COMMENTARY & ANALYSIS

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Proposed FTC Regulations Would Upend Creditability Standards

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In this article, the authors argue that recently proposed regulations concerning the foreign tax credit would fundamentally alter the predominant character test for determining creditable foreign taxes, and they examine the planned changes to that test and their possible effect.

I. Introduction

Last October the government published ambitious proposed regulations (REG-101657-20) concerning the foreign tax credit. The proposed regs address a wide range of issues affecting the availability of FTCs and would substantially rewrite the rules for determining whether a foreign levy is a creditable income tax under section 901. The regulations would introduce a new jurisdictional nexus requirement for creditability that has understandably garnered much attention.[1] But beyond this new hurdle for a tax to be creditable, the proposed regs would fundamentally alter the predominant character test for determining creditable foreign taxes established almost 40 years ago. This article examines the proposed changes to the predominant character test and their possible effect.

The FTC, which dates to 1918, is designed to mitigate the burden of double taxation for U.S. persons doing business abroad.[2] But only some taxes are eligible for the FTC. Section 901 permits credits for "income, war profits, and excess profits taxes."[3] Under the current regulations under section 901,[4] promulgated in 1983, a foreign levy is a creditable income tax only if it is a tax the predominant character of which is an "income tax in the U.S. sense." Foreign taxes are creditable, or not, for all persons subject to the tax. In this context, a tax must be a compulsory payment imposed under the authority of a foreign country to levy taxes. The predominant character of foreign tax is that of an income tax in the U.S. sense if it is "likely to reach net gain in the normal circumstances in which it applies," as determined under a three-pronged net gain test. That test looks to the events that trigger liability for tax (realization), the revenue subject to tax (gross receipts), and whether the tax permits the recovery of significant costs or expenses attributable to those gross receipts (net income). Under each prong, the foreign tax is evaluated on the basis of its predominant character. Consistent with the regulatory text and the litigated cases

[1] *See* Mindy Herzfeld, "Proposed FTC Regs: More Politics, Less Principle," *Tax Notes Int'l*, Oct. 19, 2020, p. 339.

[2] *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 9 (1932); *see, e.g.*, *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256, 283-284 (1995).

[3] Hereafter referred to as "income taxes" unless the context requires otherwise. Note that section 903 expands this term to include a tax paid in lieu of taxes otherwise generally imposed.

[4] Reg. section 1.901-2.

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under those regulations, the predominant character standard looks to the operation and effect of the foreign levy, which may be shown by introducing empirical evidence.

The proposed regs would limit the relevance of the normal circumstances in which a foreign tax applies and narrow the role of the predominant character analysis in determining if the tax meets each prong of the net gain test.[5] The foreign tax would also now need to meet a substantial jurisdictional nexus hurdle. The cumulative effect of these changes would introduce uncertainty into the relatively stable FTC regime and dilute the effectiveness of the FTC as a mechanism to reduce double taxation.

A. Path to the Predominant Character Standard

The predominant character standard embodied in the 1983 regulations has proved to be a stable, workable framework for assessing the creditability of a foreign levy, but getting there took some effort. The code does not define income taxes for purposes of the FTC, but this much is reasonably clear: The meaning of creditable income taxes is established by U.S. tax principles and not by the characterization or label applied by a foreign taxing authority.[6] But beyond this, what it means to be an income tax in the U.S. sense is not self-evident. Before the regulatory predominant character standard emerged, a patchwork of court cases and IRS rulings addressed the creditability of individual foreign taxes without clearly establishing touchstones for identifying the creditability of income taxes.[7] As one court noted, "The reaches of the word 'income' in section 901(b)(1) have been the subject of a long and tortuous history in terms of legislative background, the decided cases, and respondent's rulings."[8]

In the early 1970s, a trio of cases articulated a framework for assessing the creditability of a foreign tax that would influence the current regulations. In *Bank of America*,[9] the Court of Federal Claims held that some foreign taxes imposed on the gross income from the banking business were not creditable. After surveying prior judicial decisions, IRS rulings, and comparable provisions of U.S. law, the court concluded that the essential requirement of a creditable income tax is that the foreign country is "attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives." In this case, the taxes at issue did not meet this standard because they did not permit deductions attributable to the gross income subject to tax. However, under this formulation, even a tax levied on gross income could be creditable if it were clear that the associated costs and expenses were such that the persons subject to the tax would be expected to have some net gain remaining after payment of the tax. The Tax Court later endorsed the claims court's *Bank of America* formulation in a case involving the same taxpayer for subsequent years.[10] And in *Inland Steel*,[11] the claims court reaffirmed the *Bank of America* standard in holding that the base for a formulary tax on mining profits imposed by the Canadian province of Ontario did not reach net gain as contemplated by an income tax in the U.S. sense.

