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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON ISSUES RELATING TO THE DEFINITION OF A CREDITABLE TAX FOR PURPOSES OF SECTIONS 901 AND 903 OF THE CODE

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I. INTRODUCTION

This report[1] comments on whether guidance should be issued under Sections 901 and 903 of the Code[2] 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.

For over 90 years, domestic corporations and U.S. citizens and resident aliens ("**U.S. taxpayers**") have been entitled to a credit against their U.S. federal income tax liability on their income from foreign sources, for foreign income taxes. For over 70 years, U.S. taxpayers also have been 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

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[1] The report may be cited as NYSBA Tax Section Report No. 1332, "Report on Issues Relating to the Definition of a Creditable Tax for Purposes of Sections 901 and 903 of the Code" (November 24, 2015). The principal author of this report is Philip Wagman. Helpful comments were made by Kimberly Blanchard, Peter Blessing, Andrew Braiterman, Robert Cassanos, Peter Connors, Michael Farber, Edward Gonzalez, Stephen Land, David Moldenhauer, Michael Schler, Peter Schuur, Stephen Shay, David Sicular, Andrew Solomon, Adina Wagman and Diana Wollman. The assistance of Alan Kravitz and Caroline Phillips is gratefully acknowledged. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] References in this report to "**Section(s)**", unless otherwise stated, are to sections of the Internal Revenue Code of 1986, as amended (the "**Code**") and the regulations thereunder.

to be artificial. These rules are novel, and 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.

II. SUMMARY OF RECOMMENDATIONS

As discussed further in Part IV, our principal recommendations are:

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 below, 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.

III. BACKGROUND

A. Foreign Tax Credit – Definition of a Creditable Tax

Since 1918, the Code and its predecessor statutes have provided that a U.S. taxpayer is entitled to claim a credit against its U.S. federal income tax liability for "income, excess profits or war profits taxes" paid or accrued by the taxpayer to a foreign country or U.S. possession. [3] The legislative history for Congress' original enactment of the foreign tax credit is brief, but the Congressional reports and contemporaneous sources indicate the principal intent of the credit was to protect U.S. taxpayers against the unfair burden of subjecting their income to double taxation, and to encourage taxpayers to invest outside the United States and increase the competitiveness of American businesses in the world economy.[4]

In 1938, the Supreme Court in Biddle indicated that the reference to an "income tax" in the statutory grant of a foreign tax credit is meant to refer to an income tax "in the U.S. sense." [5] The case in fact dealt not with the proper scope of the statutory conception of a creditable tax, but rather with whether only the taxpayer on which legal liability for a tax is imposed under foreign law may claim a credit for such tax. The Supreme Court in Biddle denied a shareholder's claim of a credit for a foreign corporation's payment of UK distribution tax, without analyzing whether that tax was an income tax.[6] Nevertheless, courts since that decision have followed, and elaborated on, the principle that a foreign tax must be an income tax in the U.S. sense to be creditable. In doing so, courts and, in its rulings, the IRS discounted the relevant foreign government's statements as to whether the tax was intended to be a tax on income. [7] Instead, courts and the IRS developed a test which looked principally at whether the tax was imposed on a base of the taxpayer's realized gross income, determined in a manner generally in accordance with the principles in the Code, and whether the base allowed deductions for the material expenses associated with generating that income.[8]

In 1942, Congress adopted the predecessor to what is now Section 903 of the Code, providing a credit to taxpayers for a "tax paid in lieu of a tax on income, war profits, or excess

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3 I.R.C. § 901(b)(1); see Biddle v. Comm'r, 302 U.S. 573, 578-79 (1938).

4 Report – House Ways and Means Committee (65th Cong., 2d Sess., H. Rept. 767) at 11, reprinted in 1939-1 CB (Part 2) 86; see Michael J. Gratez & Michael M. O'Hear "The Original Intent of US International Taxation", 46 Duke L.J. 1021, 1049-51 (1996-97).

5 Biddle, 302 U.S. at 578-579.

6 Biddle, 302 U.S.at 580-582.

7 See, e.g. PPL Corp. v. Comm'r, 133 S. Ct. 1897, 1898 (2013); Inland Steel Co. v. United States, 230 Ct. Cl. 314, 677 F.2d 72, 80 (1982); Rev. Rul. 78-63, 1978-1 C.B. 228.

8 See PPL, 133 S. Ct. at 1898.

profits otherwise generally imposed by any foreign country" or a U.S. possession.[9] As was the case for the predecessor to Section 901, Congress did not elaborate at length on the intent of this provision in legislative history. The legislative history suggests Congress was concerned that, as a result of courts' and the IRS's interpretation of a creditable "income tax" as one that fairly closely resembled a U.S.-style net income tax, a credit would not be available if a foreign country enacted, for reasons related to the administrative difficulty of determining net income within such country, a tax on a U.S. corporation doing business in the country that was in place of a traditional income tax but was determined based on a measure of activity in the country other than net income.[10] Following the statute's adoption, courts and the IRS applied Section 903 in relatively few cases, usually involving relatively straightforward facts such as a tax on gross rental income or the gross amount of insurance premiums.[11]

In 1979, Treasury and the IRS drafted proposed regulations defining the concept of an income tax for purposes of Section 901 and an "in lieu of" tax for purposes of Section 903.[12] Temporary regulations were issued in 1980, and then were finalized in 1983.[13] Treasury and the IRS viewed the regulations as largely a codification of pre-existing caselaw and ruling policy.[14] The regulations defining an income tax, which have remained largely unchanged since 1983, provide that the predominant character of a foreign tax must be that of an income tax in the U.S. sense.[15] This, in turn, requires that the foreign tax be "likely to reach net gain in the normal circumstances in which it applies."[16] The regulations under Section 901 provide that a foreign

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[9] 1942 Act § 158(f).

[10] Report – Senate Finance Committee (77th Cong., 2d Sess., S. Rept. 1631) at 47-48, 131-32.

[11] See Missouri Pacific Railroad Co. v. United States, 392 F.2d 592 (Ct. Cl. 1968); United States v. Occidental Life Insurance Co. of Cal., 385 F. 2d 1 (C.A. 9, 1967); Equitable Life Assurance Soc. of U.S. v. United States, 366 F. 2d 967 (Ct. Cl. 1966); Prudential Insurance Co. of America v. United States, 319 F. 2d 161 (Ct. Cl. 1963).

[12] See 44 Fed. Register 36077 (1979).

[13] See 45 Fed. Register 75647 (1980); 48 Fed. Register 14641 (1983) (revised proposed regulations); T.D. 7918, 1983-2 CB 113 (final regulations).

[14] See T.D. 7918, 1983-2 CB 113, 114.

[15] Treas. Reg. § 901-2(a)(1)(ii).

[16] Treas. Reg. § 1.901-2(a)(3)(i). The regulations also specify that a foreign tax will not be an income tax in the U.S. sense to the extent liability for the tax is dependent on the availability of a tax credit for such tax (so called "soak-up" taxes). Treas. Reg. § 1.901-2(a)(3)(ii). In addition, the regulations provide that a "penalty" or "fine" is not a "tax" for purposes of the foreign tax credit rules. Treas. Reg. § 1.901-2(a)(2)(i).

tax will be considered to reach net gain if, judged on the basis of its predominant character, the foreign tax meets three tests: (1) a realization test, which generally requires that the foreign tax is imposed at or subsequent to the occurrence of events that would result in the realization of income under the Code; (2) a gross receipts test, which requires that the tax be imposed either on the basis of gross receipts, or on the basis of gross receipts computed under a method that is likely to produce an amount that is not greater than the fair market value of gross receipts; and (3) a net income test, which requires that the base of the tax be computed by reducing gross receipts in a manner that permits either (a) recovery of the significant costs and expenses attributable, under reasonable principles, to such gross receipts, or else (b) recovery of such costs and expenses computed using a method that is likely to produce an amount that approximates, or is greater than, recovery of such costs and expenses.[17]

The regulations under Section 903, which also have remained largely unchanged since 1983, provide that a tax is creditable regardless of whether its base is net income, if the tax is imposed "in lieu of a tax on income…otherwise generally imposed by any foreign country" and is not a "soak-up" tax.[18] An "in lieu of" tax must be imposed in substitution for, rather than in addition to, a country's generally applicable income tax. However, it is permissible for the same taxpayer both to pay income tax with respect to certain of its activities, and the "in lieu of" tax with respect to other activities.[19]

In the more than 30 years since they were adopted, the regulations under Sections 901 and 903 defining the types of foreign taxes that are creditable have not engendered a large amount of litigation. The most notable court opinion written during that period is the Supreme Court's decision in PPL Corp. v. Commissioner ("**PPL**").[20] PPL dealt with the creditability of the UK's windfall tax, which was imposed on UK utility companies that had been state-owned and were privatized in the 1980s and early 1990s. When a new Labor government came to power in 1997, it determined the prices in these privatizations (by earlier Conservative governments) to have been unjustifiably low. As a result, a law was enacted in 1997 that

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[17] Treas. Reg. § 1.901-2(b)(2), (3) and (4).

[18] I.R.C. § 903; see Treas. Reg. § 1.903-1.

[19] Treas. Reg. § 1.903-1(b)(1).

[20] 133 S. Ct. 1897 (2013).

subjected each of these companies to a one-time tax on the excess of the company's actual value (measured by the taxing statute as 9 times the company's average annual earnings during a multi-year testing period), over the valuation that the company had received at the time it had been privatized. Treasury and the IRS challenged the creditability of the tax under Section 901, asserting that the taxable base was computed by reference to asset values, not income. The Supreme Court rejected that argument and concluded the windfall tax met the tests provided in the Section 901 regulations for "an income tax in the U.S. sense"; the Court reasoned that in its actual operation, the tax essentially functioned as a tax on the net income that the relevant companies earned during the testing period even though it purported to be a tax on the value of those companies.[21]

B. Recent Developments in Foreign Tax Law to Counter Base Erosion

Since the time when the regulations defining a creditable tax under Sections 901 and 903 were adopted, the analysis of how much income is reasonably attributed to a particular taxing jurisdiction has become more complicated. This is due in part to the increased importance of services to the global economy, and the mobility of income from services, including digital services. In addition, issues concerning attribution of income to a particular country have become more difficult as multinational corporate groups have adopted increasingly complicated corporate structures and financings.

In response to these developments, some countries have recently begun to adopt, or consider adopting, rules with a stated purpose of preventing abuse and ensuring that profits economically attributable to those countries are taxed there. These countries' actions are designed to address some of the same basic issues as the OECD's "base erosion and profit shifting" ("**BEPS**") initiative, through which the OECD's member countries have made recommendations for future changes to tax treaties and the members' domestic tax legislation having a similar purpose.

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[21] Id. at 1903 - 1905.

Examples of countries' recent activity include the following:[22]

1. UK Diverted Profits Tax

In March of 2015, the UK enacted a diverted profits tax ("**DPT**"). Broadly speaking, DPT is imposed in two cases.

The first is where a UK-resident company enters into a transaction with a non-resident related party that results in tax deductions (or a reduction in income) for the UK- resident company and a corresponding increase in income for the non-resident, if (1) the non-resident is subject to tax on that income which is less than 80% of the tax the UK resident would have paid on the income; (2) the value of the tax reduction described in (1) equals or exceeds the non-tax financial benefits (if any) of the arrangement between the UK resident and the non-resident; and (3) it is reasonable to assume the non-resident's involvement in the arrangement was designed to secure such tax reduction.[23] HMRC's draft guidance provides an example of a UK company that developed valuable intellectual property in the UK, which it then sold to an affiliated passive holding company in a low-tax country and licensed back.[24] In such a case, the UK resident will have taxable diverted profits equal to the difference between its actual profits, and the profits it would have had pursuant to the alternative transaction that it would have entered into had income taxes not been a consideration.[25]

The second case involves a company that is not a UK resident and does not have a permanent establishment ("**PE**") in the UK. The company is subject to DPT if it carries on a trade of selling goods or services, if (1) an affiliate of the company conducts activity in the UK to provide assistance to such company's trade; (2) it is reasonable to assume that the parties' arrangement is designed to ensure that the company is not treated for UK tax purposes as carrying on a trade in the UK; and (3) either (a) the company has entered into transactions with

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[22] We are not specialists in the tax laws of the jurisdictions discussed below. The discussion is intended only as a brief overview of selected recent developments in those jurisdictions.

[23] Finance Act 2015, § 80; HM Revenue & Customs, "Diverted Profits Tax: Interim Guidance" ("**HMRC Guidance**"), at DPT1110 (March 2015).

[24] HMRC Guidance at DPT 1350 Example 2.

