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Legal Update

July 2023

United States: Controversial FTC Regulations Temporarily Suspended – Not a Moment too Soon!

Tax News and Developments

In brief

Notice 2023-55 suspends, for the 2022 and 2023 taxable years, the application of significant portions of controversial final foreign tax credit regulations. The Notice suspends, for foreign levies that are not digital services taxes, the heavily debated rules in the 2022 FTC final regulations for determining whether a foreign levy is an "income tax" for US tax purposes, including the net gain, cost recovery and attribution requirements.

In detail

In a surprising move, on 21 July 2023, Treasury and the IRS released **Notice 2023-55** ("**Notice**") suspending, for the 2022 and 2023 taxable years, the application of significant portions of the final foreign tax credit regulations that were released on 28 December 2021 ("**2022 FTC final regulations**").[1] This temporary relief will be welcome news for many taxpayers, although fiscal year taxpayers will only have one taxable year of relief under the Notice (for taxable years *ending* on or before 31 December 2023). The timing of the Notice is opportune on several fronts, including that many calendar year taxpayers are currently in the process of finalizing their 2022 tax returns. These taxpayers will now need to quickly assess the impact of the Notice on a multitude of foreign taxes for their tax return filing position, including dusting off any analyses regarding the creditability of various foreign taxes under the applicable former regulations. It is also noteworthy that Brazil's recent enactment of fundamental changes to its transfer pricing rules – which generally conform to the OECD arm's length principle – will become mandatory for all taxpayers starting in 2024. As readers may be aware, certain aspects of Brazil's corporate income tax raise several challenging questions for creditability under the 2022 FTC final regulations.

Treasury and the IRS also state in the Notice that they are "considering whether, and under what conditions, to provide additional temporary relief beyond the relief period." Thus, taxpayers should also be prepared for different possible eventual outcomes, including:

- additional temporary relief for 2024 and possibly beyond;
- a return to the status quo ante under the 2022 FTC final regulations following the temporary relief period; or
- additional proposed amendments to the 2022 FTC final regulations, which may supplement or replace the November 2022 proposed regulations.[2]

Readers will recall that Treasury and the IRS's suspension of final regulations is not unprecedented. Case in point: the section 987 foreign currency regulations, the application of which have been suspended for over seven years in six separate IRS notices.[3]

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[1] T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022). Treasury and the IRS released **technical corrections** to the 2022 FTC final regulations on 7 July 2022.

[2] **United States: FTC regulations get a proposed makeover - Baker McKenzie InsightPlus**.

[3] *See, e.g.,* IRS Notices 2021-59 and 2022-34.

Notably, the Notice does not provide any relief with respect to the creditability of digital services taxes (DSTs), which are specifically excluded from the scope of the relief. In addition, the Notice does not suspend the application of the also controversial rules in Treas. Reg. § 1.861-20(d)(3)(v), which may result in a distortive disallowance of foreign tax credits for certain remittances from disregarded entities, even though such regulations were included in the same package as the 2022 FTC final Regulations. We can only hope that the same sound thinking that led to the Notice causes Treasury and the IRS to provide similar relief with respect to the rules for disregarded remittances.

Background

It may be useful for readers to have a brief refresher on the short but tumultuous history of the 2022 FTC final regulations. As noted above, on 28 December 2021, Treasury and the IRS released the 2022 FTC final regulations. On 7 July 2022, Treasury and the IRS released certain very limited technical corrections to the 2022 FTC final regulations. On 22 November 2022, Treasury and the IRS released proposed regulations that would make important changes to the source-based attribution requirement for royalties by introducing a limited single-country license exception, as well as make certain important changes to the cost recovery requirement ("**November 2022 Proposed Regulations**").[4] Very generally, the single-country license exception provides taxpayers with limited relief to claim a foreign tax credit for withholding taxes imposed on royalties where the licensed intangible property is limited to use in a single country when the taxpayer is unable to meet the source-based attribution requirement for royalties because the royalty sourcing rule of the relevant foreign country does not conform to the US place-of-use rule. Taxpayers are able to rely on the November 2022 Proposed Regulations with retroactive effect to the effective date of the 2022 FTC final regulations. The November 2022 Proposed Regulations required taxpayers wishing to rely on the single-country license exception to make certain amendments to their license agreements by no later than 17 May 2023. Most taxpayers struggled to meet this deadline, especially in relation to license agreements with third parties. On 3 April 2023, Treasury and the IRS released **Notice 2023-3**, which extended the date by which taxpayers must execute their conforming agreements from 17 May 2023, to 180 days following the date that the final regulations are filed with the Federal Register.[5]

