	
Turkey	Enacted	March 2020	7.5%	Agreed to unilateral measures compromise
United Kingdom	Enacted	April 2020	2.0%	Agreed to unilateral measures compromise

(1) Anticipated effective date. To apply in respect of revenues earned from Jan 1, 2022
(2) Anticipated effective date. May be delayed until January of 2030

But wait, BEPS…

Overview: The Pillar 2 charging rules

Policy objective:

To ensure that large multinational companies pay a 15% minimum level of tax on income earned in every jurisdiction they operate.

Three shots at achieving this policy objective (in order of priority application):

Local country measure

Qualified Domestic Minimum top-up tax ("QDMTT")

Allows the local jurisdiction to collect any top-up tax to the 15% minimum tax rate that would otherwise be paid to another jurisdiction under Pillar 2.

"Parent" country measure

Income Inclusion Rule ("IIR")

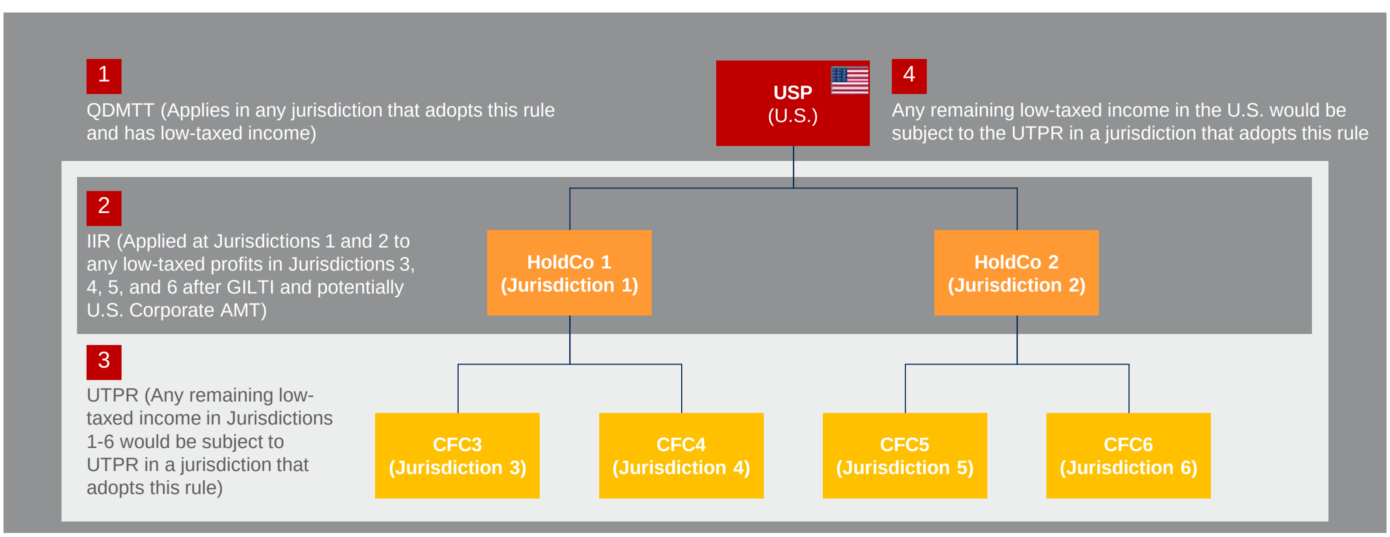
Triggers top-up tax at the level of a Parent company where the income of a subsidiary or other constituent entity ("CE") (aggregated at the jurisdictional level) is taxed at a rate less than 15%.

Backstop measure

Undertaxed profits rule ("UTPR")

1. UTPR is the ultimate backstop measure
2. The top-up tax is allocated among relevant jurisdictions that adopted UTPR
3. It operates by denying deductions (or an "equivalent adjustment").
4. Applies to income in ultimate parent jurisdiction, including the U.S.