[25] The diverted profits can be computed by applying normal UK transfer pricing principles to the UK resident, if it is the case the UK resident would have incurred the same basic types of expenses under the alternative transaction as under the actual transaction. See Finance Act 2015, §§ 82(7), 84, 85(3), 85(4)(a).

an affiliate that result in tax deductions (or a reduction in income) for the company in the country where it is subject to tax, such affiliate's tax on its corresponding income inclusion is less than 80% of the tax the company would have paid in the absence of such transactions with the affiliate, the value of that tax reduction equals or exceeds the non-tax financial benefits (if any) of the transactions between the company and the affiliate, and it is reasonable to assume the affiliate's involvement in the arrangement was designed to secure such tax reduction, or (b) arrangements are in place one of the main purposes of which is avoidance of UK corporation tax.[26] HMRC's guidance provides an example of a non-UK company in a low-tax jurisdiction (e.g., Ireland) that provides services to UK customers with support from a UK affiliate; the non-UK company has entered into a license with another related party that is a passive intellectual property holding company, which holding company is subject to even lower taxes than the non-UK company paying royalties to it.[27] In such a case, the non-UK company is deemed to have a UK PE by reason of the activities carried in the UK on by its affiliate, and it is subject to the DPT on its profits attributable to the deemed UK PE.[28] If (3)(a) above applies in such a case, then the profits attributable to the non-resident's deemed UK PE are determined on the basis of the hypothetical alternative transactions the non-resident would have entered into, had income taxes not been a consideration.[29]

DPT is imposed at a rate of 25%, as compared to a current UK corporation tax rate of 20%.[30] A company cannot credit its DPT against any UK corporation tax it owes; however, it is entitled to reduce its DPT liability by the amount of any UK corporation tax it pays on the same profits. It also is entitled to reduce its DPT liability by the amount of any non-UK income tax that it or a related party pays on the same profits, including (subject to limits) tax that a parent entity pays under a "controlled foreign corporation" ("**CFC**") regime or pays as a result of treating the entity subject to DPT as fiscally transparent.[31] The UK government has taken the

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[26] Finance Act 2015, § 86; HMRC Guidance at DPT1140.

[27] HMRC Guidance at DPT1310, Example 3.

[28] Id.

[29] Finance Act 2015, §§ 88(7), 91; and HMRC Guidance at DPT1160-1166.

[30] HMRC Guidance at DPT 1030.

[31] DPT is not self-assessed. Instead, a taxpayer must notify HMRC if it believes it may be subject to DPT, and HMRC then is entitled to conduct an audit in which DPT will be imposed. Finance Act 2015, §§ 93 - 97.

position that DPT is not an income tax or similar tax that is covered by the UK's income tax treaties.[32]

2. Australia's Proposed Multinational Anti-avoidance Law

In May of 2015, Australia's government proposed a Tax Integrity Multinational Anti-Avoidance Law for public review and comment. A variation on that proposal has been formally introduced as a bill in Australia's Parliament.

The legislation proposed in Parliament would apply to a multinational corporate group with annual worldwide revenue of over AU$1 billion.[33] In general, the law would cover a case where a member of the group that is not resident in Australia provides goods or services to unrelated Australian customers if (1) any portion of the non-resident's income from providing the goods and services is not attributable to an Australian permanent establishment of the non-resident, (2) an affiliate (or commercially dependent entity) that is an Australian resident, or is a not a resident but is acting through an Australian permanent establishment, undertakes activity in Australia directly in connection with the non-resident's provision of goods and services, and (3) relevant facts and circumstances indicate that the parties' arrangement was entered into with a principal purpose to obtain an Australian tax benefit or to obtain both an Australian tax benefit and a reduction in or deferral of a tax liability in some other country.[34] In such a case, the Australian government would have the power to identify Australian income tax benefits obtained in connection with the arrangement (e.g., deductions, avoidance of liability for withholding tax, capital losses, or the exclusion of amounts from assessable income), by comparing the Australian tax consequences of the arrangement, with the tax consequences that might reasonably be expected to have occurred if the arrangement had not been entered into (e.g., if the non-resident

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[32] HMRC Guidance at DPT 1690 ("DPT is a separate, stand-alone charge on diverted profits. It is not income tax, capital gains tax, or corporation tax and is not covered by double taxation treaties.").

[33] See Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015 – Bill (September 16, 2015), Schedule 1 § 960-555, Schedule 2 § 177DA(1)(c); House of Representatives Explanatory Memorandum §§ 2.11 – 2.19, 3.10, 3.17 – 3.20.

[34] See Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015 – Bill (September 16, 2015), Schedule 2 § 177DA(1)(a)-(c); see House of Representatives Explanatory Memorandum §§ 3.21 – 3.84.

had a taxable presence in Australia, to which income was attributable), and to cancel those tax benefits.[35]

3. Israeli Tax Authority's Draft Circular on the Definition of a PE

In April of 2015, the Israeli Tax Authority ("**ITA**") issued a draft circular with proposed guidance on when a non-resident company providing services over the internet will be found to have a PE in Israel. The draft circular provides that such a company need not have a fixed place of business, or a dependent agent in Israel with the power to contractually bind the company, in order to have a PE there.[36] Instead, a company whose core business consists of providing services over the internet may be found to have a PE when one or more of several factors are present, including whether the company operates a website optimized for Israeli customers (e.g., through the language and currency used on the website); the popularity of the website with Israeli users; whether the ability to generate income through the website increases as the number and activity of users goes up; whether the website connects Israeli customers with Israeli vendors; and whether Israeli representatives of the company are involved in marketing or support activities, and have ongoing contacts with Israeli customers.[37] The draft circular also provides that if the non-resident company has a dependent agent in Israel that has the power to enter into informal understandings (but not binding, final contracts) with customers, the company may have a PE.[38]

Each of the taxes described above appears to have one or both of two general features. First, the foreign country in question asserts a right to impose tax without relying on the traditional definition of a "permanent establishment" or traditional income sourcing rules. Second, the foreign country in question asserts the right to disregard actual items of expense incurred by the taxpayer (and in some cases, instead to attribute to the taxpayer items of deemed income or expense from a hypothetical transaction).

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[35] See House of Representatives Explanatory Memorandum §§ 3.88 – 3.116.

[36] See Foreign Cyberspace Operators Could be Swept into Israeli Tax Net, Tax Notes Today (April 7, 2015).

[37] See id.

[38] See id.

IV. <u>DISCUSSION</u>

A. <u>Foreign Taxing Jurisdiction's Connection to the Income Being Taxed</u>

One question raised by the foreign tax laws described above is whether Sections 901 or 903 should be construed to require that a taxpayer or its income must have a particular type or degree of connection with a foreign country seeking to impose tax. More specifically, it can be asked whether the idea of an income tax "in the U.S. sense," for purposes of Section 901, ought to be viewed as incorporating limits – at least broadly similar to those in Sections 871, 881 and 882 – on the foreign country's taxing jurisdiction. A similar question arises for purposes of determining when a foreign tax should be viewed as imposed in lieu of an income tax, for purposes of Section 903.

When analyzing these questions, we believe it is important to begin by recognizing that the questions touch on basic U.S. tax policy considerations, concerning the proper scope of the United States' taxing jurisdiction with respect to the income of a multinational business. These policy issues are potentially challenging ones, given the increasing complexity involved in attributing profits of a business to particular jurisdictions. The U.S. government's view on fundamental questions concerning which activities and assets of an international business should be regarded as the key generators of its profits (and how the share of the profits attributable to each of these activities and assets should be measured) will, we believe, necessarily have an impact on U.S. policy relating not just to the definition of a creditable tax, but also to transfer pricing, the proper scope and operation of Subpart F and other anti-deferral rules, and the sourcing and effectively connected income rules in the Code. When Treasury and the IRS consider whether, and to what extent, they wish to provide guidance under Sections 901 and 903 that requires a minimum connection between a foreign country and the income or activities of a taxpayer that the country seeks to tax, that analysis will occur in the context of these broader questions, and will tend to contribute to the development of the United States' overall position on these questions. Our discussion below does not seek to express a view on those basic policy issues, but it does seek to take into account the fact that guidance under Sections 901 and 903 is likely to implicate those issues.

1. Existing Law

Current law does not appear to provide for the type of requirement just described. The statutory provisions and related regulations do not, by their express terms, impose such a requirement. The regulations acknowledge the possibility that a foreign country may impose a tax on non-residents similar to that imposed by Section 871 or 881;[39] and an example concludes that a Section 903 credit is available for a country's tax on gross interest income earned by a non-resident lender on loans to resident borrowers, where the interest is not attributable to a business conducted by the lender in that country.[40] In addition, other examples in the regulations indicate that, although a connection to the taxing jurisdiction similar to that in Sections 871, 881 or 882 is sufficient for purposes of determining whether a foreign tax is creditable, such a connection is not a prerequisite for creditability.

In Treasury Regulation Section 1.901-2(b)(4)(iv), Example 4 considers the following fact pattern:

> Country X imposes a tax at the rate of 48 percent of the "taxable income" of nonresidents of Country X who furnish specified types of services to customers who are residents of Country X. "Taxable income" for purposes of the tax is defined as gross receipts received from residents of Country X (regardless of whether the services to which the receipts relate are performed within or outside Country X) less deductions that permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts.[41]

The example concludes that the tax meets the "net income" test. More broadly, however, although the example does not expressly say so, it suggests that the fact that Country X's tax is

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39 Treas. Reg. § 1.901-2(d)(1) ("For example, regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed by section 871(b) of the Internal Revenue Code is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code as it applies to persons other than those described in section 871(b), and foreign levies identical to the taxes imposed by sections 11, 541, 881, 882, 1491 and 3111 of the Internal Revenue Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others. Accordingly, each such levy must be analyzed separately to determine whether it is an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph (a) of §1.903-1").

40 Treas. Reg. § 1.901-2(b)(4)(iv) Example 2.

41 Treas. Reg. § 1.901-2(b)(4)(iv) Example 4.

imposed on nonresidents who provide services from outside of Country X, and who do not have a physical presence there, does not prevent the tax from being creditable under Section 901.

Treasury Regulation Section 1.903-1(b)(3), Example 3 is to similar effect. Country X has a tax on realized net income that is generally imposed, as well as a gross income tax imposed on a non-resident's income from Country X that is not attributable to a trade or business carried on there, including payments by residents to the non-resident for technical services performed outside Country X. The gross income tax is collected through withholding by residents on their payments to the non-resident taxpayer. Example 3 concludes the tax meets the substitution requirement for creditability in the Section 903 regulations.

Within the past several years, Treasury and the IRS have addressed the creditability of a tax imposed based on a non-traditional connection between the taxing jurisdiction, and the base subjected to tax: the excise tax imposed under Puerto Rico's Act 154.[42] Puerto Rico generally imposes tax on the Puerto Rican-source income of a foreign company (i.e., one that is not formed under the laws of Puerto Rico) that is engaged in a trade or business there, to the extent such income is effectively connected with the Puerto Rican business.[43] In 2010, Puerto Rico adopted "Act 154", which made changes to these rules. First, Act 154 deemed a foreign company to be engaged in a trade or business in Puerto Rico, where the company buys goods or services from a Puerto Rican related party and such purchases account for a significant portion (broadly, over 10%) of the Puerto Rican related party's revenue.[44] Second, the new law deemed a portion of the foreign company's income from its sale of the relevant goods (or from activity supported by the relevant services) to be from Puerto Rican sources and effectively connected with the company's deemed Puerto Rican trade or business.[45] Thus, such portion of the foreign company's income would be subject to Puerto Rican income tax. The portion of such income that was subject to tax was determined (at the taxpayer's election) either based on a multi-factor apportionment formula

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42 See Notice 2011-29, 2011-16 I.R.B. 663 (Apr. 18, 2011).

43 P.R. I.R.C §§ 1231, 1123. A nonresident company's non-Puerto Rican source income also is treated as effectively connected with a trade or business in Puerto Rico in some circumstances, but only to a more limited extent than its Puerto Rican-source income. P.R. I.R.C § 1123(f)(3)(B).

44 2010 P.R. Laws No. 154 (P.R. I.R.C. § 1123(f)(4)).

45 2010 P.R. Laws No. 154 (P.R. I.R.C. § 1123(f)(4)(A)).

or as 50% of the relevant income.[46] In addition, for a temporary period of 6 years, where a foreign company purchased goods or services from a Puerto Rican related party that had annual gross receipts of over $75 million, the foreign company would be exempt from the special source and effectively connected income rules just described but, instead, would be subject to an excise tax equal to a percentage of the price that the foreign company paid for such goods or services.[47] The 6 year effective period for Act 154's excise tax has subsequently been extended through 2017.[48]

In Notice 2011-29, Treasury and the IRS stated that the excise tax is novel and that a determination as to its creditability "requires the resolution of a number of legal and factual issues."[49] The Notice provided that, pending resolution of those issues, the IRS would not challenge a taxpayer's position that the excise tax is a tax in lieu of an income tax under Section 903. Any future guidance on the issue would be prospective, applying only to excise tax paid or accrued after the date that further guidance is issued. Treasury and the IRS have not elaborated on the nature of the issues raised by the tax. However, commentators have noted that the excise tax appears to raise constitutional questions, concerning whether the activities of a taxpayer subjected to the tax have "substantial nexus" to Puerto Rico as required by the Commerce Clause.[50]

We recommend that Treasury and the IRS 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. 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, the guidance either (A) should provide a flexible, easily satisfied standard for the ties that a country

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46 2010 P.R. Laws No. 154 (P.R. I.R.C. §1123(f)(4)(B)).