One of the most controversial elements of the 2022 FTC final regulations was the introduction of a new attribution requirement. A detailed discussion of the attribution requirement is beyond the scope of this client alert, however, our **prior client alert** on the 2022 FTC final regulations discusses the attribution requirement at length. In short, the attribution requirement was intended to ensure that US taxpayers can claim foreign tax credits only for foreign taxes that have sufficient nexus to the income being taxed and to the jurisdiction imposing the tax. Separate rules are provided for residents and nonresidents. Very generally, for taxes imposed on residents the foreign tax law must provide that any allocation to or from the resident of income, gain, deduction, or loss for related party transactions made pursuant to the foreign country's transfer pricing rules must be determined under arm's length principles.[6] For taxes imposed on nonresidents, different rules apply depending on whether the tax is imposed as a result of the taxpayer's activities in the foreign country, its income from sources within the taxing jurisdiction ("**source-based attribution requirement**"), or as a result of the situs of property in such jurisdiction.[7] The source-based attribution requirement essentially requires that a foreign country's source rules, including for services and royalties, conform to the corresponding US source rules for such items of income. The source-based attribution requirement is highly problematic because the application of the US source rules is uncertain with respect to royalties and because the vast majority of countries do not have source rules, especially for services and royalties, that clearly conform to the corresponding US source rules. Consequently, many non-controversial withholding taxes on royalties and services fees that had long been creditable prior to the 2022 FTC final regulations became non-creditable.

[4] 87 Fed. Reg. 71,271 (Nov. 22, 2022).

[5] **United States: Taxpayers get more time to conform agreements for single-country license exception to proposed FTC regulations - Baker McKenzie InsightPlus.**

[6] Treas. Reg. § 1.901-2(b)(5)(ii).

[7] Treas. Reg. § 1.901-2(b)(5)(i).

Notice 2023-55

The Notice provides relief to taxpayers during the "relief period." Section 4 of the Notice defines the "relief period" as taxable years beginning on or after 28 December 2021, and *ending* on or before 31 December 2023.[8] Calendar year taxpayers will have two taxable years of relief under the Notice: the 2022 and 2023 taxable years. However, for a taxpayer with, say, a November 30 taxable year end, the relief period applies only to its taxable year ending on 30 November 2023.[9] Consequently, pending any additional guidance from Treasury and the IRS, certain fiscal year taxpayers will need to currently apply the 2022 FTC final regulations for the 2024 fiscal year.

The Notice provides the following relief to taxpayers when determining whether foreign taxes paid during the relief period are creditable foreign income taxes. First, taxpayers may apply former Treas. Reg. § 1.901-2(a) and (b) as they existed prior to the 2022 FTC final regulations ("**former FTC Regulations**"),[10] with one important exception discussed below. The other provisions of Treas. Reg. §1.901-2 in the 2022 FTC final regulations continue to apply including, for example, the updated rules for separate levies and the updated rules for determining the amount of foreign tax paid by a taxpayer (such as the more stringent rules for determining whether a payment is a compulsory payment). Second, taxpayers are still required to continue applying Treas. Reg. § 1.903-1 as published in the 2022 FTC final regulations, except that in applying the substitution requirement under such regulations taxpayers do not need to satisfy the attribution requirement. As a result, during the relief period a foreign levy is considered to be a tax in lieu of an income tax under the general substitution requirement without regard to whether such tax meets the attribution requirement of Treas. Reg. § 1.901-2(b)(5) in the 2022 FTC final regulations. In addition, during such relief period a withholding tax is considered to be a creditable "covered withholding tax" without regard to whether the foreign country's source rules meet the source-based attribution requirement in Treas. Reg. § 1.901-2(b)(5)(i)(B).

As noted above, the Notice generally permits taxpayers to apply the former regulations under Treas. Reg. § 1.901-2(a) and (b) with some important modifications. Former Treas. Reg. § 1.901-2(a) provides general rules for determining whether a foreign levy is a creditable income tax. Among other requirements, a foreign levy is considered to be an income tax if it is a "tax" and "the predominant character of that tax is that of an income tax in the US sense."[11] The predominant character of a foreign tax is considered to be that of an income tax in the US sense if the foreign tax "is likely to reach net gain [in] the normal circumstances in which it applies" and the tax is not a "soak-up tax."[12] Former Treas. Reg. § 1.901-2(b) provides that a foreign levy meets the net gain requirement only if it satisfies each of the realization, gross receipts, and "net income" requirements.[13] The former FTC Regulations do not include an attribution requirement. It is generally accepted that the 2022 FTC final regulations significantly tightened the requirements described immediately above (in addition to providing additional requirements). For example, the cost recovery requirement in the 2022 FTC final regulations imposes much more prescriptive and onerous rules as compared with the "net income" requirement under the former regulations.[14]

[8] Section 4 of the Notice also defines "relief year" as any taxable year within the relief period.

[9] The 2022 FTC final regulations would not have applied to such taxpayer until its taxable year beginning on 1 December 2022.