In the late 1970s and early 1980s, the IRS and Treasury sought to articulate rules of general application for what it means to be an income tax in the U.S. sense. Those efforts produced various formulations before settling on the current predominant character test in 1983. And each iteration struck a slightly different balance between requiring near identity to our code, at one extreme, and at the other permitting greater departure from the specific elements of the code while maintaining fealty to the underlying principles of an income tax.

B. 1979 Proposed Regulations

Regulations proposed in 1979 provided that an income tax must be imposed on "realized net

[5] *See* preamble to REG-101657-20, at 47.

[6] *Biddle v. Commissioner*, 302 U.S. 573, 579 (1938).

[7] *Seatrain Lines v. Commissioner*, 46 B.T.A. 1076 (1942); *Santa Eulalia Mining Co. v. Commissioner*, 2 T.C. 241 (1943); *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894 (3d Cir. 1943); *Commissioner v. American Metal Co.*, 221 F.2d 134 (2d Cir. 1955).

[8] *Bank of America National Trust & Savings Association v. Commissioner*, 61 T.C. 752, 759 (1974), *aff'd*, 538 F.2d 334 (9th Cir. 1976).

[9] *Bank of America v. United States*, 459 F.2d 513 (Ct. Cl. 1972).

[10] *Bank of America*, 61 T.C. 752.

[11] *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982).

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income." For this purpose, the base of the tax must be income and not wealth, accumulated profits, or some other non-income amount such as the value of capital assets or the number of units produced. The tax must be imposed at the time income is realized under U.S. principles and permit a reasonable opportunity to recover the significant costs or expenses incurred in generating gross receipts.[12] But the 1979 proposed regulations cautioned that the foreign tax would satisfy these requirements only to the extent that it is substantially equivalent to the degree to which the U.S. income tax meets the same requirements.[13]

C. 1980 Temporary and Proposed Regulations

The 1980 temporary regulations (also issued in proposed form) layered in more specifics and represented the direct forebear of the three-prong predominant character standard in the current regulations.[14] Under the temporary regs, a foreign tax is computed based on realized net income only if it meets the realization, gross receipts, and net income tests. The realization prong looks to whether the tax is imposed on events that would trigger the realization of income under U.S. principles and specified events occurring earlier, such as the transfer or processing of readily marketable property. The gross receipts test looks to whether the base of the foreign tax consists of actual gross receipts or an amount designed not to exceed actual gross receipts and approximates fair market value. The net income test looks to whether the foreign tax permits the deduction of actual expenses and capital expenditures (costs) reasonably allocable to gross receipts or an amount designed not to be less than actual costs and is equal to or greater than actual costs.

Dropping the substantially equivalent standard from the 1979 proposed regulations, a foreign tax is creditable under the 1980 temporary regulations only if it satisfies each of the three prongs of the predominant character standard without substantial deviation.

D. 1983 Proposed and Final Regulations

The IRS and Treasury went back to the drawing board with new proposed and final regulations in 1983.[15] The proposed regulations retained the three-pronged predominant character standard but clearly represented a relaxation of the formulation in the 1980 regulations. Thus, for example, the proposed regulations dropped the requirement that a foreign tax satisfies each prong without substantial deviation. And they relaxed the predominant character test in other ways. For example, the gross receipts test was satisfied if the tax is imposed on gross receipts computed under a method that is "likely to produce an amount that is not greater than fair market value," dropping the requirement that the tax must be designed to do so. And the gross receipts test could be met even if the base of the foreign tax includes some amounts that do not meet this test. Similarly, the net income test was satisfied if the foreign tax permits the recovery of the significant costs and expenses attributable to gross receipts or an amount computed under a method that is likely to approximate the recovery of actual costs and expenses. Further, the net income test was expressly met even when the foreign law does not permit the recovery of one or more significant costs or expenses as long as it provides allowances that effectively compensate for the disallowed costs or expenses.