47 See Opinion of Steptoe & Johnson LLP (Oct. 25, 2010), reprinted in Tax Notes Today (Jan. 27, 2014).

48 2010 P.R. Laws No. 154 (P.R. I.R.C. § 2101).

49 Id.

50 See Martin A. Sullivan, Economic Analysis: The Treasury Bailout of Puerto Rico, Tax Notes Today (Jan. 27, 2014); see also Opinion of Steptoe & Johnson LLP (Oct. 25, 2010), reprinted in Tax Notes Today (Jan. 27, 2014), Appendix C.

must have to the income or activities that it is subjecting to tax (as discussed in Part IV.A.2 below); 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 (as discussed in Part IV.A.3).

2. First Alternative: Provide Guidance Requiring a Minimum Connection between a Foreign Country and the Income or Activity it Taxes

a. Authority for Guidance

If guidance is issued that requires a minimum connection between a foreign country and the income or activity being taxed, we believe such guidance would be a valid exercise of Treasury's and the IRS's authority. The determination of whether Treasury and the IRS have this regulatory authority is governed by Mayo Foundation for Medical Education & Research, Et. Al. v. U.S.,[51] which applied the two-part inquiry of Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.[52] ("**Chevron**"). The first part of the inquiry asks whether Congress has "directly addressed the precise question at issue."[53] If the answer is "yes," then the regulations must follow "the unambiguously expressed intent of Congress."[54] If the answer is "no," then the analysis proceeds to the second part of the inquiry which asks whether the administrative interpretation at issue is a "permissible construction of the statute".[55] As to the first prong of the test, Section 901(b)(1) refers only to "income, excess profits or war profits taxes," without elaborating on the characteristics a foreign tax must possess to fall into this category. Similarly, the reference in Section 903 to a tax "paid in lieu of a tax on income, war profits, or excess profits" is brief and does not have a wholly self-evident meaning. Thus, Treasury and the IRS should have the ability to issue interpretive regulations or other administrative guidance, provided the guidance adopts a "permissible" interpretation of the statute. In this regard, as noted above, caselaw and IRS rulings, as well as the current regulations under Section 901, have

[51] 562 U.S. 44 (2011).

[52] 467 U.S. 837 (1984).

[53] Mayo Foundation, 562 U.S. at 706 (quoting Chevron U.S.A Inc., 467 U.S. at 842-43).

[54] Chevron U.S.A Inc., 467 U.S. at 842-43

[55] Id.

long referred to an income tax "in the U.S. sense."[56] The U.S. international tax rules, in turn, have long contained limits on the United States' assertion of taxing jurisdiction over nonresidents, taxing only income effectively connected with a U.S. trade or business and passive-type income from U.S. sources that is not so connected.[57] Cases and administrative guidance have long compared foreign taxes to those imposed by the United States on nonresidents under Sections 871, 881 and 882, when analyzing the creditability of those taxes.[58] It would seem consistent with that history to adopt a rule that a tax will be a creditable income tax "in the U.S. sense" only if the country imposing the tax has a connection to the income or activity being taxed that is at least broadly similar to the connections required under the Code for taxation of nonresidents. This certainly appears to be a "permissible" construction of Section 901. Similarly, the concept of a foreign country imposing a tax "in lieu of" an "income tax," as provided in Section 903, would appear to incorporate the concept of an "income tax" under Section 901; a foreign tax could be viewed as imposed "in lieu" of an income tax if it does not reach net gain in the U.S. sense, but otherwise satisfies the requirements for a tax that is creditable under Section 901 (i.e., it is not a penalty, it is not a payment for a specific economic benefit, it is not voluntary, and – if guidance so requires – the taxing country has a sufficient connection to the economic base being taxed). This would seem to be similar to the basic structure of the current regulations under Section 903, and a "permissible" statutory construction.

We do not find that the Supreme Court's decision in PPL requires a different conclusion to the question of regulatory authority.[59] PPL did not purport to decide whether the statutory language of Section 901 referring to an income, excess profits or war profits tax is unambiguous,

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56 See, e.g., Biddle v. Commissioner, 302 U.S. 573, 578–579 (1938); Temp. Treas. Reg. § 4.901-2(a)(1) (1980) T.D. 7739, 45 Fed. Register 75647 ("The standard for determining whether a foreign charge is an income tax is the U.S. income tax."); Treas. Reg. § 1.901-2(a)(1)(ii).

57 I.R.C. §§ 871, 881, 882.

58 See, e.g., Bank of America Nat. Trust & Sav. Ass'n v. United States, 459 F.2d 513, 523 (Ct. Cl. 1972); Inland Steel Co. v. United States, 230 Ct. Cl. 314, 333 (1982); Temp. Treas. Reg. 4.901-2(c)(4)(iii) (1980) T.D. 7739, 45 Fed. Register 75647; Rev. Rul. 78-61, 1978-1 C.B. 221; Rev. Rul. 78-62, 1978-1 C.B. 221.

59 See Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 982 (2005) ("A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion."); see also United States v. Home Concrete & Supply, Inc., 132 S.Ct. 1836 (2014) (plurality decision) (a court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference if the prior judicial construction concluded that the statute left no "statutory gap" for the agency to fill).

or whether Congress intended a specific construction of this phrase that leaves no interpretive gaps for Treasury and the IRS to fill. Instead, the Supreme Court addressed a specific question: whether the UK windfall profits tax was creditable.[60] Its analysis focused on the precise details of how the tax was calculated.[61] In addition, the Supreme Court answered the question before it by applying Treasury Regulation Section 1.901-2, rather than by looking directly to an analysis of the statutory language and legislative history.[62] Consistent with the limited scope of this analysis, although the opinion did note that the regulations were "consistent with precedent" and "codified longstanding doctrine" (i.e., the Supreme Court's remarks 75 years earlier in Biddle),[63] the opinion did not discuss whether the regulations set forth an exclusive list of the statute's requirements for an "income, excess profits, or war profits tax," or whether the requirements enumerated in the regulations could not be amended without violating Congressional intent. The decision also did not address the interpretation of Section 903. Thus, it appears that PPL leaves room for Treasury and the IRS to issue guidance under Sections 901 and 903 requiring a foreign country to have reasonable rules of taxing jurisdiction.

b. Nature of Guidance

There is a reasonable policy argument for requiring, under Sections 901 and 903, a minimum connection between a foreign country and the income or activity that it is taxing.[64] Treasury and the IRS might conclude that, in view of recent and possible future developments in foreign tax law, it is important to ensure that the United States is not effectively encouraging another country's arguably overly aggressive drive for tax revenue, by granting a credit for tax imposed by that country on income or activity that it has little or no reason to tax. A minimum connection requirement would protect the United States' residual jurisdiction to tax its residents against improper erosion by other countries.

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[60] PPL Corp. v. Comm'r, 133 S.Ct. 1897, 1898 (2013) ("This case addresses whether [the UK windfall profits] tax is creditable for U.S. tax purposes.").

[61] Id. at 1904-1905. PPL involved taxpayers that were subject to the UK windfall profits tax as a result of activities they conducted in the UK.

[62] Id.

[63] Id. at 1898.

[64] As discussed in Part IV.A.3 below, there is also a reasonable policy argument to the contrary.

Congress, Treasury and the IRS have in the past acted to achieve similar policy objectives. The adoption of the rule denying a credit for "soak-up" taxes provides one obvious parallel.[65] A somewhat similar purpose is also reflected in the denial in the Code and regulations of a credit, when the foreign government receiving a tax payment provides a related subsidy to the taxpayer, a related party, or a party to the taxpayer's business transactions,[66] and in the rules preventing a taxpayer from claiming a credit for a payment made to a foreign government in a capacity other than as a taxpayer.[67] In all these cases the foreign tax credit has been denied, where a foreign government could be seen as potentially using the availability of the credit inappropriately to subsidize its activities and policies.

For a number of reasons, however, we recommend that any requirement of a minimum connection between a foreign country and the income or other base it is taxing be based on a flexible, easily satisfied standard. More specifically, we suggest that the guidance provide that a sufficient connection is present where a foreign country imposes tax on the basis of the taxpayer's residence or domicile there, its presence or doing business there or its realization of income from sources in the country,[68] with an express acknowledgement 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. The guidance would expressly acknowledge that permissible bases for taxing jurisdiction include, for example, treatment of a taxpayer as having a presence in the

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65 Treas. Reg. §§ 1.901-2(c), 1.903-1(b)(2).

66 I.R.C. § 901(i); Treas. Reg. § 1.901-2(e)(3). See Report – Senate Finance Committee (99th Cong., 2d Sess., S. Rept. 313) at 307 (legislative history to Section 901(i), which codified the anti-subsidy rule in Treas. Reg. § 1.901-2(e)(3)) ("[A] Treasury regulation denies a foreign tax credit for foreign taxes used directly or indirectly as a subsidy to the taxpayer. Absent this rule, the Treasury would, in effect, bear the cost of tax subsidy programs instituted by foreign countries for the direct or indirect benefit of their residents and certain nonresidents who do business with their residents."); Report – House Ways & Means Committee (99th Cong., 2d Sess., H. Rept. 426) at 351 (containing the same comments).

67 See Treas. Reg. §§ 1.901-2(a)(2)(ii), 1.901-2A; see also Rev. Rul. 76-215, 1976-1 C.B. 194. The U.S. government is understood to have acted in order to prevent foreign countries from essentially characterizing payments for, for example, mineral royalties as income taxes. See generally Glenn E. Coven, International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes, 4 Fl. Tax. Rev. 83, 100 - 103 (1999).

68 Cf. Restatement (Third) of the Foreign Relations Law of the United States, §§ 411- 412 (providing a similar standard for the proper exercise of taxing jurisdiction). This standard is also broadly similar to that adopted in prior temporary regulations under Section 901, as discussed further in Part IV.A.3 below. Temp. Treas. Reg. § 4.901-2(a)(1) (1980) T.D. 7739, 45 Fed. Register 75647 (requiring reasonable rules of taxing jurisdiction).

country as a result of the presence there of a related party engaged in integrated economic activity together with the taxpayer.

Under this standard, a sufficient connection would exist if a nonresident taxpayer with no physical presence in the taxing jurisdiction sells goods or services to customers who are resident in, or use the goods or services in, the jurisdiction, so long as the taxing jurisdiction sources income based on the location of the customer, or treats a taxpayer's provision of services (from any location) to local customers as doing business in the jurisdiction. We acknowledge that such an approach to services transactions represents a significant departure from that traditionally taken in U.S. tax law (which sources services income based on the location of the service provider and generally does not treat foreign-source services income as effectively connected); however, while the principle in U.S. law is, by now, long-established, we do not believe it represents the only rational approach to such income.[69] In addition, as indicated above, taxation imposed based on activity of an affiliate of the taxpayer in the jurisdiction imposing tax, which activity helps to produce the income of the taxpayer subject to tax, would satisfy the proposed standard.

The suggested rule would, however, deny creditability in cases of egregious overreaching by other countries. A country clearly could not tax a non-resident that (under the principles of that country's tax laws) does not conduct business in or earn income from sources in that country. In addition, if a non-resident conducts business or has a presence in the taxing jurisdiction, only income that bears some broadly rational connection to that local business or presence could be taxed there. A tax imposed on income from activities wholly unrelated to those conducted in the taxing jurisdiction would not be creditable. Moreover, even if the activities conducted by a non-resident in the taxing jurisdiction are rationally related to a broader business or set of activities that is carried on in other countries as well, that would not entitle the jurisdiction to impose tax on all of the income from the entire worldwide business or set of activities; the tax laws of the jurisdiction would need to provide some non-arbitrary criteria for determining the portion of the

[69] In Comm'r v. Piedras Negras Broadcasting Co., 127 F.2d 260 (5th Cir. 1942), which considered whether income from services provided to customers located in the United States from the taxpayer’s facilities in Mexico should be sourced to the United States, no constitutional issue was raised. Although the court decided the income should be sourced based on the location of the service provider rather than the customer, that outcome was not inevitable.

taxpayer's income attributable to the taxing jurisdiction (we recommend that Treasury and the IRS expressly provide that any non-arbitrary criteria, even if substantially different than U.S. sourcing and effective connection principles, would be sufficient for this purpose).

We believe this type of flexible, easily satisfied test would help to achieve the goal of protecting the United States' residual taxing jurisdiction over its residents against improper erosion, while not unduly sacrificing the basic objectives of Sections 901 and 903 of avoiding an unfair double tax burden for U.S. taxpayers and promoting their business endeavors abroad. Such a test also appears appropriate to us for a number of other reasons.