[10] The Notice references 23 CFR part 1, revised as of 21 April 2021, for the Former Regulations, which may be found **here**.

[11] Former Treas. Reg. § 1.901-2(a) (2021).

[12] Former Treas. Reg. § 1.901-2(a)(3) (2021).

[13] Former Treas. Reg. § 1.901-2(b) (2021).

[14] *Compare* Treas. Reg. § 1.901-2(b)(4) *with* Former Treas. Reg. § 1.901-2(b)(4) (2021). As one example, while both sets of regulations require the tested foreign tax to permit the recovery of significant costs and expenses, the 2022 FTC final regulations prescribe detailed rules enumerating the various items of significant costs and expenses each of which must be recovered. In contrast, under the prior regulations a foreign tax was considered to meet the net income requirement "even if gross receipts are not reduced by some [items of costs and expenses]." As explained above, the November 2022 Proposed Regulations would provide some relief in this regard.

No relief for Digital Services Taxes

The Notice modifies the net income requirement of the former FTC Regulations with respect to certain taxes whose base is gross receipts or gross income ─ the so-called "nonconfiscatory gross basis tax rule." Specifically, the seventh and eighth sentences of former Treas. Reg. § 1.901-2(b)(4)(i) provides:

> A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax).

The former FTC Regulations demonstrate the application of the nonconfiscatory gross basis tax rule in three examples.[15] In one of the examples, a foreign tax is imposed at the rate of 40% on the amount of gross wages realized by an employee. The foreign tax does not allow for any deductions. Despite the disallowance of any deductions, the example concludes that the foreign tax satisfies the net income requirement because "costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized" and therefore such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that . . . after the tax is paid [such that] employees subject to the tax are almost certain to have net gain."[16]

The Notice deletes the seventh and eighth sentences quoted above and replaces them with the following new rule: "No foreign tax whose base is gross receipts or gross income satisfies the net income requirement, except in the case of a foreign tax whose base consists solely of investment income that is not derived from a trade or business, or wage income (or both)."[17] The Notice goes on to explain that because of this modification, "a gross basis tax imposed on the gross receipts or gross income arising from the provision of digital services (DST) does not satisfy the net income requirement of former § 1.901-2(b)(4)(i), because the base of the tax is gross receipts or gross income and does not consist solely of investment income that is not derived from a trade or business, or wage income."

The Notice also explicitly provides that a DST remains non-creditable as an in lieu of tax under section 903 despite the non-application of the attribution requirement under the temporary relief. Specifically, the Notice explains that "a foreign country's DST that applies by its terms to any income subject to that foreign country's net income tax remains not creditable," citing the non-duplication requirements in Treas. Reg. § 1.903-1(c)(1)(ii) and (c)(2)(ii), as well as an example in the regulations relating to DSTs.[18]

Consistency Requirements for Taxpayers Wishing to Rely on the Temporary Relief

Section 3 of the Notice also imposes several consistency requirements on taxpayers who intend to rely on the temporary relief provided under the Notice. First, a taxpayer must apply the temporary relief to (1) all foreign taxes paid by the taxpayer in the taxpayer's relief year, and (2) all foreign taxes that are paid by any other person (*e.g.*, a taxpayer's controlled foreign corporation) in a taxable year that begins on or after 28 December 2021, and that ends with or within the taxpayer's relief year for which the taxpayer would be eligible to claim a credit if the taxpayer applied the temporary relief to such foreign taxes. In addition, a member of a consolidated group may apply the temporary relief to a relief year only if all members of the consolidated group apply the temporary relief to the relief year. Finally, the taxpayer may not

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[15] Former Treas. Reg. § 1.901-2(b)(4)(iv), exs. 1-3 (2021).

[16] Former Treas. Reg. § 1.901-2(b)(4)(iv), ex. 3 (2021).

[17] Curiously the Notice says that, because of the modifications to the nonconfiscatory gross basis tax rule, examples 1 to 3 of the former FTC Regulations are inapplicable. However, it would seem that the foreign tax in the example in the former FTC Regulations described immediately above relating to the 40% tax imposed on gross wages should still satisfy the net income requirement, as modified, because the base of the foreign tax consists solely of wage income.

[18] Treas. Reg. § 1.903-1(d)(1), ex. 1.

apply the temporary relief in a relief year to claim a credit for any amount of foreign tax for which a deduction is allowed in the relief year or any other taxable year.

One observation is that the consistency requirements appear to apply to a "relief year" (*i.e.*, to any taxable year within the relief period). Thus, a calendar year taxpayer could apply the temporary relief to the 2022 taxable year but then apply the 2022 FTC final regulations to its 2023 taxable year, although it is difficult to conceive why a taxpayer would do this. Another observation is that taxpayers may have claimed a deduction for foreign taxes that were not creditable under the 2022 FTC final regulations. It appears that taxpayers would be required to switch from a deduction to a credit for such taxes, but only if the taxpayer did not claim a deduction for such foreign tax in "any other taxable year."

