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Client Alert

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United States: FTC Regulations Get a Proposed Makeover

Tax Notes and Developments November 2022

In brief

On 18 November 2022, Treasury and the IRS released proposed regulations meant to clarify and amend the final foreign tax credit regulations released earlier this year under Code sections 861, 901, and 903. See our special report, Final FTC Regulations Cause Double Taxation Burden(s) Falls on Taxpayers. The proposed regulations put taxpayers on notice to review and revise certain license agreements.

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Key takeaways

- The proposed regulations make a number of helpful clarifying changes to the cost recovery requirement, which should largely put to rest most of the uncertainties that exist under the current final regulations.

- The proposed regulations also introduce a very limited single-country license exception pursuant to which a withholding tax on royalties may be creditable notwithstanding that the relevant foreign tax law has a royalty sourcing rule that is not compatible with the US place-of-use rule for sourcing royalties. The exception requires a written license agreement that characterizes the payment as a royalty and that either limits the territory of use of the IP to the country imposing the withholding tax or separately--and accurately--states the portion of the royalty that is attributable to the use of the IP in the country imposing the withholding tax.

- Taxpayers have until 17 May 2023, to review and amend their existing or execute new, as appropriate, license agreements, both intercompany and with third parties. That exercise should begin immediately, especially if it will require negotiation with third parties.

- Otherwise, the proposed regulations leave the controversial source-based attribution requirement for royalties largely intact.

- The proposed regulations also include a narrow revision to the disregarded payment rules in Treas. Reg. § 1.861-20 that provides that a disregarded payment in exchange for property does not give rise to a reattribution asset.

The proposed regulations do nothing to address the following concerns under the current final regulations:

- The attribution requirement for residents, as most relevant to Brazil.

- The source-based attribution requirement for services.

Recovery of "substantially all" significant costs or expenses

The proposed regulations modify the general rule for cost recovery to provide that the requirement is satisfied where foreign law permits recovery of "substantially all" of each item of significant cost or expense, including certain specifically enumerated items, such as capital expenditures, interest, rents, and royalties.[1]

Observation: The addition of "substantially all" to the standard requiring recovery of significant costs or expenses should provide relief in certain cases. For example, some countries, such as Mexico, do not permit the amortization of acquired goodwill, either over time or upon a later disposition of the business, and the value received for such goodwill is subject to tax upon a subsequent disposition of the business. If foreign tax law otherwise permits the recovery of capital expenditures (and such goodwill represents a minor portion of capital expenditures for all taxpayers in the aggregate to which the foreign tax law applies), then the failure to permit recovery for goodwill would appear to not cause the foreign tax law to fail the cost recovery requirement. Further clarity in the final regulations regarding the scope of "substantially all" (which can mean very different things under different provisions of the Code) and the meaning of "capital expenditures" in the context of the cost recovery requirement would be welcome.

New safe harbor

The proposed regulations also add a new safe harbor for cost recovery. Disallowances of up to 25% of a stated portion of an item (or multiple items) of significant cost or expense are permitted without causing the cost recovery requirement to be failed (e.g., foreign law disallows a deduction for 25% of a taxpayer's costs and expenses for royalties related to patents, rents, or interest).[2] Limitations (or caps) on the recovery of an item of significant cost or expense (or of multiple items of cost or expense relating to a single category of significant costs and expenses) are also permitted if either:

- Such cap is not less than 15% of gross receipts, gross income, or a similar measure.
- Such cap is not less than 30% of taxable income (determined without regard to the item at issue) or a similar measure (e.g., foreign law caps the recovery of deductions for interest at 30% of the taxpayer's taxable income (determined without regard to interest expense)).[3]

If the safe harbor applies, taxpayers are not required to identify a corresponding principle underlying the disallowances required under the Code. If the safe harbor does not apply (e.g., the limitation on a particular item of significant cost or expense exceeds 25%), and the foreign tax law does not otherwise permit recovery of substantially all of each item of significant cost or expense, then taxpayers will be required to test the restriction under the "principles-based exception"—i.e., that the disallowance is consistent with US principles.