First, such a rule reflects a recognition that foreign tax authorities are currently dealing with difficult technical and policy questions relating to the scope of their taxing jurisdiction, which have multiple possible reasonable answers. In particular, international digital services and intellectual property transactions raise complicated questions about the characterization and source of income, and the proper framework for assessing what economic factors are principally responsible for the creation of that income.[70] If a company provides digital services to customers in Country X, using intellectual property held through a Country Y branch that was developed partly in Country Y and partly in the United States, there may be multiple plausible answers to whether the company's income should be treated as a service fee, royalty, or proceeds from sale of a product; and the sourcing of the income in whole or part to Country X, Country Y, and the United States under these countries' respective tax laws might depend in part on how the income is characterized. Countries' rules addressing these questions are unsettled,[71] and international law may continue to evolve for a number of years before a widely accepted consensus emerges. A broad, easily satisfied standard under Sections 901 and 903 as to when a foreign country's exercise of taxing jurisdiction is warranted appears reasonable, given this context.

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70 See Stephen E. Shay, J. Clifton Fleming & Robert J. Peroni, "What's Source Got to Do With It?" Source Rules and U.S. International Taxation, 56 Tax Law Review 81, 128 – 131, 139 - 143 (2002); OECD, Addressing the Tax Challenges of the Digital Economy: Action 1 Final Report (2015).

71 See, e.g., David J. Shakow, The Taxation of Cloud Computing and Digital Content, Tax Notes Today (July 22, 2013); see also Gary D. Sprague & Taylor S. Reid, A Break in the Clouds: a Proposed Framework for Analyzing Cloud Computing Transactions, 92 Taxes 3 (March 2014). While this example focuses on the digital economy, other areas where countries might rationally adopt widely divergent approaches appear to exist as well (for example, taxation of multi-party international financial transactions involving hybrid instruments).

Second, if Treasury and the IRS did wish to provide tighter, more specific standards about the proper exercise of taxing jurisdiction by a foreign country over nonresidents under Sections 901 and 903, without regard to whether consensus has been reached in the international community on these points, then Treasury and the IRS would need to give consideration to the impact that such guidance would have in other, related areas of the Code. In particular, the framework of rules under Sections 861, 864, 871, 881, and 882 are, to a significant extent, approximately 50 years old, and those rules raise a number of policy questions and technical uncertainties.[72] As a result, it may be hard to determine whether, in the event a country imposes a gross or net income tax on a U.S. taxpayer's income, the country's decision to do so is the same or similar to what would be the result would, or should, be under Sections 871, 881 and 882, if the United States were in same position. Treasury and the IRS could address this issue by promulgating a body of relatively specific rules under Sections 901 and 903, which would provide parameters for deciding whether a foreign country's determinations as to the source and characterization of income and the attribution of the income to local business activities are acceptable, in the United States' view. However, it would appear important to consider to what extent similar principles would apply under the Code provisions that deal with the United States' taxation of non-residents, and under Section 482 and Subpart F.[73] Such an undertaking would involve addressing, in a relatively comprehensive way, the overarching policy questions identified at the beginning of this Part IV.A. Adopting a more measured, flexible requirement of the type we have proposed under Sections 901 and 903 would allow Treasury and the IRS to issue appropriate guidance relatively soon, while proceeding at a more gradual pace, if desired, to develop a comprehensive view on these broader policy questions.

Third, in addition to avoiding the need to address unsettled issues of foreign and U.S. tax law, we note that our recommended approach also appears to fit with traditional U.S. concepts of a fair allocation of taxing power over income between jurisdictions. Although the specific legal and policy considerations involved are different, in the context of state taxation, U.S. courts

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[72] See Shay et al., 56 Tax Law Review at 83 – 88, 154 – 155.

[73] Indeed, Treasury's and the IRS's regulatory authority would appear to depend on adopting rules under Sections 901 and 903 that either identify an income tax "in the U.S. sense," i.e., one that is at least generally similar to a tax the United States itself would impose under the Code, or else identify a tax that is a substitute or proxy for such an income tax.

broadly have held that a state may tax a portion of the income generated by a multijurisdictional business enterprise without violating constitutional requirements, so long as the criteria used to identify the income attributable to the taxing jurisdiction are rational ones.[74] This is true even though formulaic apportionment of income to the taxing jurisdiction may have been chosen by a state, rather than some more precisely tailored approach to determining the income to be taxed there.[75] Formulaic apportionment has been accepted in the context of determining not only the amount of income of a multistate U.S. business subject to tax in a given state, but also the worldwide income of a multinational group that a U.S. state can tax.[76] The latitude given to states under these authorities in determining the amount of income they are entitled to tax, is conceptually broadly like the degree of flexibility under our recommended standard to determine the required connection between a country and the income or activity it is seeking to tax.

Finally, we note that at least to some extent, practical considerations may limit overly broad assertions of taxing jurisdiction by foreign governments. Generally, a country will have only a limited ability to enforce its tax laws, if the taxpayer has few or no assets there and does not receive payments from counterparties based there. In addition, over time, countries may negotiate limits under treaties on application of potentially far-reaching tax laws (and they may already be subject to such limits, under pre-existing treaties). Countries also may exercise self-restraint in order to avoid being uncompetitive in attracting taxpayers' investment. These considerations would tend to suggest that, often, countries may limit their assertions of taxing jurisdiction without specific incentive to do so in the form of a restrictive set of regulations under Sections 901 and 903.[77]

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74 See Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 180 - 181 (1983) (to establish that income was unfairly apportioned to a state, in violation of the Constitution, the taxpayer "must demonstrate that there is no rational relationship between the income attributed to the State and the intrastate values of the enterprise, by proving that the income apportioned to [the relevant state] under the statute is out of all appropriate proportion to the business transacted by the appellant in that State,") (internal quotation marks and citations omitted); Jerome R. Hellerstein & Walter Hellerstein, State Taxation (3d ed.), ¶¶ 8.03, 8.13, 8.16.

75 See Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983); Butler Bros. v. McColgan, 315 U.S. 501 (1942); see also Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425 (1980).

76 See Barclays Bank PLC v. Franchise Tax Board, 512 U.S. 298 (1994).

77 Although the rule that we have outlined above is, we believe, a limited one that reasonably takes into account the various considerations just described, it nonetheless could occasionally lead to non-intuitive results. For example, suppose U.S. Taxpayer provides services from a branch in Country X to fee-paying customers in many jurisdictions. Country Y imposes tax at a 20% rate on all these fees, and the tax is found to violate the

c. The "Separate Levy" Test

In order to give full effect to the requirement described above of a minimum connection between a foreign country and the base it is seeking to tax, we recommend that Treasury and the IRS provide that if a country has a tax rule that fails this requirement, such tax rule will be regarded as a "separate levy," even if in form it is adopted by that country as part of a broader tax regime.

Under Sections 901 and 903, a tax imposed under particular rules adopted by a foreign country will be evaluated on a standalone basis to determine creditability if, and only if, that tax is a separate levy from the other taxes imposed by that country.[78] It follows that a tax imposed under a foreign country's law that violates the test described above in Part IV.A.2.b might nevertheless be creditable, if the law in question is part of a larger set of tax provisions most of which are relatively conventional, and the objectionable law is not treated as a separate levy.[79] By comparison, if the country adopted a new, independent taxing regime that applied only to non-residents who have a non-traditional connection to the country, that regime might more easily be characterized as a separate levy, with a credit being denied under the test proposed in Part IV.A.2.b. This difference in treatment appears to have the potential to lead to illogical

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minimum connection requirement. Country X also imposes tax on the fees at a 20% (or higher) rate; and it grants a full credit for the Country Y tax. The amount of foreign tax imposed in this case is the same as it would have been if Country Y had adopted a more restrained concept of its taxing jurisdiction, and only Country X had taxed the income. It can be asked whether the United States has done more here than preserve its residual taxing jurisdiction from undue encroachment; the United States might appear to have received a windfall. However, we believe it can rationally be argued that, in a case where the Country Y tax is not an appropriate exercise in asserting taxing jurisdiction, the United States for that reason should not grant a credit, regardless of what approach Country X takes.

78 See Treas. Reg. § 1.901-2(d); see also Lanman & Kemp-Barclay & Co. v. Comm'r, 26 T.C. 582 (1956); Elisabeth Owens, The Foreign Tax Credit, 61 – 66 (1961).

79 For example, a country's law might provide for imposition of tax on non-residents' net income deemed to be attributable to the country, where non-residents either (1) have a fixed place of business in the country, or (2) have a type of connection to the country that does not meet the minimum connection requirement described in Part IV.A.2.b. If the country's regime for non-residents is viewed as a single levy, then qualification of that levy as a creditable income tax under Section 901 would generally be tested based on the "predominant character" of the levy, that is, the manner in which the levy normally applies. Treas. Reg. § 1.901-2(a)(1)(ii), (a)(3). Thus, if, for example, the majority of the non-residents subject to the regime have a fixed place of business in the relevant country, then the predominant character of the regime might be that it is imposed on a basis that satisfies the minimum connection requirement; and the tax would thus qualify as a creditable income tax under Section 901. The same result might be reached under Section 903, if the taxable base here was something other than net income.

results, and to inappropriately allow countries an opportunity to structure the formal organization of their laws in a manner that escapes the impact of the proposed test.

A tax generally is a separate levy if "the base of the levy is different in kind, and not merely in degree, for different classes of people subject to the levy."[80] We believe that a country's rule imposing tax on non-residents in violation of the minimum connection standard that we have proposed can fairly be seen to create a taxable base for such non-residents which differs "in kind" from the base on which other taxpayers are taxed by such country. A law that violates our proposed test by definition taxes income and activities that are well beyond the reach of tax rules based on traditional concepts of taxing jurisdiction; and by definition, such a law does not reflect a plausible economic rationale for the applicable country to impose tax. The base for the tax imposed by such a law is thus different in key respects from the base for other, more common types of tax imposed on non-residents. We believe that the principles articulated in the definition of a separate levy support separate treatment of such a law, and we recommend that guidance be issued expressly providing for this approach.[81]

d. Application of the Proposed Minimum Connection Standard to the UK DPT and Proposed Australian and Israeli Rules

The UK DPT was enacted less than a year ago, and the Australian and Israeli rules described above remain in proposed form. Given these provisions' novelty, it is difficult to reach a definitive conclusion about how they would fare under the minimum connection requirement

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80 Treas. Reg. § 1.901-2(d)(1). See also id. ("foreign levies identical to the taxes imposed by sections 11, 541, 881, 882, 1491 and 3111 of the Internal Revenue Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others").

81 Where income is included in a non-resident's taxable base under such a rule, and tax is collected on that income as well as other income from unrelated activities of the taxpayer that are clearly located within the taxing jurisdiction, the amount of tax for which a credit is denied under our recommended guidance could generally be determined on a "with an without" basis (i.e., comparing the amount tax imposed on the entire base, with the amount of tax that would have been imposed if the base did not include any items of income pursuant to the rule that violates the minimum connection standard).

As an additional point, we note that, in some cases, treating a special rule that fails the minimum connection test as a separate levy possibly might have the effect of preserving the tax imposed by the remainder of the relevant foreign tax regime as eligible for a credit under Sections 901 or 903 – whereas treating that special rule as part of the same levy as the rest of the foreign tax regime might cause the entire tax imposed by the relevant regime to be non-creditable (because the rule violating the minimum connection test might be a key part of the overall regime and taint the treatment of the whole regime). On balance, we believe that a rule violating the minimum connection requirement is sufficiently different from other, more rational provisions in a taxing regime to justify dealing with such a rule separately, and that it is not problematic as a policy matter to grant a credit for the tax imposed under the remainder of such taxing regime.

described above. On balance, however, it appears to us that all three ought to be seen as satisfying such a requirement.

Beginning with the DPT, only one of its two prongs raises a significant question under the minimum connection standard: that which would impose UK tax on non-resident companies that do not have a UK permanent establishment.[82] In some cases, the DPT may deem such a company to have a UK permanent establishment and may attribute income to the deemed permanent establishment beyond what is treated as attributable under normal permanent establishment principles. While these features of the DPT, without more, might raise issues under the minimum connection test, we note that the DPT will deem a non-resident company to have a permanent establishment only where an affiliate that is a UK resident (or has a UK permanent establishment) carries on activity in the UK that is related to a trade conducted by the non-resident, and the non-resident's affairs have been purposefully structured with a goal of avoiding a UK permanent establishment. If this and the other requirements for application of the DPT are met, the non-resident will be deemed to have a UK PE, to which income and expenses will generally be attributed under normal UK corporate tax principles. HMRC guidance appears to suggest that extra profits beyond the amount dictated under those normal principles will be attributed only if activities important to value creation for the non-resident have occurred in the UK (for example, in a case where the non-resident's income is attributable to exploiting a valuable intangible, UK personnel have played a key role in decision-making regarding the development, enhancement, and exploitation of that intangible), and only to the extent that the profit economically attributable to those activities is not already taxed in the UK.[83] Taken together, these features of the UK DPT indicate suggest an effort to identify a taxpayer that has material economic connections to the UK, which connections are rationally related to the taxpayer's income subject to tax under the DPT regime. In such circumstances, our proposed minimum connection standard ought to be viewed as having been met.[84]

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[82] The second prong of the UK DPT deals with companies that are subject to the UK's taxing jurisdiction under traditional principles: UK-resident companies, and non-resident companies that have a UK permanent establishment. See Part III.B.1 above.