Coordination Rules

Because the Notice does not during the relief period adopt the former FTC Regulations wholesale, it provides certain coordination rules for applying former Treas. Reg. § 1.901-2(a) and (b) alongside the other provisions of the 2022 FTC final regulations that continue to apply. For example, the Notice directs that all cross-references in former Treas. Reg. § 1.901-2(a) and (b) to provisions in former Treas. Reg. § 1.901-2 or other former Income Tax Regulations are construed, as applicable, as cross-references to the corresponding provisions (taking into account any renumbering of those provisions) of the existing Income Tax Regulations. Similarly, the Notice provides that references in the 2022 FTC final regulations to a "foreign income tax" include a foreign tax that satisfies the requirements of former Treas. Reg. § 1.901-2(a) and (b), as modified.

The Notice does not provide any guidance to taxpayers with respect to the application of the November 2022 Proposed Regulations as they relate to the single-country license exception. Presumably taxpayers do not need to rely on the single-country license exception for taxable years within the relief period because of the Notice's direction to not apply the attribution requirement in the 2022 FTC final regulations. However, many taxpayers have either already executed the required amendments to their license agreements to conform to the single-country license exception or are in the process of making such amendments in anticipation of final regulations adopting the single-country license exceptions. For taxpayers that have already executed amendments to their license agreements, it appears that no harm will be done by leaving such amendments in place. For taxpayer that are in the process of amending their license agreements but have not yet executed such amendments, it may be advisable to refrain from executing any such amendments until Treasury and the IRS provides further guidance (if any) or until such time that Treasury and the IRS finalizes the November 2022 Proposed Regulations.[19]

Implications of the Notice on Creditability of Various Foreign Taxes

Taxpayers that will be filing their 2022 tax returns in the very near future will need to quickly assess the impact of the Notice on the creditability of various foreign taxes, which may not be creditable under the 2022 FTC final regulations, including certain withholding taxes on royalties and services fees and certain corporate income taxes.

For example, assume that Country A imposes a withholding tax on royalties and services fees paid to a nonresident. Country A's sourcing rules provide that royalties and services fees are sourced to Country A if paid by a resident of Country A. Such withholding taxes generally are not creditable under the 2022 FTC final regulations.[20] Under the Notice, taxpayers are not required to satisfy the source-based attribution requirement in testing whether the withholding taxes qualify as a covered withholding tax. Thus, the withholding taxes should be creditable as long as:

- Country A generally imposes a separate levy that is a net income tax, as described in Treas. Reg. § 1.901-2(a)(3);
- the withholding tax is a withholding tax (as defined in section 901(k)(1)(B)) that is imposed on gross income of persons who are nonresidents of Country A; and

[19] Recall that taxpayers will have 180 days following the date that the final regulations are filed with the Federal Register to execute conforming agreements. In the meantime, taxpayers may wish to consider whether having the amended agreements ready for execution is advisable.

[20] *See* Treas. Reg. § 1.903-1(c)(2)(iii), (d)(3) and (d)(4), exs. 3 and 4.

- the non-duplication requirement is satisfied.[21]

Importantly, for purposes of the first requirement, the reference to Treas. Reg. § 1.901-2(a)(3) should be read as a reference to former Treas. Reg. § 1.901-2(a)(3) (*i.e.*, the predominant character rule, including the net gain requirement under such former regulations).

Similarly, in determining whether Country A's corporate income tax is creditable (*e.g.*, for purposes of the deemed paid credit under section 960), taxpayers may apply the former, more relaxed, predominant character/net gain standards.

In addition, let's assume that Country A also imposes withholding taxes on interest and dividends and that Country A's source rules for dividends and interest satisfy the source-based attribution requirement. However, Country A's corporate income tax does not qualify as a generally imposed net income tax as described in current Treas. Reg. § 1.901-2(a)(3) (*e.g.*, Country A's corporate income tax does not satisfy the cost recovery requirement because it does not permit the recovery of all enumerated significant costs and expenses and such disallowances are not excepted under the regulations).[22] As a result, although Country A's source rules for interest and dividends satisfy the source-based attribution requirement, the withholding taxes imposed on such income are not creditable under the current regulations. The result may be different under the Notice. If Country A's corporate income tax satisfies the predominant character/net gain requirements under the former regulations, then the withholding taxes on interest and dividends should now be creditable (as long as they meet the other requirements for a covered withholding tax).

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[21] Treas. Reg. § 1.903-1(c)(2) (as modified by the Notice).

[22] Treas. Reg. § 1.901-2(b)(4)(i)(C).