Application to US multinational



Treatment of Pillar 2 taxes

- **Qualified Domestic Minimum Top Up Tax (QDMTT)**
  - Expected to be the primary charging provision that will apply to collect top up tax
    - QDMTT expected to be creditable and guidance on how these taxes will be accounted for may be released before the end of the year
- **Income Inclusion Rule (IIR)**
  - Commentary to Article 4.3.2 generally provides that to preserve the rule order, domestic tax regimes should not provide a foreign tax credit for any tax imposed under an IIR or UTPR
  - There have been raised issues of circularity if an FTC is provided since IIR and UTPR take into account the push down of CFC (subpart F) and Blended CFC taxes (GILTI)
  - Concerns about soak-up taxes
- **Under Taxed Profit Rule (UTPR)**
  - Similar issues may be raised to IIR and additional issues depending on how jurisdiction implements
  - Concerns on separate levy and CIT analysis if UTPR applies via deduction disallowance (i.e., it's part of the generally imposed net income tax in a jurisdiction)

Foreign Tax Redeterminations, Contested Taxes, and Timing

Foreign tax redeterminations (FTRs)

- **Broadly, any change in foreign tax liability that affects a taxpayer's US tax liability will be an FTR. FTRs include cases where:**
  - Taxpayer receives refund from foreign tax authority
  - Taxpayer pays taxes more than 24 months after the close of the taxable year in which accrued
  - Amount of accrued taxes when paid differs from amount originally claimed as a credit
  - Taxpayer corrects or makes other adjustments to accrued amounts to reflect the final foreign tax liability
  - Change from credit to deduction or from deduction to credit
- **US tax redetermination:**
  - If there's a change in foreign tax that impacts the US tax owed by a taxpayer, they must inform the IRS. The IRS will then recalculate the appropriate US tax amount. Notification usually takes place via an amended return

The “relation-back” doctrine

- **Regulation § 1.905-1 regifies the longstanding relation-back doctrine**
  - This principle provides that if there are any changes in a taxpayer's foreign tax obligations, such as extra payments made after settling a dispute with a foreign tax body, these changes are treated as if they were due at the end of the foreign tax year they relate to. This is especially the case for taxpayers who use the accrual accounting method.
  - If there's a "foreign tax redetermination" (as outlined in Regulation § 1.905-3), the taxpayer must reassess their US tax obligations for the year the foreign tax relates to, as well as any other impacted year.
  - Additional foreign income taxes that are applicable to a year in which the taxpayer chose to deduct foreign taxes can be written off in the year these taxes are finalized and paid. This applies even if the taxpayer decides to credit foreign income taxes for that year.
    - However, a taxpayer cannot deduct any foreign income taxes for a year in which they've opted to use the foreign tax credit.

FTRs: Mechanics

- **Notification Requirements**
  - Corporations must file amended returns, including preparing an amended Form 1118 and adding Schedule L
    - If there is an increase in US tax liability the amount is due with original return (including extensions) of year in which FTR occurs
    - Decrease in US tax liability that is due within 10-year SOL for claiming FTC refunds
    - Special rules for multiple redeterminations
    - Exceptions for filing amended returns and Forms 1118 (but not statements) if no change in US tax liability, meet requirements of "audit exception," or IRS prescribes alternative notification requirements through forms, instructions, publications, or other guidance
  - Passthrough entities may only need to provide statements with their income tax return
  - A special irrevocable pooling election may be available for certain FTRs of foreign corporations related to tax years beginning before January 1, 2018.
    - The result is that all FTRs in pre-2018 years are taken into account in the transition tax year

