

## The Foreign Tax Credit Redux

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*In the preamble to its 2022 final regulations, the Treasury Department provided multiple justifications for its amendments based on the historic policy goals of Section 901 and the manner that judicial case law has construed this provision. Yet, in fact, the amendments made by the 2022 final regulations deviate away from the historic policy goals of the U.S. foreign tax credit without any Congressional authorization for doing so. Moreover, these 2022 final regulations represent a strong repudiation of the Supreme Court's own articulation of the Biddle doctrine in the PPL decision by attempting to formulate an interpretation of the Biddle doctrine that is inconsistent with the Supreme Court's own interpretation of its own doctrine. The U.S. Treasury Department has forged a diametrically opposite policy approach in this era compared to the one that Congress chose to pursue in the circa 1918-1921 era when it enacted Section 901's predecessor. In 1918, Congress adopted a unilateral foreign tax credit before a consensus on international taxation norms was forged, and the United States worked for a consensus on international norms in the succeeding years. In contrast, in 2022, the Treasury Department sought to deny foreign tax credit relief on destination-based taxes until a further international consensus on taxation of the digital economy is fully implemented. In 1918, Congress prioritized mitigation of international double taxation above the interests of the U.S. fisc and then worked to create a consensus on international taxation. In contrast, in 2022, the Treasury Department reversed the prioritization and created the real possibility of international double income taxation, which is antithetical to the policy goal that undergirds Section 901. Seen in light of its historical objectives and historical context, the Treasury Department's amendments to its Section 901 final regulations fail to satisfy the text, purpose, and policy goals that guided the original enactment of the foreign tax credit regime.*

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*Instead of pursuing the path that it has taken, the Treasury Department should withdraw its 2022 amendments.*

*The Treasury Department also did not address the policy implications of the implementation of the OECD Pillar Two framework even though the Treasury Department has endorsed that initiative. Under Pillar Two, a top-up tax would be applied to ensure that a minimum tax is paid by multinational enterprises, regardless of where they are headquartered or operate. These top-up taxes are conceptually an additional tax needed to arrive at a minimum tax and thus do not present a double taxation concern. As a result, these top-up taxes, applied by jurisdictions that adopt the OECD Pillar Two regime, should be denied foreign tax credit relief. In 2022, Congress adopted a corporate alternative minimum tax that does not comply with the GloBE rules. By enacting a provision that does not fit neatly with the GloBE rules, the enacted corporate minimum tax may represent a better outcome than if the United States had enacted a qualified IIR in compliance with the GloBE rules. But, the enacted legislation contains a deficiency. What should have been done concurrently with the enactment of this corporate alternative minimum tax (but was not done) was a companion amendment to Section 901 so that Section 901 would not afford foreign tax credit relief for any non-covered tax that is imposed as a top-up tax under the GloBE rules. Failing to do so has put the residual U.S. tax jurisdiction at risk of being eroded through minimum taxes imposed by other nations in preference to the corporate alternative minimum tax imposed by the United States. The OECD framework envisions that top-up taxes modelled after the GloBE rules would not be afforded foreign tax credit relief among nations, and so a denial of foreign tax credit relief for such top-up taxes by the United States would have been consistent with the international consensus endorsed by the OECD framework. Thus, the U.S. failure to make this conforming amendment to Section 901 represents a self-inflicted wound. Congress should correct this mistake by amending Section 901 to make it clear that top-up taxes under a qualifying IIR or a qualifying UTPR would not be afforded U.S. foreign tax credit relief. This is the reform that is needed under Section 901, not the imposition of close conformity requirements or the jurisdictional nexus requirements envisioned by the 2022 final regulations. Reform along these lines effectuates the policy goals sought by the OECD framework and also protects the U.S. tax base. It is now time for Congress and the Treasury Department to correct these mistakes.*

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## INTRODUCTION

This has been a remarkable two years. In October 2021, the Organisation for Economic Co-operation and Development (“OECD”) and G-20 set forth a joint statement indicating their broad agreement on the Pillar One and Pillar Two recommendations of the OECD.<sup>1</sup> As of November 4, 2021, 135 nations had agreed to make changes to their domestic tax laws to conform to the OECD Inclusive Framework.<sup>2</sup> The OECD has since

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<sup>1</sup> Organisation for Economic Co-operation and Development [OECD], *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, at 1 (Oct. 8, 2021), <http://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm> [<http://perma.cc/ULK7-3SCH>].