The proposed regulations expressly held out the possibility that a tax imposed on gross income nevertheless could be found to be an income tax. Under the regulations, a tax whose base is gross receipts or gross income can satisfy the net income requirement, but only if persons subject to the tax are "almost certain never to incur a loss (after payment of the tax)."

The predominant character test was retained without substantial change in the final 1983 regulations. As the preamble confirms, the regulations adopt the "criterion for creditability" articulated in the *Bank of America* trio of cases.[16]

The predominant character test adopted in 1983 seeks to identify creditable foreign taxes by

[12] LR-100-78, 44 F.R. 36071, 36073 (June 20, 1979).

[13] 44 F.R. 36074 (June 20, 1979).

[14] 45 F.R. 75647 (Nov. 17, 1980) (temporary regulations) and 45 F.R. 75695 (Nov. 17, 1980) (proposed regulations).

[15] 48 F.R. 14641 (Apr. 5, 1983).

[16] T.D. 7918.

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reference to the essential elements of an income tax in the U.S. sense, rather than direct correspondence to the specific elements of our current income tax laws. This principles-based approach permits foreign levies to differ from our own income tax as long as they retain its core elements. The predominant character test reflected in the 1983 regulations invites the introduction of empirical evidence of the operation and effect of the tax. In this respect, the 1983 regs represented a substantial shift to permit consideration of the effect of the levy and not just its text or alleged purpose.[17]

E. Influences on Predominant Character Standard

The contours of the regulatory predominant character test were further developed through a series of litigated cases in which the IRS challenged the introduction of evidence showing the operation and effect of provisions of the foreign taxes in question. Those cases consistently found that the operation and effect of the tax are controlling and that empirical evidence showing operation and effect is permissible even if not required.

For example, in *Phillips Petroleum*,[18] the court considered whether a series of levies imposed by Norway on income from petroleum production activities satisfied the gross receipts test. For purposes of these levies, income was deemed realized when petroleum production (largely from offshore fields) reached a designated place of delivery even if the oil was not sold. And gross receipts were computed using a "norm price system" developed and administered by a board appointed by the Crown. The norm price represented an average price applicable to all taxpayers and was used to determine gross receipts even if the taxpayer sold oil to unrelated parties.[19]

The IRS conceded that the Norwegian levies satisfied the realization requirement under the 1980 temporary regulations applicable to the years in dispute, but argued that they flunked the gross receipts and net income prongs of the predominant character test. For the gross receipts prong, the IRS argued that the Norwegian levies were neither based on actual realized gross receipts nor were they computed under a permissible alternative method because the norm price system was not designed to produce an amount not greater than FMV and did not achieve that result.[20] However, on the evidence presented, including expert testimony and evidence of unrelated sales, the court found that the norm price system was both designed to produce an amount that approximated FMV and that it did so.[21] In this regard, the court rejected arguments that "approximates" should be construed narrowly in this context, noting that "valuation itself is far from an exact science."[22]

Perhaps no case underscores the effect of the predominant character test under the 1983 regulations more than the *Texasgulf* case, which considered the very same Ontario mining tax (OMT) that had been found not creditable in *Inland Steel*.[23] The OMT imposed a tax on profits generated from mining activities and not from subsequent processing and sale activities. In most cases, the base of the tax was determined using the value of the marketable minerals, as determined by a government mine assessor, reduced by the costs of further processing and an allowance for profit on processing activities. From this amount, taxpayers were permitted to deduct costs incurred in mining activities, but no deduction was allowed for interest, cost depletion, or royalties. Texasgulf Inc. established that its processing allowance exceeded these disallowed expenses in 10 of 13 years and the aggregate over a 13-year period.[24] The taxpayer also introduced evidence comparing the amount of the processing allowance and disallowed expenses using return information for the industry as a whole. That evidence showed that

[17] *See Texasgulf Inc. v. Commissioner*, 107 T.C. 51, 70 (1996) (noting that the regulations provide "objective and quantitative standards"); *see also Texasgulf Inc. v. Commissioner*, 172 F.3d 209, 216 (2d Cir. 1999) (holding that "quantitative empirical evidence may be just as appropriate as qualitative analytic evidence in determining whether a foreign tax meets the net income requirement").