Addition of non-tax public policy concerns for disallowances

The proposed regulations clarify that a disallowance of all or a portion of a significant cost or expense does not cause the cost recovery requirement to be failed where such disallowance is consistent with any principle underlying a Code disallowance provision, including the principles of limiting base erosion or profit shifting and those "addressing **non-tax** public policy concerns similar to those reflected in the [Code]."[4]

Observation: The new safe harbor appears to further allay concerns that the limitations on deductions for royalties under the German Trade Tax and the German license barrier rules cause such limitations to fail the cost recovery requirement. In broad terms, the German trade tax denies deductions for royalties that are low-taxed or benefit from a preferential regime in the recipient country, and the German license barrier disallows deductions for license payments as operating expenses if the royalties are paid to a related foreign party and the royalty is taxed under a "harmful" preferential tax regime. The application of the cost recovery requirement under the current final regulations to such total disallowances is somewhat uncertain given the obligation to identify an analogous disallowance provision in the Code. For the Italian IRAP−which disallows various deductions for purposes of computing the

[1] Prop. Treas. Reg. § 1.901-2(b)(4)(i)(A).
[2] Prop. Treas. Reg. § 1.901-2(b)(4)(i)(C)(2) and -2(b)(4)(iv), exs. 6 and 7.
[3] Prop. Treas. Reg. § 1.901-2-(b)(4)(i)(C)(2) and -2(b)(4)(iv), ex. 8.
[4] Prop. Treas. Reg. § 1.901-2(b)(4)(i)(F)(1) (emphasis added).

IRAP−there remains the question of whether such disallowances are consistent with, or address, "non-tax public policy concerns similar to those reflected in the [Code]."

Special rule for stock-based compensation

The proposed regulations include a rather helpful new example illustrating the proposed new operative rule that a disallowance addressing non-tax public policy concerns similar to those reflected in the Code does not cause the disallowance to fail the cost recovery requirement. Under the example, a foreign corporate income tax law generally permits full deductions for each item of significant cost or expenses except that **no** deduction is permitted for any stock-based payments for services. The example concludes that the cost recovery requirement is nonetheless satisfied because the Code "contain[s] targeted disallowances or limits on the deductibility of certain items of compensation in particular circumstances based on non-tax public policy reasons, including to influence the amount or use of a certain type of compensation in the labor market." The example cites sections 162(m) and 280G as examples of such provisions. Similarly, the foreign tax law's total disallowance of deductions for stock-based compensation "also reflects a principle of influencing the amount or use of a certain type of compensation (stock-based compensation) in the labor market."[5]

Observation: The new example provides welcome relief for taxpayers given that numerous major US trading partners deny deductions for stock-based compensation.

This change is proposed to apply to taxable years *ending* on or after 22 November 2022 (i.e., for calendar year taxpayers, the 2022 taxable year). Taxpayers may rely on the proposed regulations in the meantime, pending final regulations, for foreign taxes paid in taxable years beginning on or after 28 December 2021, and ending before the effective date of final regulations.

Source-Based Attribution Requirement for Royalties

To conform the source-based attribution requirement for royalties with the rule for services, the proposed regulations provide that under the foreign tax law, gross income from royalties must be sourced based on the place of use, or the right to use, the intangible, "as determined under reasonable principles (which **do not include** determining the place of use, or the right to use, the intangible property based on the location of the payor)."[6]

Observation: The proposed regulations now unambiguously provide that a rule which sources royalty income by reference to the residence (or location) or the payor generally fails (subject to the single-country use exception described below) the attribution requirement. The current final regulations include an example to similar effect,[7] but the operative rule does not include such an explicit prohibition.[8]

The proposed regulations also fix certain grammatical concerns with the current final regulations, which provide that a foreign *tax* on gross income from royalties (rather than the royalties themselves) must be sourced based on the place of use of the intangible property.

Additional observation: There is still some uncertainty as to the treatment of a foreign tax law that includes the residence of the payor, for example, as one element, in a multi-factor test, for determining the source of royalty income (or whether the income is subject to withholding tax) where such element, standing alone, is not determinative of whether withholding tax will, in fact, be required. The language added to the source-based attribution requirement for royalties suggests that the location of the payor cannot be the **sole** determinative principle for sourcing royalty income under foreign law.