[83] See generally HMRC Guidance at DPT1310, DPT 1350.

[84] As noted above, the UK has taken the position that its imposition of the DPT is not limited by its income tax treaties. We discuss considerations related to such assertions by treaty partners in Part IV.A.4.

The analysis of the proposed Australian anti-avoidance rule is similar. It appears to apply to a non-resident taxpayer without an Australian permanent establishment only where the taxpayer supplies goods or services to Australian customers, with direct assistance from an affiliate that is an Australian resident (or acts through an Australian permanent establishment). Where these requirements are met, Australia would generally impose tax on the extra profits (if any) that the taxpayer would have had in Australia, if it had not engaged in transactions with a purpose of creating Australian tax benefits. Again, on balance, it appears Australia would be following rational principles by deeming the taxpayer to have a taxable presence and attributing profits to that presence under the methodology just described, such that the minimum connection test ought to be satisfied.

It appears the proposed Israeli rules also make a legitimate effort to identify meaningful connections of the taxpayer's activities to its generation of income in the Israeli market, such that it can be rationally treated as having a taxable presence in Israel to which that income can be attributed. The rules ought to satisfy the standard we have proposed.

e. Additional Potential Limits on Creditability

In addition to the minimum connection requirement discussed above, we recommend that Treasury and the IRS adopt two other 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. The decision by Treasury and the IRS to grant a credit for a foreign tax imposed based on principles of taxing jurisdiction that stretch significantly beyond those traditionally applied by the United States is an exercise of discretion. Although we believe that exercise of discretion is generally justified when the minimum connection requirements described above in Parts IV.A.2.b and c are met, this would appear not to be the case where the relevant foreign country is not similarly accommodating with respect to the United States' and other countries' income taxes. It is reasonable for the United States to expect reciprocity.

Second, we believe that special rules are warranted for dual resident corporations. Often, a treaty between the United States and the relevant country will provide rules for the treatment of such a corporation, or else will provide for competent authority proceedings to resolve its status.[85] However, if there is no treaty with the relevant country, then both the United States and that country may claim taxing jurisdiction over the corporation's worldwide income. In such a case, the foreign country would likely satisfy the minimum connection standard described above. The United States, however, would appear to have a claim to primary taxing jurisdiction that is equal to the other country's claim, at least in the case of income generated by the corporation in third countries. Accordingly, we recommend that in such a case, the United States would not grant a credit for tax imposed by the other country on income earned in third jurisdictions. (For this purpose, the other country's sourcing rules could be used to determine what portion of the corporation's income is earned in that country, versus in third jurisdictions. That manner of dealing with sourcing would be consistent with the basic principles described above of respecting other countries' rules concerning source, character, and attribution of income to a permanent establishment.)[86]

3. Second Alternative: the Argument for Having No Minimum Connection Requirement

While we believe there is regulatory authority for the type of minimum connection requirement described in Part IV.A.2, as well as a reasonable argument for adopting such a rule, we do not see it as a foregone conclusion that the best approach would be to add such a rule

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85 See, e.g., United States Model Income Tax Convention of November 15, 2006, Art. 4(4) (the "**U.S. Model Treaty**") (if a dual resident company is organized under the laws of one of the countries, but not the other, then the company will be considered a resident of the country in which it is organized); Convention between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed Dec. 18, 1992, Art. 4(4) (competent authorities will seek to resolve the status of a dual resident company; if they cannot reach a resolution, the company generally will not be entitled to treaty benefits as either a U.S. or a Dutch resident, although it will be entitled to the foreign tax credit provided in the treaty for U.S. residents); Convention between the United States of America and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed July 24, 2001, Art. 4(5) (same).

86 This issue related to dual resident corporations will exist regardless of whether countries adopt rules of the type described in Part III.B, in order to counter base erosion. It is, in that sense, an independent issue from the others addressed in this report. However, the issue does broadly involve a question of when a credit should be granted for a tax imposed by a country on income earned beyond its borders. We believe that Treasury and the IRS's issuance of guidance on the other questions discussed in this report would provide a suitable opportunity to also address this issue.

under Sections 901 and 903. There are several possible grounds for a conclusion that no such limitation on creditability should be imposed.

First, although the statute permits such a limitation, it can be questioned how well that limitation would fit with the statute's language, intent, and history. Section 901(b)(1) provides a credit for "any" income tax accrued or paid to a foreign country or U.S. possession. Section 903 similarly provides that the term income tax includes a tax imposed by "any" foreign country or U.S. possession in lieu of its general income tax. Congress has expressly set forth a number of specific, detailed limitations on the statute's broad grant of a credit, in Sections 901 – 909.

The breadth of the statutory language in Sections 901 and 903 describing the basic types of foreign taxes that are creditable comports with the basic Congressional goals that the foreign tax credit was enacted to serve. Although the legislative history is brief, it does suggest a clear concern with the perceived unfairness of subjecting taxpayers' foreign-source income to tax twice, and it also indicates a desire to promote U.S. taxpayers' ability to compete in the international economy by relieving an otherwise substantial potential burden.[87] These policies are well-served if a credit is granted for an income tax imposed by a foreign country even if that tax represents an aggressive exercise of the country's taxing jurisdiction, in a manner that extends beyond conventionally accepted prerequisites for imposition of tax such as a local physical presence that constitutes a permanent establishment, or income sourced (under conventional principles) to the foreign country.

In this connection, it bears note that the original version of Section 901(b)(1), enacted in 1918, allowed a credit for "any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, *upon income derived from sources therein*, or to any

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[87] Report – House Ways and Means Committee (65th Cong., 2d Sess., H. Rept. 767) at 11, reprinted in 1939-1 CB (Part 2) 86 ("With the corresponding high rates imposed by certain foreign countries the taxes levied in such countries in addition to the taxes levied in the United States upon citizens of the United States place a very severe burden upon such citizens. The bill provides that a credit against the income tax imposed in the United States be allowed a citizen of the United States subject to income and war or excess profits taxes in a foreign country of an amount equal to the tax paid in such country upon income that is received from sources within such country."); see also Burnet v. Chicago Portrait Co., 285 U.S. 1 (1932) ("We think that the purpose of the statute is clear. The fact that the provision is for a credit to the domestic corporation, against income taxes payable here, of income taxes 'paid during the same taxable year to any foreign country,' itself demonstrates that the primary design of the provision was to mitigate the evil of double taxation."); Internal Revenue Manual Part 4.61.10.1 ("The purpose of the Foreign Tax Credit (FTC) is to provide relief from double taxation.").

possession of the United States (emphasis added)."[88] The wording requiring that a creditable tax be imposed by a foreign country on income from sources within that country was removed shortly afterward, in 1921, when Congress instead adopted a requirement that foreign tax credits be allowed against the taxpayer's overall income from foreign sources.[89] The limit of the credit to foreign-source income was subsequently bolstered by adding a "per country" limitation, which was designed to make sure that a taxpayer could not effectively credit tax imposed at a high rate by one country, against income derived by the taxpayer in another country that had low or no taxes.[90] The overall limitation was later removed, leaving only the "per country" limitation.[91] However, the "per country" limitation was made optional in 1960,[92] and was repealed altogether in 1976.[93] Congress opted not to re-introduce this concept in its comprehensive overhaul of the foreign tax credit rules in 1986, instead relying on the current system of different baskets for different categories of income earned by a taxpayer.[94] More recently, Congress has acted to reduce the number of baskets, finding that the increased administrability of a reduced number of baskets was a benefit that outweighed the considerations concerning averaging of foreign taxes.[95] This history can be viewed as reflecting a sustained overall shift by Congress away from the idea of allowing a credit for a foreign tax only with respect to income derived in the country imposing that tax. If Treasury and the IRS now were to take the view that a credit is not available for tax imposed by a foreign country on income or activity that does not have a suitable connection to that country, that limitation could be seen as at odds with the longstanding trend of Congressional action in this area.

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88 Revenue Act of 1918, § 222(a), 40 Stat. 1057, 1073.

89 Revenue Act of 1921, § 222(a), 42 Stat. 227, 249.

90 Revenue Act of 1932, §131(b), 47 Stat. 169, 211.

91 Internal Revenue Code Act of 1954 (P.L. 83-591), ch. 736, §904, 68A Stat. 3, 287-88.

92 Revenue Act of 1960 (P.L. 86-780), §1(a), 74 Stat. 1010, 1010. Taxpayers were entitled to elect between the "per country" limitation, and the overall limitation that had previously been repealed in 1954.

93 Tax Reform Act of 1976 (P.L. 94-455), §1031, 90 Stat. 1520, 1620-24.

94 Tax Reform Act of 1986 (P.L. 99-514) § 1201, 100 Stat. 2085, 2520.

95 American Jobs Creation Act of 2004 (P.L. 108-357) § 404, 118 Stat. 1494; Report – House Ways and Means Committee (108th Cong., 2nd Sess. 2004, H. Rept. 548(I)), 2004 WL 1380512 ("The Committee [on Ways and Means] believes that requiring taxpayers to separate income and tax credits into nine separate tax baskets creates some of the most complex tax reporting and compliance issues in the Code. Reducing the number of foreign tax credit baskets to two will greatly simplify the Code and undo much of the complexity created by the Tax Reform Act of 1986.").

In addition, when Treasury and the IRS adopted the prohibition of credits for "soak up" taxes, they appear to have specifically considered, and rejected, the requirement of a minimum connection between a foreign country and the income or activities taxed by it. Treasury and the IRS released proposed regulations under Sections 901 and 903 in 1979, which were retained in temporary regulations in 1980 and final regulations in 1983, under which a foreign tax does not have the predominant character of an income tax, and is not a creditable "in lieu of" tax, if imposition of the tax is dependent on the availability of a credit against the income tax of another country.[96] Treasury and the IRS appear to have deliberately settled on a fairly narrow rule, after reviewing alternatives. The 1979 proposed regulations stated, in the sentence immediately following the prohibition on soak-up taxes, that: "Provisions of the foreign law regarding source of income or residence as a basis for tax jurisdiction are generally not taken into account in determining whether a tax is an income tax."[97] In the 1980 temporary regulations, by comparison, Treasury and the IRS moved toward a broader rule, providing that a foreign tax would not be an income tax unless it "follows reasonable rules regarding source of income, residence, or other bases for taxing jurisdiction."[98] The temporary regulation then elaborated that "A foreign charge may meet these requirements even if the provisions of the law of the foreign country ("foreign law") imposing the charge differ substantially from the income tax provisions of the Internal Revenue Code." The prohibition on soak-up taxes was presented as an illustration of the requirement for reasonable rules of taxing jurisdiction: "A foreign charge does not follow reasonable rules of taxing jurisdiction if liability for the charge is clearly related to the availability of a credit for the charge against income tax liability to another country."[99] The temporary regulations gave two examples of the requirement for reasonable rules of taxing jurisdiction, both involving soak-up taxes that were found not to be creditable.[100] They also provided a third example, the facts of which are very similar to those of final Treasury

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96 Prop. Treas. Reg. §§ 1.901-2(b)(1), 1.903-1(a)(4) (1979), 44 Fed. Register 36071; Temp. Treas. Reg. §§ 4.901-2(a)(1), 4.903-1(a)(4) (1980) T.D. 7739, 45 Fed. Register 75647; Prop. Treas. Reg. §§ 1.901-2(a)(3)(ii), 1.903-1(b)(2) (1983), 48 Fed. Register 14641; Treas. Reg. §§ 1.901-2(a)(3)(ii), 1.903-1(b)(2).

97 Prop. Treas. Reg. § 1.901-2(b)(1) (1979), 44 Fed. Register 36071.

98 Temp. Treas. Reg. § 4.901-2(a)(1)(iii) (1980) T.D. 7739, 45 Fed. Register 75647. In the quoted text, the reference to “other bases” indicates that non-residence, non-source bases would be considered potentially acceptable.

99 Temp. Treas. Reg. § 4.901-2(a)(1) (1980) T.D. 7739, 45 Fed. Register 75647.

100 Temp. Treas. Reg. § 4.901-2(e) Examples 1, 2 (1980) T.D. 7739, 45 Fed. Register 75647.

Regulation Section 1.901-2(b)(4)(iv), Example 4 and Treasury Regulation 1.903-1(b)(3), Example 3 (discussed above).[101] The tax in this third example was found to be a creditable income tax.[102] The final regulations abandoned the requirement for reasonable rules of taxing jurisdiction, and instead specifically targeted only soak-up taxes. In addition, the two examples in the final regulations retained the fact pattern from the favorable example of reasonable taxing jurisdiction in the temporary regulations (Example 31), although they omitted the statement expressly approving treatment of the tax as a reasonable exercise of taxing jurisdiction notwithstanding the source rule, instead concluding only that the tax met the net income requirement or (in the case of the gross-basis withholding tax) the "in lieu of" requirement.[103]

Thus, the history of the soak-up rule indicates a rejection by Treasury and the IRS of the idea that a reasonable exercise of taxing jurisdiction by a foreign country should be a prerequisite for creditability. That decision can certainly be revisited in the context of current developments. However, given the increasing complexity that foreign countries now face in determining the appropriate scope of their taxing jurisdiction (described in Part IV.A.2.b), it can be asked whether, if anything, such a decision is even more justified in the current environment than it was 30 years ago.