Credit vs. deduction

- **Special 10-year statute of limitations under section 6511(d)(3) allows taxpayer to change from deduction to credit, and to change the amount of FTC, including correcting math errors**
- **The 10-year period runs from due date, without extensions, of return for year in which taxes actually paid or accrued. See Albemarle v. United States, 118 Fed. Cl. 549 (2014), aff'd 797 F.3d 1011 (Fed. Cir. 2015), reh'g denied, 805 F.3d 1060 (Fed. Cir.2015)**
  - Trusted Media Brands v. US, 899 F.3d 175 (2d Cir. 2018), held that, although taxpayers had 10 years to elect to deduct or credit foreign income taxes, the 10-year SOL did not apply to refund claims relating to foreign taxes that the taxpayer deducts rather than credits
- **For tax years beginning on or after December 28, 2021, a 3-year statute of limitations under section 6511(a) allows a taxpayer to change from credit to deduction**
- **Change election by filing amended return**

Pre-TCJA years and the SOL

- USP has owned a German GmbH, which is a CFC, for 30 years. In 2023, GmbH settles an audit with the German government with respect to 2010 that results in it paying EUR 50 in additional German tax for that year.
- This EUR 50 of additional German tax would be deemed paid under section 902 in 2016.
- Section 6511(d)(3)(A) states: “If the claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country or to any possession of the United States for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of section 901 or the provisions of any treaty to which the United States is a party, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 10 years from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued.”
- How does the SOL apply with respect to the EUR 50 of additional tax?

Payment of contested taxes

- The new regulations make it harder to claim foreign tax credits for taxes that you've paid but are still contesting.
- To claim a "provisional" credit, you'll need to enter a "provisional foreign tax credit agreement" with the IRS through Form 7204.
  - This agreement will require you to agree not to assert the statute of limitations for 3 years after you notify the IRS of the resolution of the contest.
  - You'll also need to provide an annual notice each year with your timely filed tax return until the contest is resolved. You will do so on Form 1118 schedule L and Form 1116 schedule 6.

Noncompulsory Payments

Noncompulsory payments: 1.901-2(e)(5)

- **Taxpayers wishing to claim foreign tax credits have an obligation to not pay more than they are required to pay under foreign law. Payments will not be considered an amount of foreign income tax paid to the extent it is not compulsory**
- **To ensure a payment is considered compulsory taxpayers must:**
  - Minimize their foreign income tax liability by reasonably interpreting and applying foreign tax law
  - "Exhaust all effective and practical remedies" to reduce their foreign tax liability over time
    - This includes seeking competent authority relief, where relevant
    - The time value of money is ignored for these purposes
- **However, taxpayers are not required to reduce their foreign income tax liability if the arm's length costs of doing so "would exceed the amount by which the liability could be reduced."**
  - Put into an equation, this could be read as saying no action is required to minimize foreign tax liability if:
  - $The\ cost\ to\ reduce\ foreign\ tax\ liablity > likelihood\ of\ tax\ reduction\ x\ amount\ of\ tax\ reduced$
  - This may be simplified as $costs\ incurred > scenario\ likelihood\ x\ tax\ reduction$

Noncompulsory payments - Measurement

- **Costs incurred**
  - Is there a limitation on the consulting costs that taxpayers may consider when making the decision?
    - If a valuation allowance was required, how many years of costs to reexamine this may be considered
    - Do taxpayers need to obtain a fee quote to validate external costs? Must they obtain more than one?
  - It seems reasonable to include the costs of time employees would need to spend
    - What about the opportunity cost of having employees work on foreign tax reduction instead of a more valuable internal initiative?
  - Other costs
    - A vigorous defense may have an impact on other ongoing audits. May taxpayers consider this cost? Does it matter if the ongoing audits are ancillary to the amount of tax under consideration?
- **Scenario likelihood x tax reduction**
  - How thorough do taxpayers need to be when determining the number of potential scenarios to consider?
  - If the amount of tax reduction is not a binary issue, how is the amount of reduction to be measured?