This clarification would apply to foreign taxes paid in taxable years *ending* on or after 22 November 2022 (i.e., the publication date of the current final regulations).[9] Taxpayers may choose to apply the proposed changes to the source-based attribution requirement for

[5] Prop. Treas. Reg. § 1.901-2(b)(4)(iv), ex. 10.
[6] Prop. Treas. Reg. § 1.901-2(b)(5)(i)(B)(2) (emphasis added).
[7] Treas. Reg. § 1.903-1(d)(3), ex. 3.
[8] *See also* Prop. Treas. Reg. § 1.903-1(d)(3), ex. 3 (which replaces example 3 of the current regulations with a new example).
[9] Prop. Treas. Reg. § 1.903-1(e)(3).

royalties to foreign taxes paid in taxable years beginning on or after 28 December 2021, and ending before 22 November 2022, provided that they consistently apply those rules to such taxable years.[10]

New single-country license exception

The proposed regulations would amend the rules for creditability of a "covered withholding tax" by providing a new limited exception for certain single-country licenses. If the new exception applies, then, notwithstanding that foreign tax law sources royalties other than by reference to reasonable principles based on the place of use, or the right to use, intangible property, the withholding tax imposed on royalties paid pursuant to the single-country license is deemed to be a "covered withholding tax" and is therefore creditable under section 903. The proposed regulations achieve the desired result by amending the rules for separate levies. Specifically, the proposed regulations provide that a withholding tax that is imposed on a payment giving rise to gross royalty income of a nonresident under the terms of a qualified single-country license is treated as a separate levy from a withholding tax that is imposed on other gross royalty income of such nonresident.[11]

Observation: As a technical matter, it was imperative for the proposed regulations to treat a withholding tax imposed pursuant to a qualified single-country license as a separate levy because of the requirement that "a foreign tax either is or is not a foreign income tax, in its entirety, for all persons subject to the foreign tax" and because whether a foreign levy is a foreign income tax is determined independently for each separate levy.[12]

Operation of single-country license exception:

The single-country license exception applies if: (1) the income subject to the tested foreign tax is characterized as royalty income (as determined under foreign law[13]), and (2) the payment giving rise to such income is made pursuant to a single-country license.[14] A payment is considered made pursuant to a single-country license if the terms of the license agreement pursuant to which the payment is made characterize the payment as a royalty and "limit the territory of the license to the foreign country imposing the tested foreign tax."[15]

> ***Example:*** YCo enters into a written license agreement with XCo for the right to use YCo's IP in a territory defined by the agreement as Country X, in exchange for payments that the terms of the agreement characterize as royalties and "XCo in fact uses the IP in Country X." XCo withholds 20u of tax from 100u of royalties paid to YCo under the agreement. The Country X withholding tax is a separate levy and is a covered withholding tax because the license agreement is a written agreement that characterizes the payment as a royalty and limits the territory to Country X.[16]

Observation: Unless the separately stated portions rule described below applies, the general single-country license exception appears to require the written license agreement to specifically provide that the licensed IP may only be used by the licensee in the country imposing the tested withholding tax. This will require a review, and possible amendments, of existing license agreements, all of which, as discussed further below, must be done by 17 May 2023.

Additional observation: In addition to the written license agreement characterizing the payment as a royalty, the applicable foreign tax law must also characterize the payment as a royalty for the single-country license exception to apply. Thus, if the license agreement characterizes the payment as a royalty, but foreign law characterizes the payment as other than a royalty, then the exception is not available.[17] The single-country license exception will also put additional pressure on taxpayers to determine the

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[10] *Id*.
[11] Prop. Treas. Reg. § 1.901-2(d)(1)(iii)(B)(3).
[12] Treas. Reg. § 1.901-2(a)(1)(i).
[13] Consistent with Treas. Reg. § 1.901-2(b)(5)(i)(B)(3), the source-based attribution rule for sales of property, the proposed regulations do not defer to the foreign tax law characterization with respect to the sale of a copyrighted article (as described in Treas. Reg. § 1.861-18); in such cases, the regulations provide that income from the sale of a copyrighted article is not characterized as a royalty regardless of the foreign law characterization of such income.
[14] Prop. Treas. Reg. § 1.903-1(c)(2)(iii)(B).
[15] Prop. Treas. Reg. § 1.903-1(c)(2)(iv)(A).
[16] Prop. Treas. Reg. § 1.903-1(d)(8), ex. 8.
[17] Prop. Treas. Reg. § 1.903-1(d)(10), ex. 10 (single-country license agreement characterizes the payment as a royalty but foreign tax law characterizes such payment as services; withholding tax is not a covered withholding tax). As a practical matter, in our

proper characterization of a payment under foreign law and, if necessary, to conform their agreements to reflect a royalty characterization where appropriate.