As a further point, if Treasury and the IRS decide to require a minimum connection between a foreign country and the base it taxes, then the type of minimum connection standard recommended in Part IV.A.2 would, by design, be likely to deny creditability only in a fairly limited group of cases. Given the limited practical effect of the rule, and the debatable case for

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[101] See Part IV.A.1 above.

[102] "Country X imposes a charge computed on the basis of realized gross receipts reduced by costs on residents of Country X and on nonresidents that have a permanent establishment within Country X. Country X also imposes a 20-percent charge on the gross amount of fees paid by residents of Country X for technical services performed within or without the country by nonresidents that have no permanent establishment within Country X. A nonresident has a permanent establishment within Country X if it has a place of business in the country for a period of more than 1 year. Pursuant to paragraph (a)(3)(ii) of this section, the 20-percent charge may be an income tax notwithstanding the fact that Country X determines the source of personal services income on the basis of the residence of the payor. Pursuant to paragraph (a) (4) (iii) of this section, the 20-percent charge need not meet the net income requirement." Temp. Treas. Reg. § 4.901-2(e) Example 31 (1980) T.D. 7739, 45 Fed. Register 75647.

[103] Treas. Reg. § 1.901-2(b)(4)(iv), Example 4; Treas. Reg. § 1.903-1(b)(3), Example 3.

adopting it, it can be questioned whether having such a rule would be worth the administrative effort required for the government to draft and enforce it, and for taxpayers to apply it. [104]

For these reasons, it can be argued that the grant of a credit under Section 901 or Section 903 should not be conditioned on there being a particular minimum level of nexus between the foreign country imposing a tax, and the income or activity being taxed. If Treasury and the IRS adopt this position, we recommend that they issue guidance expressly confirming the absence of any such requirement. In view of the possibility that a growing number of countries may adopt novel theories in support of an expansion of their taxing jurisdiction, it would be helpful to confirm that the conclusion indicated by the examples in the current regulations will continue to hold true.

4. Tax Treaty Considerations

Regardless of whether Treasury and the IRS choose the approach described in Part IV.A.2 (adopting an easily satisfied requirement for a minimum connection between a foreign country and the base it seeks to tax) or Part IV.A.3 (expressly providing that there is not any such requirement), we believe that cases implicating a U.S. income tax treaty raise special considerations.

A treaty represents an agreed allocation of taxing jurisdiction between the United States and its treaty partner. It generally applies to enumerated taxes of the treaty partner in effect at the time the treaty is entered into, as well as "any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes."[105] The partner country's right to impose such taxes on a U.S. resident is typically limited to taxing income attributable to a permanent establishment in that country, as well as other specific categories of income (not attributable to a permanent establishment) which arise in that

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[104] If Treasury and the IRS decide not to adopt a minimum connection requirement, and instead opt to expressly state that a foreign tax can be credited without the need for a connection between the income and the taxing jurisdiction, then some countries might have more incentive to adopt such tax regimes than they do currently, in the absence of such an express statement. Thus, the impact of adopting a minimum connection requirement (rather than stating there is no such requirement) might be somewhat wider than may at first appear to be the case. Nevertheless, it still appears unlikely to us that a minimum connection requirement would have an effect on many cases.

[105] See U.S. Model Treaty, Art. 2(4).

country. The United States commits to give a credit to the U.S. resident for such tax.[106] That commitment generally may mirror the treatment of such tax under the foreign tax credit rules in the Code which would apply in the absence of the treaty. However, U.S. treaties often provide an additional rule, requiring that the income the treaty partner has taxed be treated as foreign-source for purposes of Section 904.[107] This rule helps to ensure that the credit for the treaty partner's tax will not be limited under Section 904(a); thus, by agreeing to this rule, the United States has ceded taxing jurisdiction to the treaty partner, as part of an overall package of concessions granted by both sides in their negotiations.

If a treaty partner adopts a law expanding its taxing jurisdiction sometime after it has entered into a treaty with the United States, and the law applies to U.S. residents who do not have a permanent establishment or income sourced to the partner country under the treaty, then it appears the partner country is prohibited under the terms of the treaty from imposing the tax on U.S. residents. If the relevant country decides to override the treaty and impose the new tax, then the United States is losing the benefit of bargained-for limits on the treaty partner's taxing jurisdiction. At a minimum, in cases where the tax is imposed on U.S.-source income, the United States would be justified in denying U.S. residents the benefit of the treaty's re-sourcing rule for such income. This approach is consistent with (or perhaps mandated by) the wording of the U.S. Model Treaty's re-sourcing provision, which applies only to "an item of gross income, as determined under the laws of the United States, derived by a resident of the United States <u>that, under this Convention, may be taxed in [the partner country]</u>."[108]

However, it appears that the United States' interests may justify taking broader action than just preventing re-sourcing of U.S.-source income. Preservation of exclusive U.S. taxing jurisdiction over U.S. residents' income (of any source) that is not attributable to a permanent establishment and not otherwise taxable in the relevant country under the terms of the treaty would appear to be a core element of the treaty. If the United States grants a credit for tax

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[106] <u>See</u> U.S. Model Treaty, Art. 23(2) (the United States commits to provide a credit for enumerated taxes of the treaty partner in effect at the time the treaty is entered into, as well as any identical or substantially similar taxes).

[107] <u>See</u> U.S. Model Treaty, Art. 23(3) (income derived by a U.S. resident that may be taxed in the treaty jurisdiction is deemed to be from sources in that treaty jurisdiction).

[108] U.S. Model Treaty, Art. 23(3) (emphasis added).

imposed in violation of this principle, then it effectively is acquiescing in the treaty partner's decision to disregard the terms of the treaty.

In such a case, we recommend that the U.S. government should generally commence a competent authority proceeding claiming that imposition of the tax violates the treaty.[109] Preferably, the government would commence a proceeding with a broad scope covering all U.S. taxpayers who might become subject to the tax in question, rather than pursuing proceedings only on a case-by-case basis if and when requested by particular U.S. taxpayers. Competent authority proceedings often are commenced only after a specific U.S. taxpayer contacts the U.S. government seeking treaty relief;[110] however, under Article 25(3) of the U.S. Model Treaty, the U.S. competent authority also is entitled, on its own initiative, to contact the treaty partner's competent authority to resolve "any difficulties or doubts arising as to the interpretation or application of the Convention."[111] Proceedings under Article 25(3) do not need to involve a particular taxpayer, and are meant to provide a vehicle for addressing broad-ranging issues concerning the application of the treaty.[112] In view of the potential relevance of the issues

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109 We propose that such a competent authority proceeding would address only those cases where the tax is imposed by the treaty partner on U.S. residents in contradiction of the specific terms of the treaty. Thus, for instance, the United States' treaty with a particular partner country would not apply to limit that country's ability to impose tax on a U.S. resident's CFC. We do not propose that the tax paid to the applicable treaty partner by the CFC would be the subject of a competent authority proceeding brought by the United States under its treaty with that partner country.

110 Under Article 25(1) of the U.S. Model Treaty, a U.S. resident is permitted to contact the U.S. competent about the U.S. resident's subjection by the treaty partner to tax in a manner that contradicts the terms of the treaty; and under Article 25(2), if the U.S. competent authority has been so contacted, it is required to attempt to reach an agreed resolution with the other competent authority, where the taxpayer's claim appears justified and the U.S. competent authority is not able unilaterally to provide relief. See Rev. Proc. 2015-40, 2015-35 I.R.B. 236 (providing procedures for U.S. residents to request competent authority assistance).

111 U.S. Model Treaty, Art. 25(3).

112 See United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Art. 25(3) (the competent authorities "may agree to settle a variety of conflicting applications of the Convention"); Rev. Proc. 2015-40, § 2.01(2) ("The mutual agreement procedure articles of U.S. tax treaties grant taxpayers the right to request the assistance of the U.S. competent authority when the taxpayer believes that the actions of the United States or a treaty country result or will result in the taxpayer being subject to taxation not in accordance with the applicable U.S. tax treaty. This situation typically arises as a result of U.S.- or foreign-initiated adjustments resulting from an examination, but can arise from other U.S.- or foreign-initiated actions (such as withholding of tax by a withholding agent) or from a taxpayer-initiated position. The U.S. competent authority will endeavor to resolve competent authority issues arising under the mutual agreement procedure articles of U.S. tax treaties through consultations with the applicable foreign competent authority(ies) but in some cases may resolve such issues unilaterally (see, e.g., section 8.02). There is no authority for the U.S. competent authority to provide relief with respect to U.S. tax or to provide other assistance related to taxation arising under the tax laws of a foreign country or the United States unless

involved to a number of different taxpayers, we believe it would generally be appropriate to commence such a proceeding.[113]

We note that a treaty partner might assert in the proceeding that its imposition of a tax is not a violation of the treaty, even though such imposition contradicts the treaty's express wording. For example, commentary on the OECD's model income tax treaty suggests that a treaty might not apply to a tax that is imposed by a treaty partner pursuant to an anti-abuse rule that forms part of its domestic law, and/or a tax that a treaty partner imposes in order to prevent potential abuse by taxpayers of the treaty.[114] An analysis of the policy considerations related to such potential arguments by the United States' treaty partners is beyond the scope of this report. However, when the U.S. government institutes a competent authority proceeding, it will need to consider in what specific circumstances, if any, it is prepared to give weight to such assertions.

In addition, a decision by the United States to pursue a competent authority proceeding also might be seen as in tension with the basic U.S. principle that the later to be adopted of a treaty or a U.S. statute is generally controlling, for purposes of determining the U.S. tax to be imposed on a taxpayer.[115] The United States has invoked this principle many times when enacting treaty overrides.[116] If the U.S. government decides to pursue a competent authority proceeding of the type described above, then the government will need to determine how to reconcile its rationale for such an effort, with its explanation to treaty partners of the United States' own power to adopt overrides in the future and its justification for that power.

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such authority is granted by a treaty. The grant of such authority by the mutual agreement procedure articles of U.S. tax treaties is separate from and in addition to the authority under such articles for the U.S. competent authority to consult generally with foreign competent authorities to resolve difficulties or doubts regarding treaty interpretation or application, irrespective of whether the consultation relates to a current matter involving a specific taxpayer.") (emphasis added).

[113] We do not believe Treasury and the IRS need to provide a definitive conclusion, in regulations or other binding guidance, as to whether and in what circumstances the United States will pursue such a proceeding. However, we believe it would be helpful for taxpayers if Treasury and the IRS give at least some non-binding indication – for example, in the preamble to regulations issued to address some other issues discussed in this report – of the basic principles they plan to follow when deciding whether to commence competent authority proceedings of the type described in the text.

[114] See OECD Commentaries on Model Tax Convention, Commentary on Art. 1, paras. 7 – 9, 22 (2014).

[115] See I.R.C. § 7852(d)(1); Reid v. Covert, 354 U.S. 1 (1957); Whitney v. Robertson, 124 U.S. 190 (1888).

[116] See, e.g., I.R.C. §§ 884(e), 897, 7874.

In a case where a treaty partner adopts an override with a stated purpose of preventing base erosion, depending on the facts, the treaty partner's action might not be aimed at perceived abuses that are tied to distinctive aspects of its economy or tax system. Instead, such action may be designed to address issues commonly faced by a number of countries, which have not reached a consensus on how to address them. This may be a set of circumstances in which the United States can argue that it is especially justified in challenging the treaty partner's override, on grounds that such it not only undermines U.S. residents' expectations under the treaty, but also has significantly broader potential negative effects because it may encourage other countries to act in a similarly uncoordinated manner to expand their taxing jurisdiction. Arguably, such an assertion by the United States that this is a special case, does not conflict with the United States' general approach to its own adoption of treaty overrides.

In the event the United States institutes a competent authority proceeding, if a U.S. taxpayer pays tax to the treaty partner of the type at issue in the proceeding while it is ongoing, the taxpayer should be entitled to claim a foreign tax credit. If (and only if) the proceeding results in the treaty partner agreeing to refund tax for which the taxpayer has previously claimed a credit, then the taxpayer should lose its entitlement to the credit and its U.S. income tax liability should be increased. This approach is consistent with current law, and we believe it strikes a fair balance between the taxpayer's entitlement to relief from double taxation, and the U.S. government's interest in not having a treaty partner exploit the availability of the credit. Existing authorities permit U.S. taxpayers to claim a credit for foreign tax they pay, when the taxpayers challenge the validity of the foreign tax in judicial or competent authority proceedings.[117] As the IRS has explained:

> It is not the intention of the law to deprive the taxpayer of the right to obtain credit for foreign taxes because of the fact that the taxpayer contests the validity of the statute under which the amount of taxes were paid or because it protests the assessment and has made application for a refund. The tax assessed constitutes a liability against the taxpayer. In the instant case such liability was met by actual cash disbursements. If the protest by the taxpayers against the original assessment

[117] See IBM v. United States, 80 A.F.T.R. 2d 97-5861, 97-5862 (Ct. Fed. Cl. 1997); T.D. 7918, 1983-2 C.B. 113; Rev. Rul. 70-290, 1970-1 C.B. 160; cf. Treas. Reg. 1.901-2(e)(5) (ii) Example 3.

