Bloomberg Tax

Tax Management
International Journal™

Application of Treasury's New "Reasonably Similar" Source Rule Requirement to Claim Foreign Tax Credits for Royalty Withholding Taxes

By Gary Sprague
Baker & McKenzie LLP[*]
Palo Alto, California

NEW FOREIGN TAX CREDIT REGULATIONS

On January 4, the Treasury published in the Federal Register new foreign tax credit regulations determining when a foreign income tax would be regarded, in the words of the preamble, as "an income tax in the U.S. sense" for purposes of both §901 and §903.[1] To implement this policy principle, the final regulations included significant revisions to the "jurisdictional nexus" test expressed in the proposed regulations.[2] In summary, a foreign withholding tax can be a creditable tax only if the foreign source rule is "reasonably similar to the sourcing rules that apply under the Internal Revenue Code."[3] Further, as regards royalties, the foreign tax "must be sourced based on the place of use of, or the right to use, the intangible property."[4] The U.S.'s statutory source rule for royalties is, in fact, highly unusual compared to typical royalty withholding tax charging provisions around the world. Accordingly, this rule — setting the standard for creditability of a foreign withholding tax by whether the foreign law imposing it is reasonably similar to U.S. law — creates significant uncertainty as to the circumstances under which many if not most foreign withholding taxes on royalties can be a creditable tax under §903, at least for taxes paid to non-treaty countries. The rules are effective for taxable years beginning on or after December 28, 2021, so taxpayers will need to grapple with this uncertainty immediately.[5]

The Treasury and IRS apparently were motivated to pursue this regulation project for several reasons, but chief among them was the desire to address the creditability of various "unilateral measures" that some countries have enacted to impose taxes on certain remote suppliers that do not have tax nexus in the source state under traditional concepts.[6] The so-called digital services taxes are the leading examples of this sort of the tax, but the Treasury also had in mind taxes such as "significant digital presence" type taxes that create nexus based on the location of customers or users in the source state as opposed to actual business activity reflected in personnel and assets.[7]

The regulations did not, however, limit their restrictive consequences to these novel unilateral taxes. In-

[*] Gary Sprague is a partner in Baker McKenzie LLP's Palo Alto, California, office and focuses his practice on international corporate tax planning and advice, tax controversies, and tax issues affecting software and digital enterprises.

This article may be cited as 51 Tax Mgmt. Int'l J. No. 1 (Jan. 7, 2021).

[1] T.D. 9959, 87 Fed. Reg. 283 (Jan. 4, 2022). All section references are to the Internal Revenue Code, as amended "the Code"), or the Treasury regulations thereunder.

[2] REG-101657-20, 85 Fed. Reg. 72,078 (Nov. 12, 2020).

[3] Reg. §1.901-2(b)(5)(i)(B).

[4] Reg. §1.901-2(b)(5)(i)(B)(2).

[5] This commentary focuses on U.S. domestic law as interpreted in the new regulations. The results can be modified by an applicable U.S. treaty with the source state. This point is addressed at the end of this commentary.

[6] 85 Fed. Reg. 72,078 at 72,088.

[7] There is little doubt that the proliferation of these taxes undermines the stability of the international tax framework, as they assert tax liability on nonresidents in ways that are engineered to fall outside existing tax treaty and trade agreement obligations. While one suspects that changes to the U.S. foreign tax credit rules to restrict the ability of U.S. taxpayers to claim credits for these taxes won't have a deterrent effect on the governments imposing such taxes, it can be hoped that the revisions underway through the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting eventually will result in the withdrawal and preclusion of digital services taxes and other relevant similar measures.

stead, the regulations introduced an analytical framework for determining when a foreign income tax will be treated as an income tax ''in the U.S. sense'' that clearly is designed to make noncreditable certain taxes for which U.S. taxpayers have been claiming credits for years pursuant to the prior regulations. One high-profile casualty of the new rules is foreign withholding taxes on service fees where the service is not performed in the source state.[8] This Commentary will address withholding taxes on royalties, as the application of the new framework to royalties is more complex than that applicable to services.[9]

CREDITABILITY OF FOREIGN TAXES BASED ON SIMILARITY TO U.S. SOURCE PRINCIPLES

Section 901 allows a credit to U.S. citizens and domestic corporations for ''any income, war profits, and excess profits taxes'' paid to any foreign country.[10] Section 903 extends that definition to taxes paid ''in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country.'' Section 903 is the critical section for foreign withholding taxes, as they are imposed on gross revenue rather than net income.