[18] *Phillips Petroleum*, 104 T.C. 256.

[19] *Id.* at 262.

[20] *Id.* at 298.

[21] *Id.* at 299.

[22] *Id.* at 309.

[23] *Inland Steel*, 677 F.2d 72.

[24] *Texasgulf*, 172 F.3d at 213.

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on returns reporting liability for OMT, disallowed expenses exceeded the processing allowance only 15.9 percent of the time.[25] On the strength of this evidence, the Tax Court found that Texasgulf met its burden to establish that the OMT provides allowances that effectively compensate for the disallowed expenses.[26]

On appeal, the Second Circuit rejected arguments that the kind of empirical evidence offered by Texasgulf should not be considered in evaluating whether the OMT satisfies the net income requirement. Pointing to the text of the regulations, the court found that terms such as "effectively compensate" and "approximates" indicate "that quantitative empirical evidence may be just as appropriate as qualitative analytic evidence in determining whether a foreign tax meets the net income requirement."[27] Nor was the court moved by the fact that *Inland Steel* had reached a different result. The provision of the 1983 regulations permitting consideration of whether the foreign law provides allowances that effectively compensate for disallowed expenses, together with the mandate that a foreign tax be an income tax or not for all persons subject to it, led the court to reach a different conclusion from *Inland Steel*.[28]

In the wake of *Texasgulf*, the Tax Court ruled in *Exxon*[29] that the United Kingdom's petroleum resource tax (PRT) satisfied the net income test under the 1983 regulations even though no deduction was permitted for interest and some other expenses.[30] And here again, the court considered empirical evidence of the operation and effect of the levy on taxpayers subject to the PRT. The PRT was imposed, in addition to a modified corporate income tax, on income from petroleum exploration and production activities in offshore areas controlled by the Crown. Among other features, the PRT provided generous exemption amounts and a safeguard feature that eliminated PRT liability unless profits exceeded 15 percent of invested capital, and even then, only 80 percent of those profits were subject to tax.[31] The PRT also allowed a deduction of 135 percent of capital expenditures with the additional cost recovery, or uplift amount, intended to compensate for disallowed interest charges.[32]

The taxpayer introduced industry data collected from PRT and corporation tax returns, some of which were confirmed by the U.K. tax authorities, showing that the PRT allowances effectively compensated for the disallowance of interest expense for Exxon and other taxpayers subject to the PRT.[33] Consequently, the court held that "purpose, administration, and structure of PRT" all indicated that PRT constituted "an income or excess profits tax in the U.S. sense."[34]

Most recently, in *PPL*,[35] the Supreme Court construed the regulatory predominant character standard as requiring a "commonsense approach that considers the substantive effect of the tax."[36] The Court was analyzing a one-time tax imposed in 1997 by the United Kingdom on a small set of previously privatized companies, mostly utilities. The incoming Labour government had pledged to adopt that levy, claiming that the profits of these companies, which previous Conservative-led governments had privatized, were excessive in the years after their privatization "because the companies were sold too cheaply and regulation in the relevant period was too lax."[37] As enacted, the windfall tax was calculated as 23 percent of windfall value, representing the excess of a formulaic value based on profits earned by the formerly government-owned companies in the years immediately after their privatization over their original flotation values. However, the windfall tax could be shown to be algebraically equivalent to a tax on excess profits. And thus viewed, with only a few exceptions, the tax fell only on companies that had profits exceeding this threshold. In finding the windfall tax creditable,

[25] *Id.*

[26] *Texasgulf*, 107 T.C. at 90.

[27] *Texasgulf*, 172 F.3d at 216.

[28] *Id.* at 216-217.

[29] *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999).

[30] *Id.*

[31] *Id.* at 346.

[32] *Id.* at 347.

[33] *Id.* at 347-348.

