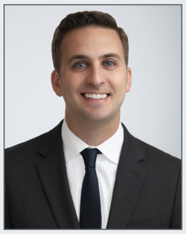
Miller & Chevalier

Treasury's Foreign Tax Credit Proposal Presents Downstream Risks

Jeffrey Tebbs and Caroline Reaves of Miller & Chevalier Chartered highlight the significant risks that taxpayers should consider when analyzing or adapting their license arrangements under Treasury's proposed foreign tax credit regulations.

Published in Bloomberg Tax, December 12, 2022



Jeffrey M. Tebbs
Member
jtebbs@milchev.com
202.626.1480

Caroline R. Reaves
Senior Associate
creaves@milchev.com
202.626.5939

The Treasury Department proposed regulations on Nov. 18 responding to concerns about the creditability of royalty withholding taxes under foreign tax credit regulations finalized in January 2022. Taxpayers can now rely on these measures, which also addresses cost recovery issues and the asset reattribution rule.

To qualify for relief under the proposed rules, taxpayers will need to analyze and potentially amend existing royalty license agreements. This article highlights the significant risks that taxpayers should consider when analyzing or adapting their license arrangements.

Background

Under the January 2022 regulations, foreign withholding taxes imposed on royalties aren't creditable unless foreign law sources the royalties based on the place of use, or the right to use, the intangible property. Royalty withholding taxes based on the residence of the payor are disqualified on an all-or-nothing basis even if the licensed intangible property is used solely within the foreign country imposing the tax.

Taxpayers expressed concern that these regulations would lead to double taxation of the same income depending on the formalities of foreign law rather than the substance of the arrangement. Treasury acknowledged those concerns in the proposed rules by clarifying that when intangible property is used exclusively in a foreign country, that foreign country should "have the primary taxing right over the royalty income."

To implement this policy, the measures introduce an exception for withholding taxes on royalties paid pursuant to single-country licenses. A tested foreign tax will satisfy the requirement to source based on place of use, if the income subject to foreign tax is characterized as gross royalty income under foreign law and royalties are paid pursuant to a single-country license. A single-country license agreement must characterize payments as royalties and limit the territory of the license to the foreign country imposing the tested foreign tax. The single-country license rule also may be satisfied under certain conditions by a license that separately states the portion of the payments due as attributable to the territory of the foreign country imposing the tax.

The taxpayer must execute qualifying license agreements on or before paying a royalty. Under a transition rule, agreements executed by May 17, 2023, may state that royalties paid on an earlier date are considered paid pursuant to the subsequent agreement.

Indeterminate Place of Use

The proposed rules don't address how to limit the territory in which the relevant intangible property is used. The proposed examples involve a generic license to use intangible property in specific territories with no explanation of its type, how it's used in the territory, the resulting product or service, or the location of the purchasers of that product or service.

Taxpayers looking to existing law addressing royalty sourcing will be left adrift. The phrase "place of use" is undefined in the tax code and regulations, and the seminal cases in the area are decades old. The available administrative guidance is undeveloped, inconsistent, and occasionally results-oriented. Determining place of use is particularly challenging for licenses of manufacturing intangible property, including patents, designs, and process know-how.

Consider a third-party license, which limits the use of manufacturing intangible property to a specific foreign country. The licensee exclusively manufactures a product in the territory imposing the tested foreign tax. Would the IRS conclude the single-country license exception is satisfied? What if the licensee sells the completed product to a distributor in the same territory and the distributor sells to customers in a neighboring country? Is the analysis affected by whether the intangible property is protected under the law of the country imposing the tax (for example, a locally registered patent)?

Given the narrowness of the single-country license exception, Treasury may be reluctant to address longstanding questions on place of use, with collateral impacts on the foreign tax credit more broadly. However, the single-country license exception will strain existing sourcing rules, extending those rules beyond their historic context of policing the line between U.S. and foreign source income.

Transfer Pricing Cliffs

The proposed rules allow a global or regional license, or an arrangement that bundles a license of intangible property together with other transfers (such as a provision of services), to satisfy the single-country license exception if the agreement "separately states" the amount of the payment attributable to royalties for use of intangible property in the country imposing the tested foreign tax. Taxpayers should approach the "separately stated" rule with caution and consider commenting on its harsher aspects.

The separately stated amount must adhere to "the principles of Sections 482 and 861." If the taxpayer "knew or had reason to know" that royalty allocations were inconsistent with transfer pricing or sourcing principles, the entire withholding tax is disqualified. Whether the taxpayer "knew or had reason to know" is determined based on whether a "reasonably prudent person" in the same position would question whether the agreement overstates the amount of the royalty—or misstates the territory in which the intangible property is used, implicating the ambiguity discussed above. Although the "reasonably prudent person" standard has been applied to withholding agents assessing the reliability of documentation under Section 1441, its application to the subjective judgments required under transfer pricing principles would be novel.

U.S. transfer pricing principles are a poor fit for an all-or-nothing determination. The regulations under Section 482 provide that any price within a range of results could constitute an arm's-length result. While prices outside that range may lead to a reallocation by the IRS, the agency must adjust the price consistent with an arm's-length result and cannot deny the benefits from the transaction altogether. In contrast, if the taxpayer fails the "reasonably prudent person" standard when separately stating royalties, none of the royalty withholding tax may be credited—not even the "correct" amount of source-based tax.

The proposed example suggests the government is concerned about intentional abuse of the exception. In the example, a taxpayer cancels an existing license with a related party, enters into replacement licenses that allocate 90% of royalties to intellectual property usage in the foreign country imposing the tax, when the taxpayer had reason to know the correct allocation was 40%. Although the example presents an egregious case, the rule itself is drafted broadly and not explicitly confined to controlled transactions, or to transactions in which the taxpayer's position reflected an allocation that was incorrect by a significant margin.

While the government's apparent concern is understandable, existing penalty rules would provide adequate safeguards, and the importation of the "reasonably prudent" standard should be reconsidered.

Conclusion

While the proposed regulations offer welcome relief on royalty withholding taxes, it will be challenging for taxpayers to rely on the "single-country license" exception. The application of the "separately stated" rule to all but the simplest arrangements may not be clear, with the potential result that the same withholding tax is creditable to certain taxpayers but not others.

Taxpayers are encouraged to evaluate their existing arrangements and submit comments by Jan. 23, 2023, to address these issues and any others identified.