In general, Treasury brought to these regulations the conceptual approach that to be a creditable tax, the foreign tax must be sufficiently similar in structure to the corresponding U.S. net or gross income-based tax. As that requirement doesn't exist on the face of the statute (the statute refers only to foreign ''income'' tax), the concept is based on jurisprudence which determines when a foreign tax reaches net gain in a way sufficiently similar to U.S. tax principles to be regarded as a creditable net income tax under §901.[11] The preamble goes so far as to assert that ''the principle of 'an income tax in the U.S. sense' incorporates an evolving standard of what constitutes an income tax in the U.S. sense,'' suggesting that U.S. law might form a continuously evolving prism through which all foreign taxes must be viewed to determine current creditability.[12]

Under the newly revised §903 regulations, the typical foreign royalty withholding tax will be a creditable tax for U.S. purposes only if it qualifies as a ''covered withholding tax.'' The most important requirement is that the covered withholding tax satisfy the source-based ''attribution requirement'' as described in Reg. §1.901-2(b)(5)(i)(B).[13] That rule states as follows:

> The amount of gross income arising from gross receipts (other than gross receipts from sales or other dispositions of property) that is included in the base of the foreign tax on the basis of source. . .is limited to gross income arising from sources within the foreign country that imposes the tax, and[14] the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply under the Internal Revenue Code. A foreign tax law's application of such sourcing rules need not conform in all respects to the application of those sourcing rules for Federal income tax purposes. For purposes of determining whether the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply under the Internal Revenue Code, the character of gross income arising from gross receipts is determined under the foreign tax law [with an exception for sales or dispositions of property, including copyrighted articles sold through an electronic medium]. . .[15]

The regulations then provide specific rules for particular types of income. The specific rule for royalties is that the foreign tax ''must be sourced based on the place of use of, or the right to use, the intangible property.''[16] This description of an acceptable source rule closely tracks U.S. domestic law. Section 861(a)(4) and §862(a)(4) define source for rentals and royalties as U.S. or foreign based on whether the payment is ''for the use of or for the privilege of using'' the property inside or outside the United States.

[8] The new rules drop from the regulations Example 3 in existing Reg. §1.903-1(b)(3), which provided as an example of a creditable tax under §903 a foreign withholding tax on fees for technical services provided from outside the source state.

[9] The new regulations introduce significant revisions to several technical aspects of the §901 and §903 interpretative guidance, including when a foreign tax can be regarded as imposed ''in lieu of'' a generally imposed income tax through meeting both a ''nonduplication'' and a ''close connection'' requirement, and revisions to the ''noncompulsory payments'' rule. This Commentary addresses only the application of the ''reasonably similar'' standard within the ''source-based attribution requirement'' to foreign royalty withholding taxes.

[10] §901(b)(1).

[11] See the cases cited in the preamble to the final regulations, at 87 Fed. Reg. 283 at 283.

[12] 87 Fed. Reg. 283 at 283.

[13] The final regulations rename the ''jurisdictional nexus'' rule in the proposed regulations as the ''attribution requirement.''

[14] The conjunction used here in the text of the proposed regulations was ''but only if'' instead of ''and.'' It is not clear whether the change was intended to indicate a substantive difference.

[15] 87 Fed. Reg. 283 at 340.

[16] Reg. §1.901-2(b)(5)(i)(B)(2). The specific rule for services is that the foreign tax law must source the income based on where the services are performed, not the location of the service recipient. This provision will cause most withholding taxes imposed on services around the world to fail the attribution requirement of the regulations, because most states that impose a withholding tax on cross-border payments for services do so on the basis that the payor is a source state resident.

ISSN 0090-4600

The new regulatory text also proves some clearer guidance for certain cases which regrettably are becoming more frequent, namely those where a foreign jurisdiction might assert the application of royalty withholding tax on a payment which is characterized as something different under U.S. law. The proposed regulations did not address whether the U.S. source attribution rule to be used as the comparator for purposes of applying the ''reasonably similar'' test would be the respective rule applicable to the U.S. or to the foreign characterization of the income item. This issue is most common in cases of the delivery of digital goods or services, where foreign tax administrations may seek to classify such payments as royalties in order to subject them to withholding tax. The final regulations explicitly state that the character of the transaction is determined under the foreign tax law (except in the case of sales of property) to identify which U.S. source rule is the comparator. Once the character is determined under foreign law, then the prescriptive rules for services (in Reg. §1.901-2(b)(5)(i)(B)(1)) and for royalties (in Reg. §1.901-2(b)(5)(i)(B)(2)) are applied to determine whether the foreign rule is ''reasonably similar'' to the corresponding U.S. rule.[17]