<sup>2</sup> *International collaboration to end tax avoidance*, ORG. FOR ECON. COOP. & DEV. (Nov. 4, 2021) [hereinafter *International collaboration to end tax avoidance*], <http://www.oecd.org/tax/beps> [<http://perma.cc/3URL-GGZQ>].

issued model rules,<sup>3</sup> commentary,<sup>4</sup> and examples<sup>5</sup> that set forth the design parameters for its Pillar Two proposal. And, draft model rules have been issued with respect to the nexus and revenue sourcing aspects of its so-called Pillar One proposal.<sup>6</sup> Under the Pillar One draft, source jurisdictions would be afforded the right to assert taxation over remote sellers based on a formulaic reallocation of residual profits back to the market jurisdiction where the customer is located, even if the multinational enterprise lacked a permanent establishment in that country.<sup>7</sup> Thus, the historical understanding of jurisdictional nexus and sourcing of gains would be modified if Pillar One's proposal were implemented. The Biden administration has enthusiastically endorsed the OECD Inclusive Framework and has argued that its implementation is critical to all nations.<sup>8</sup> The United Nations ("U.N.") Committee of Experts on International Tax Matters initially provided comments to the Pillar One proposal set forth in the OECD Inclusive Framework.<sup>9</sup> Nevertheless, this Committee

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<sup>3</sup> Organisation for Economic Co-operation and Development [OECD], *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*, at 7, (Dec. 20, 2021), <http://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm#rules> [<http://perma.cc/8YVE-7NRZ>].

<sup>4</sup> Organisation for Economic Co-operation and Development [OECD], *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, at 7, (Mar. 14, 2022), <http://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm#commentary> [<http://perma.cc/RTY8-GUGU>].

<sup>5</sup> Organisation for Economic Co-operation and Development [OECD], *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two) Examples*, at 5, (Mar. 14, 2022), <http://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm#examples> [<http://perma.cc/Y3SX-WC7X>].

<sup>6</sup> Organisation for Economic Co-operation and Development [OECD], *Public Consultation Document: Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing*, at 2, (Feb. 4, 2022), <http://www.oecd.org/tax/beps/oecd-invites-public-input-on-the-draft-rules-for-nexus-and-revenue-sourcing-under-pillar-one-amount-a.htm> [<http://perma.cc/SDL9-3CXV>].

<sup>7</sup> See *id.* at 2, 27.

<sup>8</sup> See Statement on the Organisation for Economic Co-operation and Development (OECD) Agreement on a Global Minimum Tax, 2021 DAILY COMP. PRES. DOC. 202100825 (Oct. 8, 2021); *Statement from Secretary of the Treasury Janet L. Yellen on the OECD Inclusive Framework Announcement*, U.S. DEPT OF THE TREASURY (Oct. 8, 2021), <http://home.treasury.gov/news/press-releases/jy0394> [<http://perma.cc/G5UD-SKGV>]; *Statement by President Joseph R. Biden, Jr. on Today's Agreement of 130 Countries to Support a Global Minimum Tax for the World's Largest Corporations*, THE WHITE HOUSE (July 1, 2021), <http://www.whitehouse.gov/briefing-room/statements-releases/2021/07/01/statement-by-president-joe-biden-on-todays-agreement-of-130-countries-to-support-a-global-minimum-tax-for-the-worlds-largest-corporations> [<http://perma.cc/R33K-3SK6>]; *Statement from Secretary of the Treasury Janet L. Yellen on Today's Agreement of 130 Countries to Support a Global Minimum Tax for the World's Largest Corporations*, U.S. DEPT OF THE TREASURY (July 1, 2021), <http://home.treasury.gov/news/press-releases/jy0255> [<http://perma.cc/E35V-XLLZ>].

<sup>9</sup> See U.N. Comm. of Experts on Int'l Coop. in Tax Matters, Co-coordinators' Paper on Tax Issues Related to the Digitalization of the Economy for the Twentieth Session of the

determined that it would set forth its own recommendation.<sup>10</sup> It then set forth a new Article 12B to the U.N. model treaty that would allow countries to assert taxation over income generated from digital sales into a market jurisdiction.<sup>11</sup> The U.N. approach in Article 12B allows market jurisdictions to tax income from automated digital services conducted with respect to its jurisdiction regardless of any physical nexus, and Article 12B allows the market jurisdiction to impose its tax on a gross basis, not a net basis.<sup>12</sup> The U.N. explained that its new Article 12B seeks to preserve the domestic law taxing rights for States from which payments for automated digital services are made.<sup>13</sup> The U.N. Model Treaty commentary notes that a significant minority of its members preferred the multilateral approach of the OECD Inclusive Framework in lieu of the bilateral approach that the U.N. Model Treaty affords.<sup>14</sup> In 2022, perhaps in response to these concerns, the U.N. Committee of Experts on Tax Matters announced that it would commence work on a multilateral instrument that would allow nations to adopt its Article 12B proposal on a multilateral basis.<sup>15</sup>

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U.N. Committee of Experts on Cooperation in Tax Matters, at 2–5, U.N. Doc. E/C.18/2020/CRP.25 (May 30, 2020).