[34] *Id.* at 356.

[35] *PPL Corp. v. Commissioner*, 569 U.S. 329 (2013).

[36] *Id.*

[37] *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010).

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the Court emphasized that the creditability inquiry is not controlled by the characterization of the tax by the foreign country. Instead, "the crucial inquiry is the tax's economic effect."[38] The windfall tax reached net income, and as such, was an excess profits tax as understood in the United States, and thus creditable.

II. Restructuring After All These Years

As shown, the requirement that the foreign taxes be substantially equivalent to an income tax in the U.S. sense has a long history in both case law and the regulations, prompting relatively little litigation in recent years. The changes to the U.S. international tax regime in the 2017 Tax Cuts and Jobs Act necessitated additional guidance on several matters concerning the allowance of FTCs,[39] but nothing in the TCJA suggested the need for changes to the basic question of what is a creditable income tax.

Instead, the changes to the predominant character test appear to reflect a determination by the IRS and Treasury that greater fealty to the current IRC is required for FTCs. The preamble to REG-101657-20 provides that "Treasury and the IRS have determined that it is necessary and appropriate to revise the net gain requirement in order to better align the regulatory tests with norms reflected in the Internal Revenue Code that define an income tax in the U.S. sense, as well as to simplify and clarify the application of the rules." However, unlike the proposed jurisdictional requirement, which is animated by new foreign extraterritorial taxes,[40] it is unclear what is driving the changes to the predominant character standard to rules that are more prescriptive and leave less room for creditable foreign taxes to differ from the code. A discussion of the proposed changes and the stated policy reasons follows.

A. Predominant Character

The proposed regulations would severely curtail reliance on empirical evidence of the operation and effect of a foreign levy in favor of relying on the statutory text of foreign tax laws. Further, the proposed regulations modify the predominant character test into a more prescriptive test that essentially requires a foreign tax to hew very closely to the current IRC. Gone are broad, flexible principles for creditability; instead, a foreign tax would have to share a more direct correspondence with our code to be an income tax in the U.S. sense. The preamble to the proposed regs asserts that the use of empirical data to establish the normal circumstances in which a foreign tax applies "leads to inappropriate results and presupposes an empirical analysis requiring access to information that is difficult for taxpayers and the IRS to obtain." The proposed regulations thus purport to narrow the circumstances in which empirical data is relevant. Instead, the focus of the creditability analysis would be on the terms of the foreign law.[41] This new approach can be seen in proposed changes to each prong of the predominant character standard.

1. Realization Requirement Tightened

The 1983 regulations provide that realization is satisfied if tax is imposed on events that would result in realization of income under the IRC, upon the occurrence of a specified event before a realization event under the code (pre-realization events), such as mark-to-market or the physical transfer, processing, or export of readily marketable property. The realization standard is also satisfied in the case of some deemed distributions (think subpart F inclusions), but only if the foreign country does not later impose a second tax, such as upon an actual distribution. Importantly, the realization prong is satisfied on the basis of its predominant character even if the

[38] *PPL*, 569 U.S. at 335.

[39] The IRS and Treasury had previously issued FTC regulations in response to the TCJA. *See*, *e.g.*, T.D. 9882 and T.D. 9922. The proposed regulations would provide additional guidance triggered by TCJA changes, including rules for the disallowance of credits under section 245A(d) and the effect of the repeal of section 902. *See* preamble to REG-101657-20, at 4.

[40] The preamble, *supra* note 5, notes that the jurisdictional nexus requirement is driven by the variety of novel extraterritorial taxes adopted by multiple foreign countries that Treasury and the IRS believe "diverge in significant respects from traditional norms of international taxing jurisdiction."

[41] *See* reg. section 1.901-2(b)(1) (predominant character (and nexus) requirements apply "solely on the basis of the foreign tax law governing the calculation of the foreign taxable base, unless otherwise provided, and without any consideration of the rate of tax imposed on the foreign taxable base").

