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International Tax ADVISORY ■

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Digital Services Taxes and Nexus for Foreign Tax Credit Purposes

The Internal Revenue Code has long provided U.S. taxpayers a dollar-for-dollar credit against U.S. income tax for any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States (or taxes paid in lieu of such taxes generally imposed by such foreign country or U.S. possession). The foreign tax credit (FTC), while subject to certain limitations, generally works to prevent double taxation of U.S. taxpayers subject to tax in the United States and at least one other jurisdiction when the taxpayer's foreign taxable income is attributable to the taxpayer's activities or investments in such other jurisdiction.

Under current Treasury regulations, a foreign tax qualifies as an income tax for purposes of taking the FTC if the foreign tax is likely to reach "net gain" under the normal circumstances in which it applies but only if it is not dependent on the availability of an income tax credit in another country. A foreign tax is likely to reach net gain if, and only if, the predominant character of the tax satisfies three specific requirements set out in the regulations: the realization, gross receipts, and net income requirements. The purpose of these three requirements is to ensure that the FTC only offsets foreign levies that have a base similar to the U.S. income tax base. Under these regulations, a foreign tax either is or is not an income tax in its entirety and has the same result for all persons subject to the foreign tax.

Treasury issued Proposed Regulations in November 2020 that would revise the analysis used to determine whether a foreign tax is an income tax for FTC purposes by (among other things) adding a jurisdictional nexus requirement in addition to the net gain analysis. This jurisdictional nexus requirement is satisfied if the foreign tax is imposed on residents of the foreign country or if the tax is on income attributable to a nonresident's (1) activities in the country (including functions, assets, and risks within the country) without taking into account the location of customers, users, or any other similar destination-based criterion; (2) income sourced within the country (under sourcing rules similar to that of the United States' sourcing rules); or (3) property situated in the country (including real property situated within the country and movable personal business property with a taxable presence in the foreign country).

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The preamble to the Proposed Regulations explains that the purpose of such addition is to better conform the principles used to calculate the base of the foreign tax to those used for calculating U.S. taxable income and to ensure that income subject to foreign tax bears an appropriate connection to that foreign country for the foreign tax to be eligible for the FTC. Otherwise, the preamble states, such tax "is not an income tax in the U.S. sense and should not be eligible for a foreign tax credit if paid or accrued by U.S. taxpayers."

The preamble explains the decision to add this jurisdictional nexus as a response to the implementation or consideration by several foreign countries of "novel extraterritorial taxes that diverge in significant respects from traditional norms of international taxing jurisdiction." While the preamble does not name them directly, these "novel extraterritorial taxes" are widely considered to be a reference to digital services taxes (DST) that have been enacted in several European countries, including France, Spain, Italy, Turkey, Poland, and the United Kingdom. As implemented, DSTs are imposed on revenue from the provision of digital services to customers within the taxing country by multinational Internet companies that have worldwide revenue that exceeds the threshold set by the taxing country. The categories of digital services on which DSTs are imposed vary from country to country and include, among other things, advertising, streaming, and social media services. The DST is generally imposed based on where the users of the company's digital services reside as opposed to where the company is located.

Many of the multinational companies in the crosshairs of these DSTs are large U.S. tech companies that provide services over the Internet to users in the taxing countries. For these companies, the Proposed Regulations are especially troublesome because they would prevent such companies from offsetting the newly imposed DSTs against U.S. income. Consequently, comments to the Proposed Regulations provided by trade groups, corporations, and law firms have been extremely critical.

Almost universally, comments to the Proposed Regulations advocate for the jurisdictional nexus requirement to be removed from the final regulations. Arguments against the jurisdictional nexus requirement include that it unfairly penalizes the same companies that are targeted by DSTs; its implementation is unlikely to discourage countries from imposing DSTs; when combined with other changes in the Proposed Regulations, it will increase the incidence of double taxation and frustrate the purpose of the FTC, which will ultimately reduce the competitiveness of U.S. businesses; it should be implemented by Congress and not through regulations; and its inclusion in the final regulations would be inconsistent with the legislative reenactment doctrine because a similar requirement that was included in proposed FTC regulations in the 1980s was ultimately excluded from the final FTC regulations in 1983.

While these comments will give Treasury much to think about as it works toward final regulations, an international intervention on this issue may be forthcoming. The Organisation for Economic Co-operation and Development (OECD) has, for years, made reforming the international tax system to address tax challenges arising from the digitalization of the economy a priority. The OECD released a statement in December 2020 promising that by mid-2021 it will deliver a consensus-based solution for taxing digital services while also providing an effective means to eliminate double taxation in multilateral settings. Recently confirmed Treasury Secretary Janet Yellen has voiced support for participating in OECD negotiations related to DSTs and has indicated a need for agreement in this area, providing hope to the international community that the OECD's mid-2021 goal will be met.

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