The preamble provides a little more texture as to how a foreign law might be assessed as ''reasonably similar'' to the U.S. rule. While the regulation provides that the foreign tax on gross income from royalties ''must'' be sourced based on the place of use of, or the right to use, the intangible property, there remains some grounds for interpretation as to whether the foreign law is ''reasonably similar'' to the U.S. rule. The preamble provides as follows:

> Section 1.901-2(b)(5)(i)(B) continues to require that the foreign sourcing rules must be reasonably similar to the sourcing rules under the Code. However, in recognition that the Code does not provide detailed sourcing rules addressing every category of income, or every type of income within that category, and that the interpretation and application of the Code sourcing rules are sometimes addressed only in case law and sub-regulatory guidance, & sect;1.901-2(b)(5)(i)(B) also provides that the foreign tax law's application of sourcing rules need not conform in all respects to the interpretation that applies for Federal income tax purposes. Thus, for example, the final regulations require that in the case of gross income arising from gross receipts from royalties, the foreign tax law must impose tax on such royalties based on the place of use of, or the right to use, the intangible property. However, the final regulations do not require that the foreign law, in determining the place of use of an intangible in a particular transaction or fact pattern, reach the same conclusion as the IRS in a particular revenue ruling or a U.S. court in a particular case.[18]

The last sentence perhaps reflects appreciation by the Treasury that the existing body of U.S. domestic law interpretation of the place-of-use test in §861(a)(4) and §862(a)(4) is limited, fragmented, and in some aspects inconsistent.[19] While the text of the regulations refers to the Code as the relevant comparator for the foreign law, the preamble also justifies the overall attribution rules (including withholding taxes on royalties) on the basis that for a foreign tax to qualify as a creditable income tax, the ''tax must conform with established international jurisdictional norms, reflected in the Internal Revenue Code and related guidance.''[20] The essential deficiency in using this formula to reach a reasonable policy result under these regulations is that the U.S. statutory and interpretative framework to determine the presence or absence of a withholding tax obligation, through the combination of the charging statutes of §871 and §881 combined with the source rules of §861 and §862, including IRS interpretations of source rules through public rulings, is highly unusual around the world. If the focus instead were on what are the actual established international jurisdictional norms for royalty withholding tax, the regulations would produce more predictable and reasonable results.

In most countries, royalty withholding tax is imposed based on the residence of the payor. In a typical case, royalties paid to a nonresident for the use of intangible property by a corporation resident in the taxing state would be subject to source-based tax, enforced through withholding by the resident payor.[21] The U.S. rule is clearly different, as the statute focuses on place of use, which requires an examination of the relevant intellectual property law to determine in what country a taxpayer uses the rights it has licensed. The consequences of the divergent U.S. approach are demonstrated by Rev. Rul. 72-232. In that ruling, a nonresident individual extended to a publisher located in the United States a license to print and distribute certain textbooks to be used exclusively in a foreign

[17] Reg. §1.901-2(b)(5)(i)(B) last sentence.

[18] 87 Fed. Reg. 283 at 288.

[19] *See* Sprague and Determann, *Source of Royalty Income and Place of Use of Intangible Property*, 36 Tax Mgmt. Int'l J. 351 (2007).

[20] 87 Fed. Reg. 283 at 285.

[21] Royalties payable to a third party by a branch of a nonresident operating in the source state and allocable to revenue allocated to the branch also might be subject to a gross-based tax under typical withholding tax charging provisions.

ISSN 0090-4600

country. The ruling states that the books were copyrighted in both the United States and the foreign country. The textbooks were not written for use in the United States and were sold exclusively in the licensor's country. The U.S. publisher paid royalties to the licensor on account of the books sold in that foreign country. The question was whether the royalties constituted U.S.- or foreign-source income, as that would determine whether they were subject to U.S. withholding tax. The ruling concluded that the royalties were entirely foreign-source income — and thus avoiding the 30% U.S. tax — apparently because the market opportunity being exploited was outside of the United States, even though the publisher exercised the copyright in the United States to make the actual reproductions of the textbooks.