Selected Jurisdictional Considerations

Creditability of Brazilian corporate income taxes

- **The Brazilian corporate income tax likely failed two aspects of the net gain requirement with the final foreign tax credit regulations were issued in 2022**
  - The disallowance of deductions for related party transactions (e.g., extremely low royalty rates required under Brazilian law) violated the cost recovery requirement
  - Brazilian transfer pricing methodology did not follow the arm's length standard – which likely violated the attribution requirement
- **Subsequently Brazil has passed legislation to bring their transfer pricing rules in line with OECD arm's length guidelines**
  - This removes the biggest impediment to Brazilian corporate income taxes being considered a creditable foreign tax for US federal income tax purposes
  - However, taxes paid prior to 2023 would still be noncreditable under the final regulations

Creditability of Mexican corporate income taxes

- **Mexico's corporate income tax contains an inflation adjustment which seeks to recognize the effects of inflation for tax purposes in the areas of monetary assets and liabilities and depreciable property**
  - No similar concept exists in the United States, which raises the question of whether Mexico's corporate income tax satisfies the realization requirement under the 2022 final regulations?
  - Because a foreign tax is either creditable or noncreditable in its entirety, the 2022 regulations could effectively treat all corporate income taxes paid to one of our largest trading partners as noncreditable

Disregarded Payments and Treas. Reg. § 1.861-20

Allocation of foreign income taxes: Three-step approach

Step 1

- Assign items of foreign gross income to statutory and residual groupings and apply disregarded payment rules

Step 2

- Allocate and apportion deductions allowed under foreign law to the foreign gross income in the groupings

Step 3

- Allocate and apportion the foreign income tax by reference to the foreign taxable income in the groupings

- That amount of foreign gross income in Step 1 is determined according to foreign law
- The character and grouping of foreign gross income is determined based on a US Corresponding Item ("**US CI**") would be assigned. Special rules apply where there is no US CI
- Step 1 also includes rules for allocating and apportioning foreign income taxes imposed due to disregarded payments. These rules apply to both
  - Disregarded payments between a US corporation and its foreign branches
  - Disregarded payments between a CFC and its foreign disregarded entities

Applying the disregarded payment rules: 1.861-20(d)(3)(v)

- **The methodology for applying the disregarded payment rules (part of Step 1 in the allocation of foreign income taxes) is as follows:**
  - Identify the taxable units and disregarded payments
  - Characterize each disregarded payment as one of the following:
    - Reattribution Payment
    - Remittance
    - Contribution
    - Disregarded Payment in Exchange for Property
  - Apply rules based on whether there is a US CI
  - Apply the multiple payment rules

1. Identify taxable units and disregarded payments

- **Types of taxable units**
  - <u>Individuals and Domestic Corporations</u>: Foreign branches, foreign branch owners, non-branch taxable units (e.g., foreign disregarded entities)
  - <u>Foreign Corporations</u>: A taxable unit is a "tested unit" as defined in the high-tax exception regulations (see1.951A-2(c)(7))
- **Disregarded payments exist in transactions where**:
  - Property is transferred to or from a taxable unit
  - The transaction is disregarded for US federal income tax purposes, and
  - The transaction is recorded on the books of the taxable unit
- **Disregarded payments can include all of the following**:
  - Transfers that would have been contributions to capital if regarded
  - Transfers that would have been a distribution if the transferor were considered a US corporation
  - Sales of depreciable and non-depreciable property
  - Any other payment that would have impacted income, gain, deduction or loss calculations at the taxable unit if the transaction was regarded for US federal income tax purposes

2. Characterize disregarded payments

- **Reattribution payments**
  - Primarily non-property dealings that are part of either the branch's or the owner's ordinary business
  - Assign income and assets for purposes of 1.861-20, but do not assign taxes
  - Reattribution is limited to the payor taxable unit's taxable income. Any excess is treated as either a contribution or a remittance
- **Remittances**
  - Primarily equity related transactions between the business and the business owner
  - Considered made ratably out of all the accumulated after-tax income of the taxable unit
    - Accumulated after tax income of the taxable unit is determined by reference to the tax book value of the taxable unit's assets

