

FTC Regs: Constructing A Path Forward

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In this article, the authors explore how the recent changes in the foreign tax credit regulations have introduced several possibly unintended consequences to the engineering and construction industry.

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The engineering and construction (E&C) industry has a long history of its U.S.-based workforce providing technical engineering assistance to projects located in foreign jurisdictions. Also, the industry focuses on fostering innovation, including the development and use of new technologies and engineering principles, so that many E&C companies qualify for various credits and incentives in the foreign jurisdictions in which they operate. Because effective and clear regulations on applying foreign tax credits to prevent double taxation are important for the global competitiveness of the U.S. E&C industry, this article explores how those companies will be affected in seemingly unintended ways by the final FTC regulations.

Overview

The final FTC regulations were published in the *Federal Register* January 4.¹ They largely

adopted proposed regulations issued in 2020 that advanced revisions to the definitions of “foreign income tax” in reg. section 1.901-2 and “in lieu of tax” in reg. section 1.903-1.² In particular, the final FTC regulations change the determination of creditable foreign income taxes, including the amount of foreign taxes that would be creditable under sections 901 and 903. The regs finalize an attribution requirement that generally targets extraterritorial taxes (such as digital services taxes). The effect of that attribution requirement is not limited, however, to DSTs and the like.

Under the IRS's prior administrative practice, a reduction in foreign tax liability through the application of government incentives in the form of tax credits (for example, research and development or investment credits) that are refundable under foreign law did not reduce the amount of foreign income taxes paid for purposes of the FTC, if it could be established that the foreign government issued more than a de minimis amount of cash payments to taxpayers whose available credit exceeded their foreign tax liability.³ Under that administrative practice, those credits were treated as constructive payments of cash that gave rise to taxable income. The final FTC regulations provide that refundable credits will reduce the taxpayer's foreign income tax that may be claimed as a credit by the amount of that refundable credit unless those credits are fully refundable in cash at the taxpayer's option. If foreign law allows the full amount of a tax credit to be paid in cash at the taxpayer's option, the taxpayer's choice to apply all or a portion of the

¹ See T.D. 9959.

² See REG-101657-20.

³ See TAM 200146001; GCM 39617; Rev. Rul. 86-134, 1986-2 C.B. 104.

tax credit in satisfaction of its foreign income tax liability is treated as a constructive payment of cash to the taxpayer in the amount so applied, followed by a constructive payment of the foreign income tax liability against which the credit is applied.

The changes made by the final FTC regulations apply to foreign taxes paid or accrued in tax years beginning on or after December 28, 2021.

U.S. E&C companies, now more than ever, conduct their operations globally with, on average, more than 30 percent of their revenue⁴ generated from sources outside the United States. Inherently, E&C companies are subject to tax in the foreign jurisdictions in which they service commercial and governmental clients because the contractual nature of the industry generally requires a local contracting enterprise to hold the necessary licenses.⁵ Further, the E&C industry involves the provision of professional services related to complex projects for which only a limited portion of the available labor force has the requisite experience — that is, trained and experienced engineers are hard to come by in the current labor market. This limited available skill set, exacerbated by COVID-19, has resulted in an increasing prevalence of engineering services being provided and supported from the United States and design centers around the world. The implication is that such engineering and design center support is charged under transfer pricing principles to the local contracting enterprise.⁶ These engineering and design center support charges are often classified as technical service charges and subject to foreign withholding tax.

The E&C industry is multifaceted and arguably focused on tackling some of the world's toughest problems — national and global security, cyberintelligence, environmental sustainability, transportation infrastructure, access to reliable water supplies, and so on. The market demands innovation in the face of that complexity. As such, the industry has a long history of fostering innovation, taking on risk for the development and use of new technologies and engineering principles, improving the structural design standards to mitigate hazards, etc. That innovation and uncertainty have led to many E&C companies qualifying for various credits and incentives in the foreign jurisdictions in which they operate. To administer those credits and incentive programs, many foreign jurisdictions use an offset mechanism in which that credit or incentive is applied first to offset other forms of tax otherwise due and payable.

Given this profile, effective and clear regulations governing the application of FTCs to prevent double taxation are high priorities for the global competitiveness of the U.S. E&C industry. As this article highlights, the E&C industry will be affected by the final FTC regulations in several seemingly unintended ways.

Attribution Requirements

The attribution requirement provides separate rules to determine whether a foreign tax is creditable based on whether the tax is imposed on residents or nonresidents of the jurisdiction imposing the tax. For a tax imposed on nonresidents to be a foreign income tax (and, therefore, a creditable foreign tax), it must meet one of three attribution requirements:

1. nexus based on activities;
2. nexus based on source; or
3. nexus based on situs of property.

Given the profile of the E&C industry, sourced-based nexus is likely to have the largest unexpected impact on the industry.

To meet the source-based nexus test, the base of the foreign tax must be limited to gross income arising from sources within the foreign country imposing the tax. The source rules must be reasonably similar to those of the IRC but need not conform in all aspects to U.S. sourcing rules. The regulations specify source rules under the

⁴This percentage was determined based on the most recent Form 10-K reports filed for the top E&C companies.

⁵The focus of this article is on E&C operations within a foreign jurisdiction that are not protected by a status of forces agreement or similar arrangement between the United States and an applicable foreign government.

