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Foreign Tax Credit Considerations After Notice 2023-55

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Notice 2023-55 provides taxpayers with temporary relief from applying certain provisions of the final regulations that overhauled longstanding rules for determining whether a foreign tax is creditable (the "2022 Final Regulations"). The notice is the latest, and most significant, acknowledgment by Treasury and the IRS that the final regulations raise major issues. For the many taxpayers grappling with the new rules, the relief in the notice is very welcome. The relief is not, however, a panacea—it is temporary and leaves certain major issues unresolved. Treasury and the IRS have said they are considering extending the relief, though it remains to be seen whether the government will expand either the applicability date of the notice, the scope, or both. At the same time, the government and taxpayers are confronting new foreign tax credit questions due to global and U.S. developments, including questions about the credibility of foreign taxes likely to be enacted consistent with the OECD's Pillar 2 aspects as well as questions about the foreign tax credit provisions of the corporate alternative minimum tax.

How Did We Get Here?

The 2022 Final Regulations affected the creditability of not just the so-called "novel extraterritorial taxes," including digital services taxes, at which the regulations were principally aimed but also major foreign taxes that had historically been creditable, such as the Brazilian corporate income tax and withholding taxes on royalties and services, among other taxes. The new rules affect businesses across a variety of industries, as well as individuals.

With respect to the definition of foreign income tax under §901, the 2022 Final Regulations moved from a "predominant character" test that looked to whether the tax was likely to reach net gain in the normal circumstances in which it applied, to a four-part net gain test, with two requirements in particular-- cost recovery and attribution—creating the biggest issues.

The cost recovery rule requires that the foreign tax law permit recovery of significant costs and expenses, subject to a "principles-based exception" that permits disallowance that is consistent with a principal underlying the disallowances required in the U.S. tax code. Certain costs, specifically capital expenditures, interest, rents, royalties, services payments, and R&E, are per se significant costs. Following the 2022 Final Regulations, Treasury and the IRS subsequently issued technical corrections clarifying certain aspects of the cost recovery requirement as well as proposed regulations (the "2022 Proposed Regulations") that would require recovery of "substantially all" of each item of significant cost

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or expense, provide three numeric safe harbors (for example, a safe harbor for a disallowance of a stated portion of an item where the disallowance does not exceed 25% of the cost or expense), and modify the principles-based exception to permit disallowance consistent with any principle underlying the disallowances required under the income tax provisions of the Code, including the principles of limiting base erosion or profit shifting and addressing non-tax public policy concerns similar to those reflected in the Code.

The attribution requirement appears in both the new regulations under §901 (addressing foreign income taxes) and §903 (addressing foreign taxes in lieu of an income tax) and generally requires a sufficient nexus, under rules that use U.S. concepts, between the foreign country and the taxpayer's activities. For resident taxes, the attribution rule requires that the country's transfer pricing rules use arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion. That requirement created issues in particular for the Brazil corporate income tax, which has used transfer pricing rules with a formulary approach that relies on fixed margins. (Brazil has since passed legislation that shifts from the fixed margin approach to the arm's length standard in 2024, with an election to apply the rules in 2023.)

For nonresident taxes, the attribution rule requires that the foreign tax be imposed on income that is attributed to the country based on one of three principles—activities, source, or the situs of property. The source-based attribution rule requires that a foreign tax imposed based on source be limited to income arising from sources within the foreign country, where the sourcing rules of the foreign tax law are "reasonably similar" to the sourcing rules of the Code. That presents challenges because countries often do not use source rules like our own (e.g., place of use for royalties and place of performance for services). The 2022 Proposed Regulations introduced a "single-country license exception," which would provide some relief where the intangible property giving rise to the royalty being taxed by a foreign country is, in fact, being used solely in that foreign country. However, satisfying the requirements for the exception presented challenges for some taxpayers, such as those with unrelated party license arrangements that would require renegotiation to meet the documentation requirements of the proposed regulations. In addition, the single-country license exception also did not address withholding taxes on services, another major area of concern.

The 2022 Final Regulations also modified the requirements for a foreign tax to qualify as an in lieu of tax under §903. The regulations require that a levy be a tax and meet a substitution requirement, which can be satisfied if the tax is a "covered withholding tax" or satisfies four requirements—(i) there must be a generally-imposed net income tax, (ii) the in lieu of tax must substitute for not only the generally-imposed net income tax but also any other separate levy that is a net income tax, (iii) but for the existence of the in lieu of tax, the generally-imposed net income tax would otherwise have been imposed (the "close connection" test), and (iv) the aforementioned attribution requirement. The covered withholding tax rule also includes an attribution requirement.
One of the fundamental issues with the 2022 Final Regulations is that key elements assume that foreign tax laws are, or should be, designed like our own federal income tax. In many instances, the regulations prioritize conformity over relieving double taxation. This is a fundamental change from the historic approach to the foreign tax credit.