This is a well-accepted interpretation of §861(a)(4) in the U.S. domestic context. Suffice it to say, it would be a highly unusual result under foreign law. Would foreign law have to include a similar interpretation which excludes from the scope of local withholding tax royalties paid on sales of exported copyrighted articles for it to be regarded as "reasonably similar" to U.S. law based on place of use? Importantly, the regulations and preamble do note that the foreign law's application of the source rule based on place of use need not conform in all respects to the application of those rules for federal tax purposes. Would the tax be a creditable tax if foreign law considered that the taxpayer in Rev. Rul. 72-232 "used" the rights at the location of the textbook production, thereby purporting to follow a "place of use" rule but coming to the opposite result? In the statutory regime of many countries, the IP law niceties of where an IP right is used is just not relevant under foreign tax law. In many cases, the foreign charging statute simply imposes the obligation to collect withholding tax on residents that make payments of royalties to nonresidents. It certainly can be assumed that in most cases the taxpayer in fact would use the IP at the location of its business activities in the source state, but the actual location of use would not be the statutory basis for imposing the tax. How does a taxpayer analyze foreign law in that case to demonstrate whether the foreign law is "reasonably similar" to U.S. sourcing principles?

EXAMPLES TAKE A NARROW VIEW

Two examples in the new regulations create cause for concern. Reg. §1.903-1(d) Examples 3 and 4 both deal with a foreign royalty withholding tax imposed on payments to a CFC by an unrelated person. In Example 3, the payment was for use of the IP both inside and outside the payor's country, but the source state withholding tax was imposed on the full amount. The Example concludes that the tax, in full, does not meet the attribution requirement because the source country's source rule for royalties (residence of the payor) is not "reasonably similar" to the source rule that applies under the Code. Example 4 is even more remarkable. In that case, the royalty in fact was paid solely for the use of the IP in the source state, but the result was the same. The tax in full is not creditable, as the source rule based on the residence of the payor is not "reasonably similar" to the U.S. royalty source rule.

This is an unreasonable result, even fully embracing the point that the purpose of these new regulations is to preclude from U.S. credits novel unilateral measures that are pushing (or breaking) the boundaries of international tax norms. There is nothing unusual in the international context of a royalty withholding tax obligation that imposes tax based on the simple fact that a resident makes a royalty payment to a nonresident. Example 3 does not describe what the business activity was that led to the conclusion that the relevant IP was used both inside and outside the source state. As quoted above, the preamble to the final regulations states that the foreign rule does not need to conform in all respects to the U.S. rule, and even points out that in determining the place of use in a particular transaction or fact pattern, the foreign law does not need to reach the same conclusion as the IRS in a particular revenue ruling or U.S. courts in a particular case.

Rev. Rul. 72-232, discussed above, offers a useful hypothetical to examine application of the new regulations. The conclusion of that ruling could be challenged on a copyright law basis; after all, the textbooks in fact were reproduced in the United States, which is a clear use of the textbook copyright. If foreign law would treat that hypothetical as a use of the IP in the payor state, regardless of the fact that the textbooks were exported as was the case in Rev. Rul. 72-232, would that then make the tax "reasonably similar"? In other words, if the local courts were to conclude that all IP use happens at the place of the business activities of the licensee, would that make the foreign law "reasonably similar"?[22] Proving that point probably would require the taxpayer to make an investigation into foreign copyright, patent, trademark and other relevant IP law. There would be no reason for foreign tax law to have considered that issue, if all royalty payments by residents are subject to withholding tax, and the answers under foreign copyright law

[22] See *Sanchez v. Commissioner*, 6 T.C. 1141 (1946), *aff'd*, 162 F.2d 58 (2d Cir. 1947), in which the Tax Court concluded that a royalty paid by a licensee for the use of U.S. and foreign patents was entirely sourced in the United States at the location of the licensee's business activities, even though the licensee sold its chemicals to customers outside the United States with a license to use the patented process in their non-U.S. sugar refining operations.

ISSN 0090-4600

undoubtedly will be driven by copyright law policy considerations. How about a foreign law that would not impose withholding tax on a royalty payment allocable to a PE established outside the residence state; could that be a rule close enough to a ''place of use'' rule to be regarded as ''reasonably similar''? Did Treasury really mean to preclude the credit if the text of the foreign statute simply imposes tax on royalties paid by residents to nonresidents, even though in the vast majority of cases licensees of U.S. IP owners will in fact use the IP in their state of residence? It is hard to see why that typical case, where a foreign licensor uses the IP in its business conducted in its state of residence, should not be regarded as a case ''reasonably similar'' to the U.S. source rule, even if the foreign statute adopts the typical statutory formulation used around the world that imposes tax on royalties paid to a nonresident licensor by a resident taxpayer instead of referring to a ''place of use''.