Separately stated portions

The single-country use exception may apply even if the license agreement does not limit the territory of the license to the foreign country imposing the tested withholding tax. Specifically, the exception also applies if the license agreement "separately states a portion (whether as a specified amount or as a formula) of the payment subject to the tested foreign tax and such portion is . . . attributable to the part of the territory of the license that is solely within the foreign country imposing the tested foreign tax."

> **Example:** In a license agreement for worldwide rights to use the IP in exchange for a payment equal to 10 percent of the licensee's revenue; the separately stated formula in the license agreement provides that the first 30u of the payment represents a payment for services, and 40% of the remainder represents a payment of a royalty for the use of the IP in the licensee's country. The portion of the withholding tax in respect of royalties attributable to use of the IP within the licensee's country is a covered withholding tax, and the remainder of the withholding is non-creditable.[18]

Taxpayers are required to determine whether the license agreement misstates the territory in which the relevant intangible property is used or overstates the amount of the royalty with respect to the part of the territory of the license that is solely within the foreign country imposing the tested foreign tax. The regulations apply a "knows, or has reason to know" standard, taking into account whether "a reasonably prudent person in the position of the taxpayer" would question whether the agreement misstates the territory or overstates the amount of the royalty. For these purposes, the regulations provide that the "principles of sections 482 and 861 apply to determine whether the terms of the agreement misstate the territory in which the relevant intangible property is used or overstate the amount of a royalty."[19]

Observation: The requirement to apply the principles of section 861 suggests that Treasury and the IRS expect taxpayers to use US sourcing principles (and in particular the place-of-use test of sections 861(a)(4) and 862(a)(4)) to determine whether and, if so, to what extent the licensed intangible property is in fact used in the country imposing the tested foreign tax. Such an interpretation is supported by language in the preamble to the proposed regulations:

> "[I]n . . . cases [where a taxpayer licenses intangible property for use solely within the foreign country in which the licensee is resident, but the foreign country sources royalties based on the residence of the payor], the foreign country imposing tax on the royalty income should, from a US perspective, have the primary taxing right over the royalty income because the intangible property giving rise to the royalty is in fact being used solely in that foreign country. That is, notwithstanding the difference in sourcing rules for royalty income, there is complete overlap between the jurisdiction with the primary right to tax **based on US tax principles** and the taxing rights exercised by the taxing jurisdiction." (Emphasis added.)

Therefore, it would appear that in applying the single-country license exception taxpayers should not resort to any applicable foreign tax law sourcing rules (or foreign IP law) for determining the place of use of IP, but rather should use US principles under sections 861(a)(4) and 862(a)(4), including case law and IRS guidance thereunder. In effect, Treasury and the IRS appear to have concluded that if, applying US principles, the relevant intangible property is actually used in the country imposing the withholding tax, then notwithstanding that the foreign royalty sourcing rules are not compatible with the US sourcing rules, a credit should still be available.

Additional observation: If the taxpayer misstates the territory in which the relevant intangible property is used or overstates the amount of the royalty with respect to the part of the territory of the license that is solely within the foreign country imposing the tested foreign tax, then the withholding tax becomes non-creditable *in its entirety*. In other words, the taxpayer does not get the benefit of claiming a credit for the portion of the payment that is properly attributable, applying the principles of sections 482 and 861, to the use of the intangible property within the country imposing the tax.[20] There will inevitably be disputes between taxpayers and the IRS over the amount of the royalties attributable to the use of the IP within the country imposing the tested foreign tax, but given the total

experience it is more likely that a foreign country would attempt to characterize a payment, even if nominally for services, as a royalty. *See, e.g.*, Australian draft ruling on software distribution resellers, ATO Draft Taxation Ruling TR 2021/D4 (June 25, 2021).

[18] Prop. Treas. Reg. § 1.903-1(c)(2)(iv)(B) and -1(d)(9), ex. 9

[19] Prop. Treas. Reg. § 1.903-1(c)(2)(iv)(C).

[20] Prop. Treas. Reg. § 1.903-1(d)(11), ex. 11.

denial of credits if the taxpayer misstates or overstates the royalty attributable to use within the country, taxpayers will be incentivized to carefully document their position.