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foreign tax is imposed in some instances on events that would not meet the realization standard, and even if some persons are occasionally subject to the tax only on those non-realization events.[42]

The proposed regulations largely retain the existing elements of the realization test but restrict the extent to which a tax also may be imposed on non-realization events without flunking. A foreign tax that is otherwise imposed on qualifying realization (or pre-realization) events may be imposed on one or more categories of non-realization events only if "the incidence and amounts of gross receipts attributable to such nonrealization events is insignificant relative to the incidence and amounts of gross receipts attributable to events covered by the foreign tax that do meet the realization requirement." The realization test generally has not been the focus of the decided cases, and the proposed changes do not completely eliminate the relevance of empirical evidence. For example, empirical evidence would seem relevant to show that gross receipts attributable to non-realization events are insignificant. Instead, these changes qualitatively signal that there is less room for a foreign tax base to include amounts that do not satisfy the realization test and still qualify as creditable. As discussed below, bigger changes show up in the gross receipts and net income prongs of the predominant character test.

2. Changes to Gross Receipts Requirement

The 1983 regulations provide that the gross receipts test is satisfied if, judged on the basis of its predominant character, a foreign tax is imposed on actual, realized gross receipts or on a base "computed under a method that is likely to produce an amount not greater than fair market value." Again, in keeping with the general approach of the predominant character standard, the regulations confirm that a foreign tax may satisfy the gross receipts test even if it is imposed on some nonqualifying amounts.[43]

The proposed regulations would eliminate the rule that allows gross receipts to be computed under a method that is likely to produce an amount not greater than gross receipts. Although a levy will not flunk the gross receipts test if the base includes insignificant non-realization amounts, it cannot be based on an approximation of gross receipts. The preamble claims that a tax based on alternative measures of gross receipts "fundamentally diverges from the measurement of realized gross receipts" under the code and could result in a taxable base that exceeds the proper amount of income.[44]

Under the proposed regulations, the gross receipts test is only satisfied if the tax is imposed on actual gross receipts, gross receipts arising from some pre-realization timing events (for example, mark-to-market), or on gross receipts from an insignificant non-realization event (for example, imputed rental income from owner-occupied housing). The proposed rule would thus appear to disqualify taxes based on alternative measures of gross receipts, including the norm price system at issue in *Phillips Petroleum*. At the same time, the proposed rule would appear to narrow the role for empirical evidence to determine whether the extent to which gross receipts based on non-realization events are significant.

3. Net Income/Cost Recovery

The proposed regulations significantly narrow the ways in which a foreign tax may meet the net income or cost recovery requirement. A foreign tax satisfies the net income prong of the 1983 regulations if, judged on its predominant character, the tax permits the recovery of the actual significant costs and expenses reasonably attributable to the gross receipts subject to tax. Further, the net income test is satisfied if recoverable costs and expenses are computed under a method that is likely to produce an amount that approximates the actual costs and expenses. And a tax may satisfy the net income requirement even if it does not permit the recovery of one or more significant costs or expenses, provided that it offers allowances that effectively compensate for the nonrecovery of those significant costs or expenses.

As under current law, a tax satisfies the cost recovery standard of the proposed regulations if it permits the recovery of significant costs or

[42] Reg. section 1.901-2(b)(2).

[43] Reg. section 1.901-2(b)(3).

[44] Preamble to REG-101657-20, at 51-52.

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expenses reasonably attributable to gross receipts. But the proposed regulations drop the rule permitting costs or expenses to be calculated under a method that is expected to approximate actual costs or expenses. And the proposed regulations would gut the rule that permits a tax to provide allowances that effectively compensate for disallowed costs. Instead, a foreign tax under which significant costs or expenses are disallowed qualifies only if the foreign law permits "the recovery of an amount that by its terms may be greater, but can never be less, than the actual amounts of significant costs or expenses." According to the preamble, the compensating allowance rule under the 1983 regulations "fundamentally diverges from the approach to cost recovery in the Internal Revenue Code, and so is inconsistent with an essential element of an income tax in the U.S. sense."[45] Alternative allowances would satisfy the cost recovery prong of the predominant character test "only if the foreign tax law expressly guarantees that the alternative allowance will equal or exceed actual costs."