'INTERNATIONAL NORMS'

As noted above, while the technical focus is an endeavor to define the foreign tax credit as available only for taxes that fit into a tight U.S.-shaped model, the new regulations also express the principle that the credit should be available for taxes that ''conform with established international jurisdictional norms.'' The essential fallacy here is that the details of U.S. domestic law are not the perfect expression of ''accepted international norms,'' with the U.S. interpretation of source of income for royalty payments being only one divergence, albeit a dramatic one.[23] The norm around the world is that a nonresident taxpayer licensing the use of intangible property to a resident entity is subject to tax, enforced by withholding, regardless of how or where the resident uses that property. There is nothing in the policy underlying the foreign tax credit, the campaign against offensive unilateral measures, or even the attribution nexus rules generally (to the extent the point is to limit creditable taxes to those imposed consistently with ''international norms'') that suggests that such taxes should not remain creditable.

A further unusual feature of the U.S. taxation regime for nonresidents deserves mention. The IRS has long held that §871 and §881 can be enforced on an extraterritorial basis, so that a nonresident, which makes a payment of U.S. source royalties (as determined under §861(a)(4)), can be subject to an obligation to withhold tax under §1441 or §1442 even though that payor is not engaged in a U.S. trade or business. That position is expressed in Rev. Rul. 80-362.[24] While the Tax Court expressly declined to follow that ruling in *SDI Netherlands B.V. v. Commissioner*,[25] the IRS has never withdrawn or modified the ruling. Surely the Treasury and IRS do not want to endorse the view that extraterritorial enforcement of withholding obligations ''conform with established international jurisdictional norms''. Rather, the Treasury should be vigorously asserting that the United Kingdom's recently enacted Offshore Receipts in Respect of Intangible Property law, which expressly imposes payment obligations on nonresidents with no jurisdictional nexus to the United Kingdom, goes beyond accepted international norms, and so does the German tax administration's recently discovered theory by which it argues that royalty payments between two entities not resident in Germany can be subject to German royalty withholding tax.[26] A foreign jurisdiction which does not assert its withholding obligations on an extraterritorial basis should score points that its regime is within international norms, in contrast to the apparent U.S. principle expressed in Rev. Rul. 80-362.

IF A TREATY APPLIES

This Commentary has addressed the creditability of foreign royalty withholding taxes under U.S. domestic law as interpreted by the new regulations where there is no relevant U.S. tax treaty. In cases where the U.S. taxpayer is the beneficiary of a tax treaty with the taxing state, the regulations note that a foreign levy will be treated as a foreign income tax if it is treated as an income tax under the relief from double taxation article of a U.S. income tax treaty with the taxing state and is paid by a U.S. citizen or resident electing the benefit of that treaty.[27] The regulations thus recognize that a tax paid to a treaty state may remain creditable if the relief from double taxation article of the treaty requires that the U.S. grant a credit for the tax, even if the tax otherwise would fail the source attribution rule under domestic law. Accordingly, at least in cases where there is no dispute between the U.S. and the treaty partner whether the tax is properly imposed in accordance with the treaty, one would expect that a tax allowed by the treaty would end up as a creditable income tax (subject as always to the obligation of the taxpayer to exhaust all effec-

[23] The U.S. effectively connected income rules also are fairly unusual, in their all or nothing attribution results based on the definition of a ″U.S. office″ and the source of the particular income item.

[24] In that ruling, the IRS concluded that a nonresident could be required to withhold tax on royalties paid to another nonresident if those royalties were U.S.-source income. As in principle this treatment could apply to serial payments by several intermediaries, this ruling has been called the ''cascading royalties'' ruling.

[25] 107 T.C. 161 (1996).

[26] *See* Gary Sprague, *U.K. Proposes Extraterritorial Withholding Tax on Royalties*, 47 Tax Mgmt. Int'l J. 197 (Mar. 9, 2018).

[27] Reg. §1.901-2(a)(1)(iii).

ISSN 0090-4600

tive and practical remedies to reduce over time the taxpayer's liability for foreign income tax[28]). Nevertheless, as the relief from double taxation articles of U.S. treaties do exhibit some significant variations among their terms, taxpayers will need to closely examine all relevant treaties.

[28] Reg. §1.901-2(e)(5).

Finally, the new source attribution rules address only whether the tax is a creditable tax. Taxpayers still will need to address the application of domestic law limitations on the credit in §904, even if the tax satisfies the source attribution requirement, including the application of any resourcing rule under the relevant treaty or §904(d)(6).

ISSN 0090-4600