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International Tax ADVISORY ■

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What's in a Name? Final FTC Regulations Rebrand the Jurisdictional Nexus Requirement

On December 28, 2021, the Treasury Department and the IRS issued another tranche of final foreign tax credit (FTC) regulations, which were officially published in the *Federal Register* on January 4, 2022. The final regulations are effective March 7, 2022 and generally apply to taxable years, or foreign income taxes paid or accrued in taxable years, beginning on or after December 28, 2021.

The final regulations are by no means a light read, spanning 101 pages in the *Federal Register*. For purposes of this advisory, we are focusing only on the attribution requirement, one of the most controversial provisions in the final regulations. It is worth noting that, among other things, the final regulations cover the disallowance of a credit or deduction for foreign income taxes on dividends eligible for a dividends-received deduction; the allocation and apportionment of interest expense, foreign income tax expense, and certain deductions of life insurance companies; the definition of a foreign income tax and a tax in lieu of an income tax (including the attribution requirement); the definition of foreign branch category income; and the time when foreign taxes accrue and can be claimed as a credit. The final regulations also include clarifying rules relating to foreign-derived intangible income.

The Attribution Requirement (f/k/a the Jurisdictional Nexus Requirement)

As a dollar-for-dollar credit against U.S. income tax, the FTC is intended to mitigate double taxation of foreign-source income. Under the former regulations addressing when a foreign tax will be creditable for U.S. purposes, issued in 1983, a foreign levy was creditable if it was a tax and had the predominant character of an income tax in the U.S. sense. Until now, the FTC regulations did not consider whether a sufficient nexus existed between the income subject to tax and the foreign jurisdiction imposing the tax.

The Treasury Department and the IRS decided it was time to modernize the former regulations to address changing circumstances, especially considering the taxation of the digital economy. The preamble to the final regulations explains that a nexus requirement is necessary because "many foreign jurisdictions have disregarded international taxing norms to claim additional tax revenue, resulting in the adoption of novel extraterritorial taxes that diverge in significant respects from U.S. tax rules and traditional norms of international taxing jurisdiction."

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The jurisdictional nexus requirement was introduced in the proposed regulations published in November 2020. Under the proposed regulations, a foreign tax imposed on a nonresident would satisfy the jurisdictional nexus requirement in one of three ways: (1) if the tax is attributable, under reasonable principles, to the nonresident's activities within the foreign country (the "activities-based requirement"); (2) if the tax is based on income sourced to the country imposing the tax (but only if the sourcing rules in the foreign country are reasonably similar to the sourcing rules in the United States) (the "source-based requirement"); or (3) if the tax is based on income from the sale or disposition of certain real or movable property located in the country imposing the tax (the "property-based requirement").

Despite drawing intense criticism, the final regulations adopt the jurisdictional nexus requirement introduced in the proposed regulations. While the final regulations make several modifications to the requirement, including replacing the term "jurisdictional nexus requirement" with "attribution requirement," the requirement in the final regulations is largely the same as the requirement in the proposed regulations. The preamble to the final regulations offers insight into the changed term, noting that the term "attribution requirement" replaces "jurisdictional nexus requirement" to "more clearly reflect that the rule provides limits on the scope of gross receipts and costs that are attributable to a taxpayer's activities and thus appropriately included in the foreign tax base for purposes of applying the other components of the net gain requirement."

The IRS received a number of comments on the proposed regulations and thoroughly responded to these comments in the preamble to the final regulations. In response to certain comments, the IRS modified and clarified aspects of the attribution requirement.

Modifications to the activities-based requirement

The final regulations provide additional clarity on the activities-based requirement. For example, the final regulations clarify that the activities-based requirement is not met when the nonresident is deemed to have a trade or business in the taxing jurisdiction by reason of activities conducted by another person, other than in the case of a party acting on behalf of the nonresident. The final regulations also clarify that a foreign tax law that attributes income to a nonresident based on the mere location of persons purchasing from the nonresident does not meet the activities-based requirement.

Modifications to the source-based requirement

The final regulations modify the source-based requirement to provide additional flexibility and clarity to address comments arguing that the determination of whether foreign sourcing rules are reasonably similar to U.S. sourcing rules would be complex and result in significant uncertainty because U.S. sourcing rules are not well defined. While foreign sourcing rules must be reasonably similar to the sourcing rules under the Code, the final regulations provide that the foreign tax law's application of sourcing rules does not need to conform in all respects to the interpretation that applies for U.S. income tax purposes. While numerous comments expressed concern about the increased incidence of unrelieved double taxation of cross-border payments for digital services when the source-based requirement is implemented, the IRS declined to except digital services.

To provide additional certainty, the final regulations specify the source principles that foreign tax law must apply to be considered reasonably similar to U.S. source rules. For example, gross income from services must be sourced based on where the services are performed, and gross income arising from gross receipts from royalties must be sourced based on the place of use of, or the right to use, the intangible property. It is worth noting that the U.S. source rule for royalties is unusual compared to typical source rules for royalties around the world (which are often residency based), which raises the issue of whether many foreign withholding taxes on royalties will be creditable in the United States.

Modifications to the property-based requirement

The final regulations clarify when the property-based requirement will be satisfied. A foreign tax can include in its base, under rules reasonably similar to the U.S. rules under the Foreign Investment in Real Property Tax Act of 1980, gross receipts attributable to (1) the sale or disposition of real property situated in the foreign country; or (2) the disposition of an interest in a corporation or other entity that is a resident of the foreign country that owns real property situated in the foreign country. Additionally, the final regulations clarify that a foreign tax imposed based on the situs of property may include in its base, under rules reasonably similar to the U.S. effectively connected income rules, gains derived from (1) the sale or other disposition of property forming part of the business property of a taxable presence in the foreign country; and (2) the disposition of an interest in a partnership or other pass-through entity that has a taxable presence in the foreign country to the extent the gains are attributable to the entity's business property in that foreign country. The preamble to the final regulations states that a foreign tax on any other gains of a nonresident will not satisfy the property-based requirement.

Modifications regarding interaction with treaties

The IRS received a number of comments expressing concern about how the jurisdictional nexus rule (now the attribution requirement) will affect the application of tax treaties between the United States and foreign jurisdictions. In response to these comments, the final regulations clarify that a foreign tax that is treated as an income tax under the relief from double taxation article of the relevant U.S. income tax treaty will meet the definition of a foreign income tax as to U.S. citizens and residents electing to claim benefits under that treaty. As noted in the preamble to the final regulations, U.S. multinationals with controlled foreign corporations (CFCs) should be mindful of the fact that CFCs are not treated as U.S. residents under U.S. income tax treaties, so CFCs resident in a third country do not qualify for benefits under U.S. income tax treaties. Thus, the final regulations clarify that taxes paid to a U.S. treaty partner by a third-country CFC are treated as a separate levy that must independently satisfy the requirements to be creditable.

Lingering Questions and Issues

While the final regulations undoubtedly offer some much-needed clarification of the attribution requirement, taxpayers and practitioners are still left wondering about several important questions. Among them, the final regulations, surprisingly, do not provide a rule for determining how "reasonably similar" a foreign rule must be for purposes of the source-based requirement. This leaves a lot of gray area for both taxpayers and the IRS when implementing the source-based requirement. Another open question is how the attribution requirement will interact with OECD Pillar One, which, once enacted, will impose destination-based sourcing requirements that are inconsistent with the attribution requirement. Going forward, taxpayers need to be mindful of the attribution requirement when determining their FTCs because certain foreign taxes that were previously creditable in the United States might now be treated differently.

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