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KPMG in the US

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New regulations apply nexus rule restricting eligibility for US foreign tax credits

Mark Martin and Thomas Bettge of KPMG in the US discuss certain aspects of recent US Treasury final regulations regarding foreign tax creditability.

On January 4 2022, the US Treasury Department published final foreign tax credit regulations.

The new regulations span over a hundred pages in the Federal Register and address a dozen different topics, ranging from the timing for claiming tax credits for contested foreign taxes to the sourcing of subpart F and global intangible low-taxed income (GILTI) inclusions. One particularly significant change is a revised definition of what constitutes a creditable foreign income tax. This article focuses on a few of the most salient issues raised by that new definition.

Section 901 of the Internal Revenue Code provides US citizens and domestic corporations a credit for income taxes paid or accrued to a foreign country during a taxable year, subject to the limitation of section 904, which is designed to prevent crediting foreign taxes against US-source income.

Before the recent update, Treas. Reg. § 1.901-2 generally provided that a foreign levy constituted an ‘income tax’ if it was a tax (i.e. a compulsory payment made under the authority of the foreign government to levy taxes) and its predominant character was that of “an income tax in the US sense”. This basic principle was fleshed out by in considerable detail in the regulation, but the historical definition of a creditable income tax notably did not include a requirement that the tax in question be levied on income with nexus to the taxing jurisdiction.

The new regulations change that. Proposed regulations issued in 2020 floated a jurisdictional nexus requirement that would generally require the foreign country imposing a tax to have sufficient nexus to the taxpayer’s activities or investments that give rise to the foreign taxes for the taxes to be creditable under section 901.

This proposal drew a number of public comments arguing that a nexus requirement was inappropriate because section 901 allows a credit for income taxes paid to foreign countries, and the plain meaning of an ‘income tax’ refers to whether the base of the tax is net income rather than its nexus to the country imposing the tax.

Nonetheless, the final regulations adopted the jurisdictional nexus concept, though it was restyled as an attribution requirement and some changes were made to the initial proposal. Except for Puerto Rican taxes, for which a one-year transition period is provided, this revised definition applies to foreign taxes paid in taxable years beginning on or after December 28 2021. The new regulations also update the definition of taxes in lieu of income taxes (e.g. withholding taxes) under section 903.

In the preamble to the final regulations, Treasury explained that a nexus requirement is reasonable because judicial and administrative interpretations of section 901 “have consistently followed the principle . . . that the determination of whether a foreign tax is creditable under section 901 is made by evaluating whether such tax, if enacted in the United States, would be an income tax,” and that “US tax law has long incorporated a jurisdictional nexus limitation in taxing income of foreign persons.”

Under the new nexus rules, foreign source-based taxes must apply sourcing rules similar to the US sourcing regime. For most other foreign taxes imposed on a nonresident of the taxing jurisdiction, the new regulations generally require that the tax be based on principles similar to existing permanent establishment and US effectively connected income rules.

If the foreign tax is imposed on residents of the taxing jurisdiction, the new attribution rule requires that the tax regime apply the arm’s-length principle to any allocations made with respect to intercompany transactions, “without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.”

In other words, a residence-based tax is now creditable in the US only if the foreign jurisdiction applies accepted transfer pricing (TP) principles, rather than fixed prices or margins for controlled transactions or formulary apportionment.

Importantly, the residence-based tax rule does not mean that a specific taxpayer’s TP needs to be arm’s-length for the associated foreign taxes to be creditable (note, however, that the voluntary tax rules under section 901 may effectively require this in some cases). Rather, it means that the foreign jurisdiction’s allocation rules must comply with the arm’s length principle.

In other words, even if a foreign country’s TP rules produce arm’s-length results for a taxpayer’s transactions, the tax paid to that country could be non-creditable if the country’s rules produce non-arm’s length results with respect to other transactions in which the taxpayer did not engage.

The IRS would need to make this determination on a jurisdiction-by-jurisdiction basis (though it is currently unclear how it would go about this), and a conclusion that the jurisdiction does not apply the arm’s-length principle would render all of that jurisdiction’s residence-based taxes non-creditable. An adverse determination in this regard seems most likely to apply to Brazil, but the IRS may determine that other jurisdictions fail to meet this standard as well.

The final regulations also require a foreign levy to meet the attribution requirement in order to qualify as an ‘in lieu of’ tax under section 903. This generally makes withholding taxes imposed on payments for services performed outside of the taxing jurisdiction, or withholding taxes imposed on royalties for the use of intangible property used outside of the taxing jurisdiction, non-creditable.

The attribution requirement was meant to prevent the US fisc from bearing the burden of credits for what Treasury regards as problematic digital service taxes (DSTs). However, the regulations go beyond just targeting DSTs and deny creditability for a much broader swathe of foreign taxes, many of which are of long-standing and have long been accepted as creditable in the US.

Notably, it appears that taxes under pillar one’s Amount A – if adopted – would not be creditable under these rules. Because pillar one would also eliminate participating jurisdictions’ DSTs, its implementation – which is currently targeted for 2023 – could provide an occasion for Treasury to revisit the role of a nexus requirement in the US foreign tax credit regime

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