It is unclear how explicit foreign law must be to provide an express guarantee as contemplated by the proposed regulations. But the lone example that is given in the proposed regulations, that of percentage depletion under the IRC, suggests that the text of foreign law must unambiguously provide that an alternative allowance will equal or exceed actual costs and leaves no room for empirical evidence that this is likely to be the case. Section 611 authorizes a deduction for depletion of mineral properties. In general, the capitalized costs of mineral properties may be ratably recovered as minerals are produced.[46] Alternatively, section 613 provides recovery of capitalized costs of mines, oil and gas wells, and other mineral deposits through a deduction calculated as a percentage of the gross income from the property. Over time, percentage depletion may exceed actual costs — because it is not bounded by cost basis. But section 613 also provides that "in no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section." This kind of guarantee is likely to be a rare feature under foreign law.

Eliminating the rule allowing courts to consider whether allowances under a foreign tax effectively compensate for the disallowance of significant costs or expenses would arguably overturn the holdings in *Texasgulf* and *Exxon*. Theoretically, empirical evidence would remain relevant under the cost recovery standard to evaluate whether a disallowance is significant.[47] But even so, the proposed regulations provide a broad list of costs or expenses that are per se significant that includes "costs and expenses related to capital expenditures, interest, rent, royalties, services, or research and experimentation." Costs not captured in this wide net do not come readily to mind.

Apparently acknowledging that the IRC sometimes disallows costs or expenses that, by this definition, are significant, the proposed regulations add a new rule that has attracted criticism. Under this rule, a foreign tax may satisfy the cost recovery rule even if it disallows significant costs or expenses, as long as the disallowance is "consistent with the types of disallowances required under the Internal Revenue Code." So for example, a foreign tax still could be creditable if it included a provision consistent with the interest disallowance rules of section 163(j) under current law.[48] This new rule would require frequent reconsideration of creditability depending on amendments to the code. As one commentator noted, a foreign tax that included an identical provision likely would not have been creditable in years before 2018 when section 163(j) became effective.[49]

Lastly, the proposed regulations eliminate language that a tax on gross receipts can ever

[45] *Id.* at 55.

[46] Reg. section 1.611-2.

[47] Preamble to REG-101657-20, at 57.

[48] Following the TCJA, section 163(j) generally caps deductions for business interest to an amount equal to the sum of the business interest income of the taxpayer, 30 percent of adjusted taxable income, and any floor plan financing interest for the tax year.

[49] *See* Catherine G. Schultz, "Proposed FTC Regulations Reg. 101657-20," National Foreign Trade Council (Feb. 10, 2021). Another commentator noted that this new rule would create uncertainty over whether a disallowance is consistent with disallowances under the code. *See* Gordon E. Warnke, "Report on Proposed Regulations Providing Guidance Related to the Foreign Tax Credit," New York State Bar Association (Feb. 9, 2021).

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satisfy the net gain requirement. Instead, "the base of a foreign tax should conform in essential respects to the determination of taxable income for Federal income tax purposes." But of course, this is exactly what the predominant character standard seeks to do under the 1983 regulations. Treasury and the IRS have determined that any foreign tax imposed on a gross basis "is by definition not an income tax in the U.S. sense, regardless of the rate at which it is imposed or the extent of the associated costs." The preamble contends that this change would eliminate the compliance and administrative burden of the empirical standard inspired by *Bank of America*.

B. Consequences of the Changes

The role of empirical evidence would be significantly narrowed if the proposed regulations were adopted. The preamble levels three criticisms at the use of empirical evidence to evaluate creditability: It argues that empirical evidence of the sort invited by the current regulations is unnecessary to evaluate creditability in some respects. Further, the absence of specific guidance on evaluating empirical data makes it difficult to apply the regulations. And finally, in some cases, reliance on empirical evidence creates uncertainty and is an undue burden on taxpayers and the IRS alike.[50] These criticisms miss the mark in important respects.

It is certainly the case that resorting to empirical evidence is unnecessary in many, if not most, cases. The creditability of a foreign tax under the current regulations often may be assessed without empirical evidence. The statutory language of the foreign law will always be the starting point for any creditability analysis. Further, the current regulations do not mandate the use of empirical evidence but merely permit it. As the Second Circuit explained in *Texasgulf*, the regulatory text indicates that "quantitative empirical evidence may be just as appropriate as qualitative analytic evidence in determining whether a foreign tax meets the net income requirement." For this reason, the court held that empirical evidence of the type offered there "may be used to establish that an allowance effectively compensates for nonrecoverable expenses."