The 2022 Final Regulations also presented compliance and administrative challenges. For example, the regulations generally require key requirements for creditability to be assessed by reference to the terms of the foreign tax law, not the tax's overall substantive economic effect or how the tax applies in

practice. In some cases, the reason for a foreign country's enactment of a provision or formal legislative history could be relevant (e.g., under the close connection test in the §903 regulations).

Notice 2023-55

Notice 2023-55 allows taxpayers to rely on certain provisions of the prior final foreign tax credit regulations (i.e., those that applied before the 2022 Final Regulations) for a limited time period. First, taxpayers can rely on the prior version of Treas. Reg. §1.901-2(a) and -2(b), which contain the definition of foreign income tax and the old net gain requirement with the more flexible predominant character test. For this purpose, a rule in the old regulations for nonconfiscatory gross basis taxes is modified to provide that no foreign tax whose base is gross income satisfies the net income requirement, except where the tax base consists solely of certain investment income.

Second, with respect to in lieu of taxes, taxpayers must apply the final regulations, but are not required to apply the attribution requirements in Treas. Reg. §1.903-1(c)(1)(iv) (jurisdiction to tax excluded income) and Treas. Reg. §1.903-1(c)(2)(iii) (source-based attribution requirement).
The notice contains a consistency requirement, so that a taxpayer must apply the notice to all foreign taxes that they or any other person pay in a year ending within the relief period and for which the taxpayer would be eligible to claim a credit. All members of a consolidated group must apply the relief.

The relief is temporary--it applies to taxable years beginning on or after December 28, 2021 (the effective date of the 2022 Final Regulations) and ending on or before December 31, 2023. This relief period has created issues for fiscal-year taxpayers who are already in a tax year that ends beyond the relief period. The IRS has indicated publicly that it is aware of the issue and that it may be addressed in subsequent guidance.

What's Next?

By allowing taxpayers to rely on key aspects of the prior regulations, the notice gives taxpayers a reprieve from applying certain of the most challenging aspects of the 2022 Final Regulations, including attribution and cost recovery. Accordingly, the notice is helpful for taxpayers dealing with, for example, questions related to the Brazil corporate income tax (though certain other technical foreign tax credit issues may arise for taxpayers that elected to apply the new Brazilian transfer pricing regime in 2023), corporate tax regimes presenting cost recovery issues, services and royalty withholding taxes that may have failed the source-based attribution rule, and nonresident capital gains taxes that may have failed the attribution requirement.

The notice does not address, however, all of the material issues created by the 2022 Final Regulations. For example, the notice did not provide relief from the new regulations under §903, other than the attribution requirement. As a result, taxpayers still have to apply the nonduplication rule, which requires that an in lieu of tax substitute for not only the generally-imposed net income tax but also any other separate levy that is a net income tax, as well as the close connection test. Taxpayers and commentators have argued that these requirements go beyond the language of §903 and are inconsistent with prior court interpretations.

The notice also did not address the rules for the allocation and apportionment of foreign taxes in Treas. Reg. §1.861-20, which were also finalized in the 2022 Final Regulations. These complex rules present various compliance and interpretational questions and can result in taxpayers not being able to use

otherwise creditable foreign taxes because of how the taxes are assigned to groupings. Treasury and the IRS addressed one issue in the 2022 Proposed Regulations (limiting the application of the reattribution asset rule), but issues remain.

The notice also did not address emerging questions about the creditability of foreign taxes that may be imposed consistent with Pillar Two. Treasury and IRS representatives have said that they are considering these issues.

If the temporary relief is not extended to cover more years, there almost certainly will be controversies on major issues, such as regulatory validity and the interaction of the regulations with tax treaties, presented by the regulations covered by the notice. (And, if the substantive scope of the notice is not expanded, controversies on the rules left in place may arise in the meantime.) There is also likely to be controversy on the interpretation of the regulations, especially the elements of the regulations that further require a detailed analysis of the foreign tax law. Those provisions also seem likely to present administrative challenges for the IRS. For now, the notice delays a full reckoning with those issues.

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