> prevails, any difference can readily be adjusted pursuant to the provisions of section 905(c) of the Code.[118]

That logic applies equally here. Section 905(c) requires a U.S. taxpayer claiming a foreign tax credit to notify the IRS in the event that the foreign tax is refunded, and authorizes the IRS to determine the resulting adjustment to the taxpayer's U.S. tax liability and to assess the taxpayer. It is an exception to the normal statute of limitations on assessments, thus giving the U.S. government the ability to recover tax revenue after a successful, but protracted, competent authority proceeding.[119]

By comparison, an approach under which a taxpayer is denied the ability to claim a credit while the competent authority proceeding is ongoing seems unduly harsh to us. Such a taxpayer would be placed in a worse position than it would be in if the United States had no treaty with the foreign country in question: the taxpayer would, at least on an interim basis, be subjected to double taxation, even though eventually it might manage to recover either the foreign tax or the U.S. tax it had paid, after the competent authority proceeding had ended.[120]

In order to ensure straightforward application of Section 905(c), the U.S. government could include in any agreement reached in a competent authority proceeding terms concerning the timing and process for its treaty partner to pay refunds to affected U.S. taxpayers. Treasury and the IRS also could issue guidance requiring any U.S. taxpayer that pays tax to a treaty partner of the type at issue in the competent authority proceeding to include with its U.S. return for the year of payment a statement that such payment had been made and the amount paid.

We note that the UK has taken the position that its imposition of the DPT is not subject to limitation under its existing income tax treaties, apparently including the UK income tax treaty with the United States. The U.S. government might consider taking the approach just described, in the case of the DPT.

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[118] Rev. Rul. 70-290, 1970-1 C.B. 160.

[119] There is no statute of limitations on adjustments under Section 905(c). See I.R.C. § 6501(c)(5).

[120] After the conclusion of the competent authority proceeding, the taxpayer might receive either a foreign tax refund (if the United States prevailed in the proceeding), or a U.S. tax refund (if the United States did not prevail in the proceeding and the taxpayer at that point claimed a foreign tax credit and sought a refund of U.S. tax it had paid previously).

As discussed below in Part IV.B, in some cases a treaty partner may seek to attack types of cross-border related-party transactions perceived by it to result in inappropriate base erosion, by adopting rules that broaden the taxable base of a locally resident entity participating in the transaction; and sometimes the resident's taxable base may be broadened sufficiently far as to include income that under U.S. principles is attributable to non-resident entities that do not have a permanent establishment in the country imposing tax. As explained in Part IV.B, so long as the treaty partner's rules represent a rational approach to allocating income and expense between the resident and its non-resident affiliates, we believe there is not a strong case for commencing a competent authority proceeding asserting that such rules violate the treaty. A treaty partner's adoption of such rules does not appear to us to involve the same disregard of core elements of a U.S. treaty as is present in the circumstances discussed above.

B. Foreign Taxing Jurisdiction's Application of Anti-Base Erosion Rules to the Measurement of a Taxpayer's Net Income

Foreign jurisdictions' initiatives like those discussed in Part III.B above reflect foreign governments' close attention to how multinational corporate groups allocate income from their worldwide operations among their members. Foreign countries' consideration of new rules for allocation of income among affiliated parties is, in significant respects, a companion development to foreign countries' efforts discussed in Part IV.A to expand the reach of their respective taxing jurisdictions beyond conventional limits: the two types of foreign tax rules both represent possible ways of dealing with the same potentially problematic fact patterns.

> **Example.** Low-Tax Subsidiary provides services from outside Foreign Country to customers located in that country. Although Low-Tax Subsidiary does not itself have offices in Foreign Country, it receives support and assistance from Foreign Country Subsidiary in marketing to local customers. Foreign Country Subsidiary has no power to enter into legally binding contracts with customers on behalf of Low-Tax Subsidiary. Low-Tax Subsidiary pays a service fee to Foreign Country Subsidiary which is intended be on arm's length terms.

Foreign Country's laws may allow it to assert that Low-Tax Subsidiary is subject to tax, despite not having a permanent establishment in the country; this could be viewed as broadening Foreign Country's assertion of jurisdiction beyond traditional concepts of a PE and traditional income sourcing rules. Alternatively, Foreign Country's law instead may support an assertion that the transfer pricing between Low-Tax Subsidiary and Foreign Country Subsidiary is incorrect or, more broadly, might support an assertion that the companies' overall arrangement is abusive and must be re-characterized (for example by deeming Foreign Country Subsidiary to receive the fees paid by the customers and, in turn, to pay a royalty or intercompany fee to Low-Tax Subsidiary).

The discussion below focuses on the latter type of rule, which seeks to increase the taxable base of the locally resident affiliate, rather than to impose tax on the non-resident. Specifically, the discussion considers whether guidance under Sections 901 and 903 should cause the creditability of a foreign country's tax to be dependent on whether, and to what extent, its tax laws provide for income and expense from related-party transactions to be adjusted, or disregarded and replaced with notional items of income and expense, in such cases.

1. Existing Law

The current regulations provide that a foreign tax meets the "gross receipts" requirement for status as an income tax under Section 901 only if, "on the basis of its predominant character, it is imposed on the basis of (A) gross receipts or (B) gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value."[121] The regulations provide an example of how this test would be applied in a related-party context. In Treasury Regulation Section 1.901-2(b)(3)(ii), Example 1, headquarters companies in Country X are subject to tax on income from providing management and coordination services to affiliates in an amount equal to the headquarters companies' cost of providing the services plus 10%, rather than being taxed based on the actual amount of intercompany fees they receive. The example notes that it would be difficult to determine on a case-by-case basis the arm's length amount of fees received by such companies, and that the formula is meant to overcome that difficulty. The example then goes on to state, however, that "It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates." (It is not clear from the example how this is established, in view of the stated difficulty in determining the arm's length amount of fees in such transactions.) The example concludes the tax meets the gross receipts requirement.[122]

[121] Treas. Reg. § 1.901-2(b)(3).

[122] See also Treas. Reg. § 1.901-2(b)(3)(ii) (same result on slight variation to fact pattern).

In addition, the Section 901 regulations provide that a foreign tax meets the "net income" requirement to be treated as an income tax under Section 901 only if, "judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts…to permit (A) recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or (B) recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses."[123] The regulations go on to state that principles of foreign tax law that attribute costs and expenses to gross income may be reasonable "even if they differ from principles that apply under the Code."[124]

Caselaw and rulings relating to the application of these tests provide little guidance about how the tests are meant to apply, when a foreign country's tax laws contain unusual rules for determining income or expenses attributable to transactions between related parties. Authorities dealing with foreign tax regimes not specifically aimed at related parties suggest that, in general, courts and the IRS have only limited tolerance for rules that impose tax based on imputed income items and/or formulas for approximating expenses.[125] Regarding imputed or notional income, while some early precedents suggest imputation (for example, of rental income on real property owned and occupied by the taxpayer) might be an acceptable feature of a creditable income tax, later precedents appear generally to reject such an approach in a non-related party context.[126]

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[123] Treas. Reg. § 1.901-2(b)(4).

[124] Treas. Reg. § 1.901-2(b)(4)(i).

[125] The Code, by comparison, provides a formula to determine the minimum level of effectively connected income of foreign insurance companies. See I.R.C. § 842.

[126] See, e.g., F.W. Woolworth Co. v. Comm'r, 54 T.C. 1233 (1970); Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (3d Cir., 1943); GCM 36552, 1976 WL 39249 (Jan. 19, 1976); see also Phillips Petroleum Co. v. United States, 104 T.C. 256 (1995). Phillips Petroleum was decided under the temporary regulations adopted in 1980, which provided the gross receipts test would be met by a formula if the formula was "designed to produce an amount that is not greater than fair market value and that, in fact, produces an amount that approximates, or is less than, fair market value, but only in the case of (A) Transactions with respect to which it is reasonable to believe that gross receipts may not otherwise be clearly reflected; or (B) Situations to which paragraph (c)(2)(i)(C) of this section (relating to a transfer or processing of readily marketable property) applies." Temp. Treas. Reg. § 4.901-2(c)(3)(ii). The net income requirement imposed essentially corresponding criteria with respect to expenses. Temp Treas. Reg. § 4.901-2(c)(4)(i)(B). The Tax Court reviewed Norway's Petroleum Tax Act, which Norway adopted to counter the sophistication of large, multinational oil companies in

Similarly, authorities dealing with formulas to estimate expenses outside the related-party context suggest such formulas potentially raise issues under the net income requirement. Prior to issuance of the current regulations, some courts expressed willingness to treat gross income taxes imposed on passive-investment type income received by non-resident taxpayers without a local PE as a tax meant to reach net income, on the theory that such taxpayers generally had minimal or no expenses (at least, in the taxing jurisdiction) associated with such income.[127] However, courts and the IRS were reluctant to accept broader application of this principle to other fact patterns, and that reluctance is memorialized in the current regulations.[128]

A foreign tax that fails either of these tests, in addition to not being creditable under Section 901, also will not be creditable under Section 903, unless it is a separate levy that is imposed in substitution for (and not in addition to) a country's general income tax with respect to one or more activities of the taxpayer.

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establishing advantageous transfer prices for transfers of petroleum products extracted from the Norwegian continental shelf area: the Act (i) imposed transfer prices set by a government agency in place of those actually used by taxpayers for related-party transfers of such products and (ii) provided for nondeductibility of some related-party expenses. The Tax Court reviewed extensive evidence showing the required transfer prices were designed to, and in fact did, result in gross receipts that approximated or were less than fair market value for most taxpayers, and that its disallowance of related-party expenses "simply denies deductions for expenses which are already suspect" due to the common interests that exist between the parties" and that "even if they were legitimate, would be insignificant." Phillips Petroleum, 104 T.C. at 316.

127 See, e.g., Bank of America Nat. Trust & Sav. Ass'n v. United States, 459 F.2d 513 (Ct. Cl. 1972); Santa Eulalia Min. Co. v. Commissioner, 2 T.C. 241 (1943); I.T. 3385, 1940-1 C.B. 103; I.T. 4013 (dealing with Mexican tax on interest), 1950-1 C.B. 65 (dealing with a Brazilian tax on gross earnings from interest and dividends).

128 See Treas. Reg. § 1.901-2(b)(4)(i) ("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)."); see, e.g., Bank of America Nat. Trust & Sav. Ass'n v. United States, 459 F.2d 513 (Ct. Cl 1972); Bank of America Nat. Trust & Sav. Ass'n v. Comm'r, 61 T.C. 752 (1974).

Following the issuance of the current regulations under Section 901, in Texasgulf, the Tax Court and the Second Circuit accepted the imposition of a foreign petroleum tax that allowed a formulaic deduction in place of interest expense and some overhead expenses, based on evidence showing most taxpayers' formulaic deduction exceeded the expenses disallowed. Texasgulf, Inc. v. Comm'r, 172 F.2d 209 (2d Cir. 1999).

2. Recommendations Regarding Transfer Pricing Rules and Rules Recharacterizing Related-Party Transactions

a. Application of the Definition of an "Income Tax" in the Section 901 Regulations

We recommend that guidance under Section 901 expressly confirm that the statute and regulations do not deny a credit for a tax imposed by a foreign country's laws based on any rational approach taken by that country to allocation of income and expenses between related parties, even if that approach differs significantly from that taken under U.S. tax law.

In cases where a country's laws require an increase in a taxpayer's gross receipts (or a decrease in its expenses) from the amount that, in form, the taxpayer receives (or incurs) in a related-party transaction, it does not appear that such a requirement should be viewed as in conflict with the policy goals behind the gross receipts test or net income test in the Section 901 regulations. In the above example at the beginning of Part IV.B, Foreign Country's tax laws are not seeking to impute unrealized income to Foreign Country Subsidiary, or to disregarded costs and expenses incurred to third parties; instead, Foreign Country's laws are essentially seeking to allocate to Foreign Country Subsidiary a larger share of the net income recognized by Parent's corporate group from transactions with customers in Foreign Country. Countries frequently adopt different approaches when making such an allocation, even when they ostensibly are simply applying traditional "arm's length" transfer pricing principles; and often more than one approach can be seen as reasonable. Some countries' rules, including possibly the UK DPT or (in some cases) the proposed Australian anti-avoidance rule, may apply by recharacterizing a transaction rather than purporting to simply apply conventional arm's length principles. At bottom, however, such recharacterization rules appear to be rationally designed to identify the assets and activities within a multinational group that are the key sources of generation of income within the taxing jurisdiction, in cases where the normal arm's length standard may be difficult to apply.

