FOREIGN TAX CREDIT REGULATIONS: NEXUS AS THE NEW CREDO

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INTRODUCTION

A U.S. taxpayer that is subject to income tax in both the U.S. and a foreign country can reduce the amount of tax payable to the U.S. by claiming a credit for foreign income taxes paid or accrued to one or more foreign countries. The principle is simple: taxpayers should not pay tax twice with regard to the same item of income. The application of the principle is not so easy, requiring a taxpayer to overcome several hurdles, including whether the tax is creditable.

The Internal Revenue Code ("Code") provides a credit for two broad classes of tax. First, Code §901 allows a credit for foreign taxes levied on "income, war profits, or excess profits." This is generally understood as the requirement that the foreign tax be an "income tax." Second, Code §903 allows a credit for foreign taxes levied "in-lieu-of" a tax on such items. An example is a gross income tax imposed on nonresidents in connection with income not attributable to a trade or business in the country, where residents with a trade or business are generally taxed on realized net income.[1]

A tax is generally creditable under Code §901 if it meets the net gain requirement. The net gain requirement is met if the foreign tax meets three tests:

- The realization test
- The gross receipts test
- The net income test

The realization test broadly requires that the tax be imposed on income when the income is realized.[2] The gross receipts test generally requires that the tax be imposed on gross receipts or certain equivalents.[3] The net income test requires that the tax be imposed on net income (*i.e.*, after recovery of expenses through deductibility or amortization).[4]

New regulations were adopted at the end of 2021. This article addresses some of the highlights.

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1 See the I.R.S. website.

2 Treas. Reg. §1.901-2(b)(2)(i).

3 Treas. Reg. §1.901-2(b)(3).

4 Treas. Reg. §1.901-2(b)(4)(i).

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NEW REGULATIONS

The new regulations modify the net gain requirement by requiring closer conformity to U.S. tax law, which is a recurring theme of the new regulations, and add another criterion: the attribution requirement.[5] This had been known as the jurisdictional nexus requirement in the proposed regulations but was renamed.

The effect is that some foreign taxes that were previously viewed to be creditable under prior regulations may no longer be creditable under the new regulations. The regulations take particular aim at taxes imposed under destination-based criteria, such as customers' location. An example would be a digital services tax that has become popular outside the U.S.

The components of the requirement differ depending on whether the taxpayer is a resident of the foreign country. Foreign tax paid by nonresidents of the foreign country meets the attribution requirement if there is nexus based on one or more of the following criteria: activities, sourcing rules, or property.

Attribution to Nonresidents

Activities-Based Nexus

Activities-based nexus requires that only gross receipts and costs reasonably attributable to the nonresident's activities in the foreign country are included in the tax base.[6] Such activities can include "functions, assets, and risks located in the foreign country." In general, attribution is reasonable if it follows principles similar to those set out in Code §864(c), which sets rules for determining effectively connected income ("E.C.I."). This means that gross receipts cannot be taken into account as part of the tax base if they are sourced based on the location of customers or users, or of people from whom the nonresident makes purchases. This requirement excludes rules that tax a taxpayer based on the activities of another person, including a trade or business or permanent establishment created by another person, unless that other person is an agent for or a flow-through entity owned by the taxpayer. In essence, this follows the holding in *Miller v. Commr.,*[7] a case that held a foreign corporation did not have U.S.-source income or effectively connected income when it was a subcontractor of a U.S. related party having a contract with a U.S. customer and all activities of the foreign corporation were performed outside the U.S.

Source-Based Nexus

Source-based nexus is twofold.[8] First, income that is included based on source is limited to income sourced to the foreign country. Second, the foreign country's sourcing rules must be similar to U.S. sourcing rules. In response to criticism, the final regulations require reasonable similarity but not complete conformity to U.S. sourcing rules for foreign persons. Specific rules are provided for three types of income:

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[5] T.D. 9959.

[6] Treas. Reg. §1.901-2(b)(5)(i)(A).

[7] T.C. Memo 1997-134, aff'd without pub. op., 166 F3d 1218 (9th Cir. 1998).

[8] Treas. Reg. §1.901-2(b)(5)(i)(B).

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- Income from services must be sourced to the place of performance, which cannot be based on the service recipient's location.
- Royalties must be sourced to the place of use or right to use the intangible property.
- Income from sales of property is completely excluded from eligibility for source-based nexus. If a taxpayer wants a foreign tax credit for such income, the foreign tax rule must fit either activities-based or property-based nexus.

Property-Based Nexus

> ***"Property-based nexus is the only way to meet the attribution requirement for a foreign tax imposed by a foreign country on nonresidents based on the situs of property, including ownership in a corporation or flow-through entity."***

Property-based nexus is the only way to meet the attribution requirement for a foreign tax imposed by a foreign country on nonresidents based on the situs of property, including ownership in a corporation or flow-through entity.[9]

Property-based nexus requires comparison to two provisions of U.S. tax law. First, with regard to real property, creditable foreign tax is limited to sums raised under rules similar to F.I.R.P.T.A., which imposes U.S. tax on foreigners holding U.S. real property. The second concerns tax incurred through disposition of property other than shares in a corporation, but including interests in a partnership, and based on the situs of property other than real property. Creditable foreign tax is limited to sums attributable to property that forms part of the business property maintained by the nonresident in the foreign country, as determined by rules similar to the E.C.I. rules under U.S. tax law.