Documentation−limited time to amend existing license agreements

In general, for the single-country license exception to apply, the relevant license agreement must be executed no later than the date of payment that gives rise to the royalty income that is subject to the tested foreign tax.[21]

For license agreements that are already in existence (or if no license agreement currently exists), the proposed regulations provide that **the agreement must be executed no later than 17 May 2023,** and must state (according to the preamble, whether in the terms of the agreement or in recitals) that any royalties paid before the date of execution of the agreement are, for purposes of Prop. Treas. Reg. § 1.903-1(c)(2)(iv), considered paid pursuant to the terms of the agreement.

Observation: Taxpayers will need to quickly review their existing license agreements—both intercompany and those with third parties—to ensure compliance with the single-country license exception. For licenses that cover more than one country, this exercise will also require taxpayers to determine the portion of the payment that is properly attributable to use of the IP within the country imposing the tested foreign tax. Taxpayers will not be required to undertake this exercise for foreign withholding taxes that are creditable under an applicable US income tax treaty.[22] Negotiations with third parties may take additional time; therefore, taxpayers are well-advised to begin this exercise as soon as possible.

Taxpayers are required to provide to the IRS upon 30 days' notice the written license agreement in respect of which a taxpayer relies on the single-country license exception.[23] According to the preamble, where the withholding tax is imposed on a partnership, then the partnership is considered to be the taxpayer and is required to maintain the license agreement, even though the party that claims the credit is the partner and not the partnership.

No Reattribution Assets for Disregarded Sales of Property

The proposed regulations also make a narrow revision to the disregarded payment rules in Treas. Reg. § 1.861-20. The revised rules provide that a disregarded payment in exchange for property does not give rise to any reattribution assets.

To allocate and apportion the foreign income taxes resulting from a disregarded payment, certain payments (i.e., reattribution payments) require the payor taxable unit to reattribute income to the recipient taxable unit.[24] If the recipient taxable unit makes a remittance (e.g., a distribution to another taxable unit), the foreign income taxes resulting from the remittance are allocated and apportioned based on the proportionate tax book value of the taxable unit's assets. "To more accurately reflect the character of the remitting taxable unit's earnings," the rules also require the payor taxable unit to reattribute the portion of any assets that generated the reattributed income to the recipient taxable unit.[25]

Under the final regulations, it was unclear how these rules applied in the case of a disregarded payment in exchange for property. The technical corrections to the final regulations clarified that such a payment could be treated, at least in part, as a reattribution payment. As a result, it appeared that a disregarded sale of property could also cause assets (in addition to income) to be reattributed to the recipient of the payment. The proposed regulations, however, would carve out disregarded payments in exchange for property from the types of payments that give rise to reattribution assets. Treasury determined that reattribution is not needed for disregarded payments in exchange for property because the rule "does not more accurately balance among the taxable units all of the assets that produced" the underlying income.

This change is proposed to apply to taxable years ending on or after the date final regulations adopting this change are filed with the Federal Register. Taxpayers may rely on the proposed regulations Pending final regulations, for taxable years beginning after 31 December 2019, and ending before the effective date of final regulations. Once finalized, taxpayers can choose to apply this rule to

[21] Prop. Treas. Reg. § 1.903-1(c)(2)(iv)(D).
[22] Treas. Reg. § 1.901-2(a)(1)(iii).
[23] Prop. Treas. Reg. § 1.903-1(c)(2)(iv)(D).
[24] *See* Treas. Reg. § 1.861-20(d)(3)(v)(B).
[25] *See* Treas. Reg. § 1.861-20(d)(3)(v)(C)(1).

taxable years beginning after 31 December 2019, but must consistently apply the rule to all years starting with their first taxable year beginning after 31 December 2019.

Treasury requested comments on whether similar revisions should be made for other types of disregarded payments. Treasury also requested comments on any other issues related to the allocation and apportionment of foreign income taxes to disregarded payments that could be included in future guidance projects.

Observation: This revision provides needed guidance for taxpayers that were grappling with how to apply these rules with respect to disregarded sales of property, and particularly disregarded inventory sales. Taxpayers may want to amend prior returns to apply this rule to earlier taxable years. Separately, taxpayers may want to take this opportunity to comment on other problematic aspects of the Treas. Reg. §1.861-20 rules.

Public Comments

Public comments on the proposed regulations must be submitted in writing by 21 January 2023 (i.e., 60 days from the date of publication of the proposed regulations in the Federal Register, which occurred on 22 November 2022).

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