The move away from empirical data makes the creditability determination more reliant on foreign law characterizations of a tax, contrary to the Supreme Court's decisions in *Biddle* and *PPL*. In *Biddle*, the Court considered the creditability of a U.K. tax levied on dividends. Finding that the term "income tax" as used in section 131 (predecessor to section 901) must be understood in light of our tax laws, the Court observed, "There is nothing in its language to suggest that, in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation." Picking up on this theme in *PPL*, the Supreme Court explained that "instead of the foreign government's characterization of the tax, the crucial inquiry is the tax's economic effect."[51]

Indeed, the windfall tax at issue in *PPL* is a good example of how labels and even the way the U.K. government described the tax do not tell the full story. The Labour government at the time of enactment argued that the tax was needed because the privatized companies it targeted had been sold too cheaply and then were laxly regulated in the years after privatization. But this arguably contradictory description, and the unique terminology introduced in the text of this one-time levy, obscured the nature of the tax. By its terms, the base of the windfall tax was the difference between the "value in profit-making terms" of the privatized companies and the aggregate price at which they were sold in an initial public offering.[52] However, readily available information about the incidence of the tax for all companies subject to it showed that the "windfall tax is a tax on realized net income disguised as a tax on the difference between two values, one of which is completely fictitious." As it turns out, "value in profit-making terms" was determined largely by reference to the reported profits of the subject companies in the years after privatization. And, in substance, the windfall tax

[50] Preamble to REG-101657-20, at 47.

[51] *See also PPL*, 569 U.S. at 329 ("We apply the predominant character test using a commonsense approach that considers the substantive effect of the tax.").

[52] *See PPL*, 135 T.C. at 313.

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operated like a classic excess profits tax imposed on net gain.

It seems likely that if a court could only consider the text of a tax without regard to its operation and effect, as contemplated by the proposed regulations, the U.K. windfall tax would not be creditable.

III. Is Any of It Necessary?

As discussed, the IRS justifies the changes to the predominant character test by stating that the current regulations are burdensome for taxpayers to comply with, difficult for the IRS to administer, and uncertain in their application because they require in some cases an empirical analysis of how foreign taxes affect taxpayers. The preamble states that the proposed regulations solve this problem by providing an objective standard that looks almost entirely to the face of the foreign law itself, rather than to its effect. But that standard is essentially whether foreign law matches U.S. law. While the requirement that a foreign tax be an income tax in the U.S. sense has long been a requirement for creditability, the proposed regulations would interpret this standard to require that the foreign tax law adhere closely to the current U.S. tax code.[53] Thus, to solve a problem with tax administration, the regulations would significantly narrow the universe of foreign taxes that could be creditable. The complexity of the current code results from countless policy and political compromises designed to raise revenue while encouraging or discouraging behaviors. The current U.S. income tax is far from an ideal or pure income tax, given the various special rules, allowances, and disallowances it reflects. The 1983 regulations avoid the need to address the intricacies and vagaries of the current code by adopting the essential principles of a tax that falls on net income and testing foreign taxes against these principles based on their operation and effect. This flexible framework has proven to be durable and in keeping with the remedial purposes of the FTC. Requiring a foreign tax to adhere more closely to the specifics of the current U.S. tax code will introduce uncertainty and dilute the effectiveness of the FTC in reducing double taxation. ■

[53]This more restrictive test under section 901 could push more taxpayers to argue that a foreign tax is a creditable in lieu of tax under section 903. But the proposed regs would narrow the range of foreign taxes that are creditable. Today a foreign tax qualifies as an in lieu of tax under section 903 only if it "in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed." Reg. section 1.903-1(b)(1). The foreign country's reasons for imposing the tax are immaterial. The proposed regs tighten the substitution requirement by requiring proof that the foreign country made a "cognizant and deliberate" decision to impose the tested levy rather than the generally applicable income tax. *See* preamble to REG-101657-20, at 75-76. This rule would mandate an inquiry into the intent of the foreign country, a significant departure from the current regs.

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