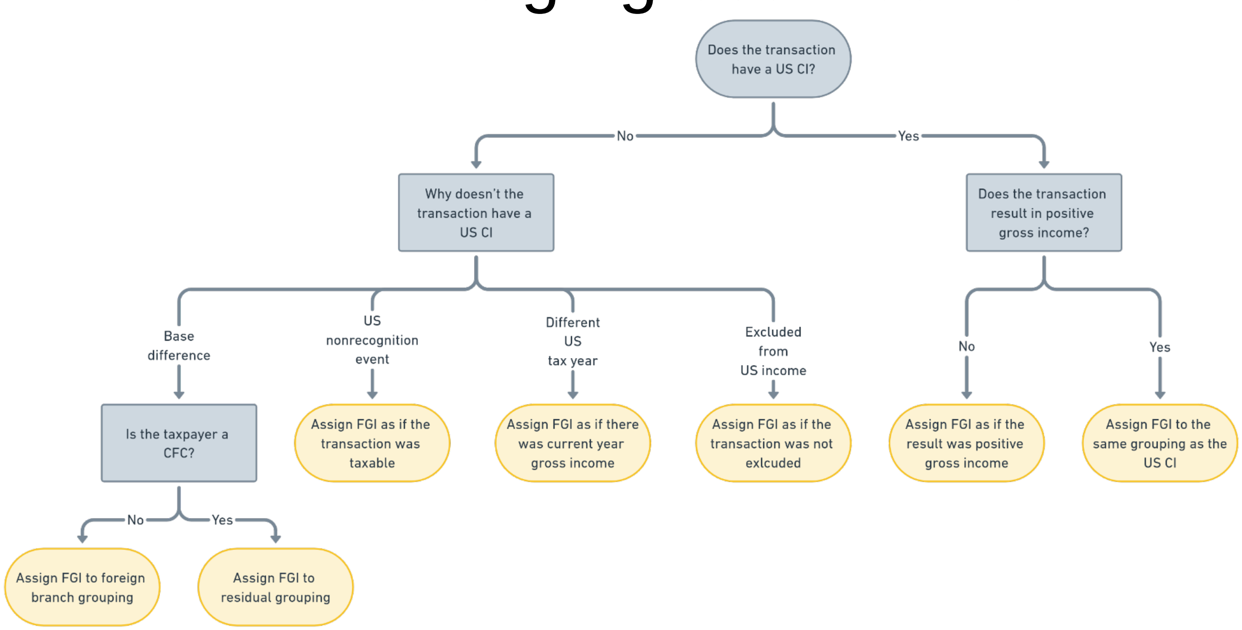
2. Characterize disregarded payments

- **Contributions**
  - The excess amount of a disregarded payment (other than a disregarded payment received in exchange for property) made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment, if any, that is a reattribution payment
  - Taxes associated with contributions are allocated to the residual category, which results in no credit for CFCs under §960
- **Disregarded sales and exchanges**
  - Characterized and assigned as a timing difference in the taxation of the property's built-in gain
  - Characterized and assigned to the grouping to which such corresponding US item would have been assigned if the deemed sale were recognized under federal income tax law

2. Characterize disregarded payments

- **Types of taxable units for individuals and domestic corporations**
  - Foreign branches
  - Foreign branch owners
  - Non-branch taxable units (e.g., foreign disregarded entities)
- **Types of taxable units for foreign corporations**
  - A taxable unit is a "tested unit" as defined in the high-tax exception regulations (see1.951A-2(c)(7))
- **Disregarded payments exist in transactions where:**
  - Property is transferred to or from a taxable unit
  - The transaction is disregarded for US federal income tax purposes, and
  - The transaction is recorded on the books of the taxable unit
- **Disregarded payments can include all of the following:**
  - Transfers that would have been contributions to capital if regarded or distributions if transferred
  - Sales of property and any other payment that would have impacted income, gain, deduction or loss calculations at the taxable unit if the transaction was regarded for US federal income tax purposes

3. Allocate and apportion taxes by foreign gross income



Questions?