Attribution to Residents

Wider latitude is provided for a foreign tax imposed on residents of the foreign country imposing the tax. The foreign tax on all of a resident taxpayer's worldwide income will pass the attribution requirement.[10] However, the foreign tax rules must require that income between the resident and affiliated entities (*i.e.*, income subject to transfer pricing rules) be calculated under arm's length principles. As with attribution to nonresidents, the tax cannot take into account destination-based criteria.

Income Tax Treaties

Tax treaties sometimes override domestic law, and the final regulations, to an extent, provide for that. If the article on relief from double taxation in a tax treaty between the U.S. and the foreign country treats a foreign tax as an income tax, that tax will be considered an income tax. However, such relief is limited to U.S. residents. A more limited form of relief is available to C.F.C.'s.

APPLICATION

Mr. A is a U.S. person who, through two tiers of flow-through entities, owns and operates a resort in Spain. He does not reside there. The resort is owned directly by a Spanish flow-through entity, which is owned by a Danish flow-through entity. Mr. A decides to sell the resort by selling all of his interests in the Danish entity. The transaction results in the imposition of Spanish capital gains tax at 19%, the rate for

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[9] Treas. Reg. §1.901-2(b)(5)(i)(C).

[10] Treas. Reg. §1.901-2(b)(5)(ii).

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nonresidents, based on the underlying real property being located in Spain. There is no Danish tax liability.

Mr. A naturally wants a foreign tax credit to offset his U.S. tax liability. Since Mr. A is a nonresident, the Spanish tax must have nexus with Mr. A based on activities, sourcing rules, or property. A sale of ownership interest in a flow-through entity is a sale of property, so source-based nexus is not a possibility. Furthermore, a tax on a nonresident's gains from the disposition of property based on the situs of the property can only meet the attribution requirement through property-based nexus. Activities-based nexus is therefore also eliminated.

The Spanish tax substantively has a similar effect as F.I.R.P.T.A.: a nonresident is taxed on the disposition of real property in the country. But were the situation reversed, with Mr. A as a Spanish resident holding interests in U.S. real property, Mr. A would not face F.I.R.P.T.A. tax. This is because the entity that Mr. A is disposing of would not be a U.S. corporation, and F.I.R.P.T.A. taxes foreigners who directly own U.S. real property or shares in a U.S. corporation holding real property. To achieve the mirror result (U.S. tax liability, to match Spanish tax liability in the actual scenario), Mr. A would have to make a check-the-box ("C.T.B.") election. He would then be considered a direct owner of the second-tier U.S. entity. But it is arguable that Spanish law effectively reaches the same result of a C.T.B. election for Mr. A by attributing the sale of the Danish entity to the underlying asset. The two countries' laws are mechanically different but achieve the same result. In fact, as one commenter noted, the language of the proposed regulations would have allowed this tax to be creditable, as the proposed regulations did not require the foreign tax to be similar to F.I.R.P.T.A.

The final regulations require reasonable similarity to F.I.R.P.T.A. and specify that the tax must be "attributable to the disposition of real property situated in the foreign country… (or an interest in a *resident* corporation or other entity that owns such real property) [emphasis added]." The Spanish tax therefore does not achieve property-based nexus.

Tax treaties are a backup. The final regulations require examination of the article on relief from double taxation, which allows for a credit to be taken. In the Spain-U.S. Income Tax Treaty, this is Article 24. In comparison to certain other treaties, such as the France-U.S. Income Tax Treaty, Article 24 of the Spain-U.S. treaty does not specify which taxes are considered income taxes. Instead, it simply allows a credit to U.S. citizens and residents for "income tax paid to Spain." But Article 2 (Taxes Covered) clarifies that the treaty (presumably including Article 24) applies to Spain's individual income tax. By allowing the credit against Spanish income tax, Article 24 appears to treat the individual income tax as an "income tax paid to Spain." Additionally, the preamble to the proposed regulations states that the new regulations are not meant to change the effect of existing tax treaties. It is likely that the treaty would have come to Mr. A's rescue.

CONCLUSION

A more circuitous path is now required to reach the correct answer. The more stringent requirements suggest that other U.S. persons in Mr. A's position may no longer be able to claim a foreign tax credit for a tax that is imposed on an indirect real property gain through two layers of corporations. Mr. A would have been among their number were it not for the treaty. Not all taxpayers will have this escape route.

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As one commenter to the proposed regulations noted increased reliance on tax treaties could lead to more inequitable imposition of U.S. tax, as the U.S. has many more treaties with developed than developing countries. While this comment reflects current views on social justice, it ignores the fact that, in the past, developing countries abstained from entering an income tax treaty with the U.S. for several reasons. For some countries, a treaty would impair the country's ability to collect full withholding tax on dividends, interest, and royalties. For others wishing to provide low tax rates for certain investments, U.S. tax law did not allow U.S. corporations to claim a "tax-sparing" foreign tax credit. A tax-sparing foreign tax credit would allow a U.S. corporation to claim an indirect foreign tax credit at the time it receives a dividend from a 10%-owned foreign subsidiary as if the general rate of income tax in the developing country were imposed, rather than a lower, incentive rate. Now that the U.S. has moved away from the indirect foreign tax credit and has adopted a foreign dividends received deduction for dividends received from certain foreign subsidiaries, developing countries may have greater interest in opening income tax treaty negotiations with the U.S.

Mr. A is one of the luckier taxpayers as the U.S. has an income tax treaty in effect with Spain.

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