⁶Another notable shift in the E&C industry is the increasing use of technology. Much of this technology is used by engineers in providing services. However, as E&C companies create bespoke technology, they will need to consider if their cross-border charges should also include the licensing of technology intellectual property.

foreign country pertaining to services and royalties⁷:

1. Income from services must be sourced based on where the services are performed.
2. Income from royalties must be sourced based on the place of use of, or the right to use, the intangible property.

Withholding Tax Application

The attribution requirements have implications on withholding taxes for payments made for technical services. Generally, a foreign country that withholds tax on a payment for services performed outside the country will not meet the source-based nexus requirement.

Example 1: Assume an E&C company (Company A) is a U.S. tax resident that performs services solely within the United States. Company A provides technical services relating to a construction project to a company residing in Saudi Arabia (Company B). Company A is not resident in Saudi Arabia and has no nexus in Saudi Arabia from a U.S. tax perspective. While the United States sources services based on where the services are performed, Saudi Arabia imposes a 15 percent withholding tax on services, based on the residence of the payer, even though those services are wholly performed within the United States. There is no tax treaty between the United States and Saudi Arabia. Because of the attribution requirement, the foreign taxes would not be eligible for the FTC, unless the foreign law requires a sufficient connection between the foreign country, that is, Saudi Arabia, and the taxpayer's activities or investments in that country to impose the tax. Thus, in this simplified example, the Saudi Arabia withholding tax would not qualify as a creditable tax for the FTC.

Example 2: Assume an E&C company (Company C) resides in Korea and pays a technical fee to Company A. There is a tax treaty between the United States and Korea. The withholding tax imposed under Korean law does

not satisfy the attribution requirement, and therefore is not creditable, absent the application of a tax treaty. If the Korea-U.S. tax treaty treats the withholding tax as an income tax under the relief from double taxation article, and Company A elects treaty benefits, the Korean withholding tax may be creditable under the final FTC regulations.⁸

Example 3: An E&C company (Company D) is located in a foreign jurisdiction (Country X) and provides technical services to Company B (a Saudi Arabia resident). There is a tax treaty between Country X and Saudi Arabia that restricts Saudi Arabia from imposing withholding tax on these technical services payments to residents of Country X unless those services are performed in Saudi Arabia. In this case, the foreign taxes could be eligible for the FTC, because the foreign-to-foreign treaty modifies the services payment to be sourced in a manner reasonably similar to U.S. tax law (that is, based on where the services are performed).⁹

Refundable Credits

To the extent a foreign tax liability may be reduced by a tax credit, the amount of foreign tax treated as paid for U.S. federal income tax purposes may be reduced. For example, the United Kingdom offers corporation tax relief on a company's R&D costs, which is approximately 13 percent of the company's qualifying R&D expenditure. Assume a taxpayer has a \$100 tentative income tax liability in the United Kingdom, and the United Kingdom grants a \$20 R&D expenditure credit to the taxpayer that may be applied against that tax liability. Under the new FTC regulations, the \$20 credit would reduce the amount of U.K. tax paid from \$100 to \$80, because the U.K. credit first offsets any corporation tax liability, and there is no option for the taxpayer to receive the full amount of the credit in cash. Accordingly, the U.K. credit results in a reduction of the U.K. effective tax rate for U.S. tax purposes.

⁷ Reg. section 1.901-2(b)(5)(i)(B).

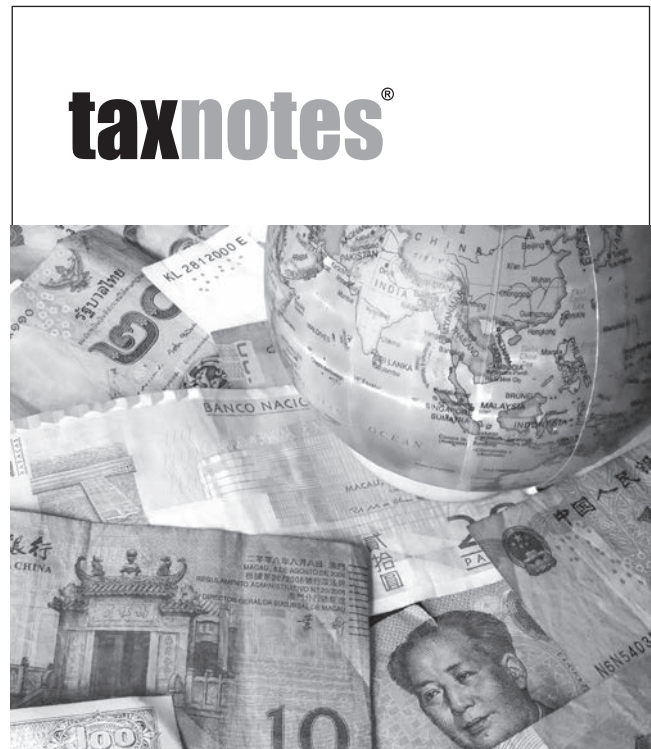
⁸ Reg. section 1.901-2(a)(1)(iii).

⁹ *Id.*

Similar to the United Kingdom, several foreign governments (for example, the Netherlands, France, and Canada) administer R&D incentives through a refundable credit regime. Under the new FTC regulations, those credit regimes would reduce the amount of foreign tax paid, unless they were fully refundable in cash at the taxpayer's option (that is, if the credit need not be applied against foreign tax liability).¹⁰ ■

¹⁰ The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

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