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November 24, 2015

The Honorable Mark Mazur
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The Honorable John Koskinen
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The Honorable William J. Wilkins
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Re: Report No. 1332 Relating to the Definition of a Creditable Tax for Purposes of Sections 901 and 903

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report comments on whether guidance should be issued under Sections 901 and 903 that addresses whether a foreign tax is creditable under those provisions, when a foreign country imposes tax based on an assertion of taxing jurisdiction that reaches beyond conventional limits, or when the tax is imposed under a regime that imputes income and/or denies deductions to a taxpayer that engages in behavior perceived by the taxing country potentially to be designed to shrink the taxpayer's local taxable base.

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Domestic corporations and U.S. citizens and resident aliens ("U.S. taxpayers") have long been entitled to a credit against their U.S. federal income tax liability on their income from foreign sources, for foreign income taxes. U.S. taxpayers also are entitled to a credit for taxes imposed on them by a foreign country in lieu of the foreign country's generally applicable income tax (for example, a tax imposed on the gross receipts of a specific class of taxpayers in place of a tax of their net income). These credits represent a unilateral relinquishment by the United States of primary taxing jurisdiction to the foreign countries imposing such taxes.

Some foreign countries have recently adopted, or are considering adopting, rules that would enable them to tax persons that lack connections to those countries traditionally recognized as a basis for asserting taxing jurisdiction. In addition, countries have adopted rules that enable them to adjust a taxpayer's taxable base (gross income or deductions) in a manner designed to counter potential attempts by the taxpayer to reduce the base in a manner perceived to be artificial. These rules raise questions as to whether tax imposed under such rules is the type of tax for which a credit under Sections 901 or 903 should be available.

As discussed in the report, our principal recommendations are as follows:

1. The Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") should provide guidance that expressly addresses whether a foreign tax is creditable when the country imposing the tax does not have a connection to the income or activities of the taxpayer that has traditionally been recognized as a basis for asserting taxing jurisdiction. We believe that such guidance should not require that a traditional connection exist as a prerequisite for creditability, and should not impose stringent or narrowly drawn requirements as to the proper bases for a country to assert taxing jurisdiction. Instead, we recommend that the guidance either (A) should provide a flexible, easily satisfied standard for the minimum ties that a country must have to the income or activities that it is subjecting to tax; or (B) should expressly confirm that the country imposing tax need not have any particular kind or degree of connection to such income or activities.

2. If Treasury and the IRS opt to pursue the approach described in recommendation 1(A), we recommend that:

a. Guidance should provide that a sufficient connection is present where a foreign country imposes tax on the basis of the taxpayer's residence, domicile, presence or doing business there, or its realization of income from sources in the country. We recommend that the guidance expressly acknowledge that a particular country's concepts of presence or doing business, of income attributable to a local presence or business, and of characterization and sourcing of income generally, may differ substantially from those reflected in the Code (and may include, for example, treatment of a taxpayer as having a presence in the country as a result of the presence there of a related party engaged in integrated economic activity together with the taxpayer).

b. If a country has a tax rule that does not satisfy the standard just described, then tax imposed pursuant to that rule should be treated as a separate levy for purposes of Sections 901 and 903, even if that rule is a part of a broader tax regime that includes other, more conventional rules. A credit should be denied for that separate levy under Sections 901 and 903.

c. The specific foreign tax rules described in Part III.B of the Report, including the UK diverted profits tax, ought to be viewed as satisfying our proposed standard.

d. In addition to the requirement discussed above, Treasury and the IRS should adopt two other narrowly targeted limits on the availability of the foreign tax credit. First, a credit should not be granted for taxes imposed by a foreign country under principles of taxing jurisdiction that go substantially beyond those reflected in Sections 871, 881 and 882, if that country itself does not either grant a credit to its residents against the tax it imposes on their income from foreign sources for other countries' income taxes levied under a concept of taxing jurisdiction as broad as the concept incorporated in that country's own income tax laws or, alternatively, exempt such income from that country's income tax. Second, in the case of a dual resident corporation whose residency is not determined pursuant to a U.S. income tax treaty, the United States should not grant a credit for tax imposed by the other country on income earned in third countries.

3. Regardless of which of the two approaches described in recommendation 1 is adopted, if a foreign country enacts a tax that would otherwise be creditable under Sections 901 or 903, and the country has a pre-existing income tax treaty with the United States but seeks to impose the tax without regard to the limits imposed by the treaty, then the U.S. government should generally commence a competent authority proceeding in which it seeks to prevent this from occurring. If a U.S. taxpayer pays tax to the treaty partner of the type at issue in the competent authority proceeding during the time the proceeding is pending, the taxpayer should be entitled to claim a credit for such tax. If the proceeding ultimately results in the treaty partner agreeing to refund the tax for which the taxpayer has claimed a credit, then the taxpayer would, of course, lose its entitlement to the credit and its U.S. income tax liability would be increased.

4. Guidance under Section 901 should provide that, if a foreign country imposes tax on a base that makes use of special rules to compute a taxpayer's income and expenses attributable to related-party transactions, that tax should be a creditable income tax under Section 901, so long as the special rules are designed to rationally allocate the related parties' combined profits among them in a manner that reflects the assets and activities that are responsible for generating the profits. The guidance should make it clear that such special rules may include provisions that deem the taxpayer to recognize income not in form received by it, and/or impose formulaic limits on or deny entirely deductions for related-party payments, so long as such provisions meet the foregoing standard.

5. In cases where a foreign tax is imposed under a country's rules that fail the standard described in recommendation 4, guidance should provide that the tax imposed pursuant

to those rules will be treated as a separate levy for purposes of Sections 901 and 903, even if those rule are a part of a broader tax regime that includes other, more conventional rules. A credit should be denied for that separate levy.

6. If, as a result of foreign tax rules of the kind described in recommendation 4, a different regarded entity recognizes income for U.S. federal income tax purposes than the regarded entity that is subject to foreign tax on such income, that should either be a "splitting event" under Section 909, or result in treating the entity recognizing the income as the "technical taxpayer" under Treasury Regulation Section 1.901-2(f)(3). We prefer the latter approach.

7. A foreign tax regime's denial of deductions to a taxpayer to prevent potential base-stripping (e.g., under a thin-capitalization rule) should not cause the resulting tax not to be a creditable income tax under Section 901, even when the deductions denied are for amounts payable to unrelated parties.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

David R. Sicular
Chair

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