In this respect, the United States itself has adopted rules that depart from the normal reliance of the traditional arm's length standard on observed comparable transactions between unrelated parties, and that are not currently widely accepted in other countries' transfer pricing rules.[129] It is hard to see why the United States should object to other countries adopting rules that can be seen as going beyond traditional arm's length principles, such as recharacterizations of cross-border related-party transactions, or a formulaic approach to dividing income among affiliates in situations where data on third-party comparable transactions is scarce or where third-party transactions are not truly comparable. So long as a foreign country's rules for allocating or imputing income and expenses to a member of a multinational group are rationally designed to achieve the goal of matching profits with the assets or activity in a group that are responsible for generating those profits, it would seem those rules ought to be viewed as compliant with the gross receipts and net income tests. It is appropriate to treat such cases differently than, for example, a foreign statute's definition of gross receipts to include imputed rental income from owned property,[130] or the value (determined under a formula) of minerals extracted by the taxpayer that are not readily marketable and are not sold to any (related or unrelated) party,[131] or a law outside the related-party context that creates formulas or proxies for a taxpayer's material expenses.[132] Authorities addressing such cases should not be viewed as dispositive, or even necessarily as relevant, here.

The recommended approach appears consistent with Congress's and Treasury's approach to other significant differences between a taxpayer's taxable base as determined under U.S. and foreign principles. In each case, Congress and Treasury have adopted special rules to address these differences while acknowledging, at least implicitly, that tax imposed on the foreign base meets the basic definition of an income tax under Section 901.[133]

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[129] See, e.g., Treas. Reg. § 1.482-6(c)(3) (residual profit split); see also Treas. Reg. § 1.482-7(d)(2) (cost sharing arrangement must include stock-based compensation as a cost to be shared); Altera Corp. v. Comm'r, 145 T.C. ____ (2015) (invalidating Treas. Reg. § 1.482-7(d)(2) and noting evidence of its inconsistency with terms of actual cost-sharing contracts between unrelated parties); I.R.C. § 842 (formulaic allocation of minimum level of effectively connected income to foreign insurance companies); Treas. Reg. § 1.882-5 (formulaic allocation of interest expense to a foreign corporation's U.S. branch).

[130] Cf. F.W. Woolworth Co. v. Comm'r, 54 T.C. 1233 (1970).

[131] Cf. Treas. Reg. § 1.901-2(b)(2)(i), (iii); Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (3d Cir., 1943).

[132] See Texasgulf, Inc. v. United States, 17 Cl. Ct. 275 (1989); cf. Inland Steel Co. v. United States, 677 F.2d 72 (Ct. Cl. 1982).

[133] See I.R.C. § 901(m) (differences in tax base attributable to covered asset acquisitions); I.R.C. § 904(d)(2)(H) (rule for basketing of foreign taxes attributable to permanent base differences); Treas. Reg. § 1.901-2(e)(5)(iv) (denying credits for foreign taxes imposed in connection with structured passive investment arrangements); Treas. Reg. § 1.901-2(f)(3) (taxes imposed on a combined basis).

In addition, the recommended approach is conceptually consistent with our proposal in Part IV.A.2.b above. There we proposed that, if Treasury and the IRS adopt a requirement of a minimum connection between a foreign country and the income or activities it seeks to tax, one satisfactory connection should be that a multinational group has a permanent establishment or other taxable presence in the country, to which the income or activities at issue have some rational connection. We propose to take essentially the same approach where, instead of having a permanent establishment, a multinational group has a subsidiary in the relevant country, to which the base the country seeks to tax is rationally connected.

We note that, in those unusual cases in which a country has related-party rules that fail the proposed requirement described above, taxing a local affiliate on an arbitrarily determined base amount, we propose that Treasury and the IRS adopt an approach similar to that recommended in Part IV.A.2.c above. That is, whether or not the relevant country drafts the objectionable related-party rules in the form of a separately imposed tax or, instead, drafts those rules as part of a larger tax regime, we propose that the amount of tax imposed under those rules be treated as a separate levy for purposes of Sections 901 and 903, and that a credit be denied for such tax. If a country's rules assign income and expense to a company with respect to its related-party transactions in a manner that does not have an economically rational basis, it would appear that tax imposed under such rules can logically be viewed as "different in kind, and not merely in degree" from a country's other, more traditional rules, and thus be treated as a separate levy. Moreover, for reasons essentially similar to those articulated in Part IV.A.2, it would seem that a credit ought to be denied for that separate levy – that is, the concept of an "income tax in the U.S. sense," and of a tax imposed in lieu of such an income tax, implies that the taxable base must have a rational connection to the taxing jurisdiction, and the levy in question would fail that test.[134]

To eliminate any possibility for uncertainty, we recommend clarifying changes to the Section 901 regulations. First, it should be expressly stated that any foreign tax rules that determine gross receipts or deductible expenses attributable to transactions involving related

[134] By adopting the recommended approach, Treasury and the IRS can ensure that a multinational corporate group will be subject to the same treatment whether it has a local subsidiary in the relevant country (which would be covered by the proposal just described in the text) or a branch in that country (which would be covered by our proposed rule described in Part IV.A.2.c).

parties in a manner rationally designed to identify the approximate relative economic contributions of a taxpayer, and its affiliates, will be treated as satisfying the gross receipts and net income tests. Second, in Treasury Regulation Section 1.901-2(b)(3)(ii), Examples 1 and 2 should be revised to make it clear that, so long as it is established that the criterion just described has been satisfied, the gross receipts test will be satisfied. Third, as noted immediately above, in the rare cases where a country's tax rules determine amounts of income and expense from related-party transactions on an irrational basis, the regulations under Sections 901 and 903 should provide that the tax imposed under such rules is a separate levy that is not a creditable tax.

b. Treaty Considerations

We have considered whether the above analysis should be different when the United States has a treaty with the country imposing the relevant tax. We believe that (by contrast to the issues discussed in Part IV.A.4 above) there is not a strong reason for the U.S. government to commence a competent authority proceeding in which it argues that the type of tax rules described above violate the treaty.

Article 9 of the U.S. Model Treaty (similar to many U.S. treaties currently in effect) provides that when "conditions are made or imposed between the two [related] enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then any profits that, but for those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly."[135] This provision also indicates the United States and its treaty partner should coordinate their respective imposition of tax in such cases, so that profits on which one company pays tax in one country are not also subject to tax in the other country in the hands of the other company.[136] It might be asked whether a treaty partner's tax laws of the kind described above represent a violation of Article 9, when a company that is resident in the treaty partner country is taxed under such laws on profits that are simultaneously taxed under Section 482 to a U.S. related party.

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135 U.S. Model Treaty, Art. 9(1).

136 U.S. Model Treaty, Art. 9(2).

In our view, the answer to that question is not clear-cut. The phrasing used in Article 9 is relatively open-ended: it permits, but does not require, a party to the treaty to make adjustments if a resident enters into non-arm's length transactions with related parties; and it does not prescribe any particular methodology to be used to make such adjustments.[137] In addition, the wording provides for the United States and its partner to make coordinated transfer pricing adjustments only in the event they agree. Article 9 thus suggests a recognition by the United States and its treaty partner of the difficulty involved in allocating income between related parties and of the possibility for differing reasonable approaches. Thus, where a treaty partner imposes tax based on related-party rules that are rational, but that depart from conventional transfer pricing standards and are at odds with Section 482, there does not appear to be a compelling case for Treasury and the IRS to challenge such rules as contradicting the provisions of the treaty. The treaty partner in such a case (by contrast to the circumstances discussed in Part IV.A.4) would appear not to have acted with disregard for a core agreed element of the treaty.[138]

c. Potential Application of the Technical Taxpayer Rule or Section 909

If tax is imposed under a foreign anti-avoidance regime when a transaction occurs between related parties that are separate regarded entities for U.S. tax purposes, then it is possible that one of those entities may be taxed on income that, under U.S. principles, belongs to the other. In the example at the beginning of Part IV.B, for instance, the fee charged by Foreign Country Subsidiary to Low-Tax Subsidiary might be respected under U.S. tax principles, but Foreign Country may treat Foreign-Country Sub as receiving a bigger fee, and/or royalties or other additional payments. One policy question arising in such case is whether the time at which the relevant income is subjected to U.S. tax should be coordinated with the time at which a credit can be claimed for the foreign tax imposed on the income.

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[137] Treasury's commentary about the methodology to be used is similarly open-ended, stating only that an appropriate adjustment "may include modifying the terms of the agreement or re-characterizing the transaction to reflect its substance." United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Art. 9 Para. 1.

[138] Although it thus seems unwarranted to pursue the same type of broad ranging competent authority proceeding here as is described in Part IV.A.4, in a particular case, a U.S. taxpayer might seek competent authority relief based on its individual facts; and the U.S. competent authority could decide on a case by case basis whether such relief is merited.

In the current versions of the "technical taxpayer" rules of Treasury Regulation Section 1.901-2(f)(3) (dealing with foreign tax imposed on the combined income of multiple parties) and the regulations under Section 909, a determination has been made not to apply those rules in cases of transfer pricing adjustments under foreign law.[139] That decision appears appropriate to us, because transfer pricing adjustments typically would not reflect the advance U.S. tax planning or manipulation these rules are intended to prevent. In addition, given the frequency of transfer pricing adjustments, subjecting them to either set of rules might create a significant administrative burden for taxpayers.

By comparison, application of foreign tax laws like the UK DPT or the proposed Australian multinational anti-avoidance rule would appear likely to be a less common occurrence, focusing on relatively complex, carefully planned structures. Even if such structures are not specifically designed to manipulate foreign tax credits, they may often involve core tax planning by a multinational group to optimize its worldwide tax position. It appears appropriate to ensure that, if this type of tax is imposed by a foreign country, in an effort to prevent perceived tax avoidance, U.S. taxpayers do not get an opportunity to benefit from that (at the U.S. government's expense) by claiming a credit without repatriating the related income. Moreover, it appears possible to us that, at least in some cases, one element of taxpayers' planning may be to ensure that, in the event such taxes are imposed, they would be imposed in a manner that has relatively favorable U.S. tax consequences, including being segregated into entities that do not realize the relevant income for U.S. tax purposes.

Thus, by contrast to ordinary transfer pricing adjustments, it appears that transactions that are subject to a foreign country's related-party anti-abuse rule are relatively likely to constitute a limited, clearly demarcated group of transactions, to which Treasury Regulation Section 1.901-2(f)(3) or Section 909 would appropriately be applied.

Our preference would be to amend Treasury Regulation Section 1.901-2(f)(3) to cover such cases. Under this approach, a U.S. parent would not find itself in a situation in which it

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[139] See Treas. Reg. § 1.901-2(f)(3)(ii)(D) (foreign tax liability is not treated as being imposed on the combined income of related parties solely because foreign transfer pricing rules reallocate income from one party to another); Treas. Reg. § 1.909-2(a)(1), (b) (splitting events exist only in connection with the splitter arrangements identified in the regulation, which do not include transfer pricing adjustments).

would be possible to repatriate the income in question without bringing with it any of the relevant foreign tax credits; but the U.S. parent also would be prevented from inappropriately accelerating its foreign tax credits.

3. Recommendations Regarding the Treatment of Earnings-Stripping Rules and Other Limits on Deductibility of Payments

Some countries permanently disallow deductions for cross-border payments of expenses by a resident taxpayer, in situations identified as potentially abusive. Thin capitalization or earnings stripping rules may require permanent disallowance of interest expense of an over-leveraged borrower, even in cases where the lender is unrelated. A country also may disallow interest expense on hybrid instruments held by related or unrelated parties.

Where such rules disallow deductions in transactions between affiliates, we believe the analysis should logically be the same as for the transfer pricing and other related-party regimes discussed in Part IV.B.2 above: such disallowance rules typically should not cause issues as to whether a foreign tax meets the definition of a creditable income tax. In addition, when foreign tax law denies deductions in transactions not only between related parties, but also between unrelated parties, it appears a similar conclusion is appropriate. It is true that the operation of such rules does not merely re-allocate an expense among affiliates, but rather disregards entirely what may be a material amount. Nonetheless, rules of this nature can be viewed as a foreign country's adoption of a different view than the United States as to whether a payment in the relevant circumstances represents a genuine expense, as opposed to (for example) an item better treated as a return on an equity investment in the taxpayer by its owners. It does not appear that disallowance of such items represents a decision by the foreign country not to impose tax on the basis of net income.

The regulations currently in effect can logically be read as supporting this result, because they require only that the "predominant character" of a foreign tax be that it grants deductions for a taxpayer's expenses attributable, under reasonable principles, to its gross income (or for a formulaic amount that approximates such expenses). The regulations also suggest that a rule that permanently disallows an expense may be part of a regime determining which expenses are attributable to the taxpayer's income.[140] Guidance expressly confirming that anti-abuse rules disallowing deductions do not prevent the net income test from being met would, nevertheless, be helpful, in view of the increasing number and variety of such rules in foreign tax laws.

140 Treas. Reg. § 1.901-2(b)(4)(i) (citing Section 265 as an example of a provision in the Code that matches expenses to income).