<sup>10</sup> See U.N. Comm. of Experts on Int'l Coop. in Tax Matters, Rep. on the Twenty-Third Session, para. 75, U.N. Doc. E/2022/45-E/C.18/2021/4 (Oct. 2021). This work ultimately resulted in a proposed new Article 12B to the U.N. Model Convention that would allow market jurisdictions to assert taxation over persons that earned income from digital activities within a market jurisdiction. See U.N. Comm. of Experts on Int'l Coop. in Tax Matters, Rep. on the Twenty-Second Session, paras. 76–84, U.N. Doc. E/2021/45/Add.2-E/C.18/2021/2 (Apr. 2021).

<sup>11</sup> See U.N. DEP'T OF ECON. & SOC. AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, at 24–27, U.N. Doc. ST/ESA/378, U.N. Sales No. E.21XVI.1 (2021) [hereinafter U.N. MODEL DOUBLE TAXATION CONVENTION]. For a detailed explanation of the Article 12B, see generally *id.* at 434–75 (commentary on Article 12B).

<sup>12</sup> The commentary to the U.N. Model Convention explains that the constraints faced by developing countries' tax administrations justifies allowing tax on a gross basis as that is an established means of collecting tax on nonresident persons. See *id.* at 24, para. 2; see also *id.* at 436, para. 5 (commentary on Article 12B). To address concerns about the imposition of a gross revenue tax on unprofitable companies, the commentary asserts that a modest gross rate of taxation of three or four percent would likely obviate this concern; but then it provides that taxpayers subject to the new article with the ability to opt for taxation on net profit at the rate applicable under domestic law. Taxpayers that exercise this option would be taxed on their “qualifying profits,” which the draft article defines as thirty percent of the beneficial owner's consolidated automated digital business segment profitability ratio, multiplied by its gross automated digital services revenue in the jurisdiction. See *id.* at 24–25, para. 3; see also *id.* at 435, para. 4, 449–54, paras. 39–51 (commentary on Article 12B).

<sup>13</sup> See *id.* at 24, para. 2.

<sup>14</sup> See *id.* at 436–40, paras. 8–16 (commentary on Article 12B).

<sup>15</sup> See U.N. Comm. of Experts on Int'l Coop. in Tax Matters, Rep. on the Twenty-Fourth Session, paras. 57(a), 62, U.N. Doc. E2022/45/Add.1-E/C.18/2022/2 (Apr. 2022) (the report designates this effort as “Workstream A”).

Yet, amid these global developments, the U.S. Treasury Department issued final regulations in 2022 under Section 901, providing, for the first time, that a foreign levy is eligible for foreign tax credit relief only if the foreign taxing jurisdiction (i) utilizes jurisdictional nexus and sourcing rules that closely conform to the existing U.S. rules (referred to as an “attribution requirement”)<sup>16</sup> and (ii) calculates its tax base in a manner that closely conforms to the current U.S. statutory provisions.<sup>17</sup> The 2022 final regulations represent a substantial reformulation of the U.S. foreign tax credit eligibility standards. Later in 2022, Congress enacted a new fifteen percent corporate alternative minimum tax as part of the Inflation Reduction Act of 2022.<sup>18</sup>

Unfortunately, for reasons that will be further addressed in Part I, the Treasury Department’s regulatory amendments represent an inappropriate departure from the text, purpose, and policy goals of the historic mission of the U.S. foreign tax credit. A careful review of the 2022 final regulations in light of the legislative history, case law, and statutory text of Section 901 is addressed in Part I.

In Part II, this article will address the changes to Section 901 that should have been made at the time that Congress enacted a new corporate alternative minimum tax as part of the Inflation Reduction Act of 2022. The OECD Pillar Two proposal envisions jurisdictions will impose top-up taxes in accordance with the GloBE rules set forth in the OECD Pillar Two project. The imposition of these top-up taxes poses a normative design challenge to the U.S. foreign tax credit regime because these top-up taxes should not reduce the U.S. taxation on foreign income, but should instead be imposed in addition to the U.S. tax. The OECD framework agrees that these top-up taxes should not be afforded foreign tax credit relief so as to reduce any covered taxes like the U.S. taxation of Controlled Foreign Companies (“CFCs”) or its own domestic minimum tax on U.S. income. Nevertheless, current U.S. law does not envision the concept of a “top-up” tax, and thus, at present, such taxes are afforded U.S. foreign tax credit relief under existing law. It is here where reform of Section 901 should have been done but was not. For the reasons discussed in Part II, Congress should amend Section 901 to deny foreign tax credit relief for any top-up tax enacted in accordance with the GloBE rules.

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<sup>16</sup> See Treas. Reg. § 1.901-2(b)(5) (as amended in 2022).

<sup>17</sup> See *id.* §1.901-2(b)(4).

<sup>18</sup> See I.R.C. § 55(b)(2) (West 2022).

## I. CONSIDERATION OF THE TREASURY DEPARTMENT'S AUTHORITY FOR THE 2022 FINAL REGULATIONS

What motivated the regulatory shift set forth in the 2022 final Treasury Regulations? In 2020, the Treasury Department announced that it was concerned that several foreign countries had adopted, or were considering adopting, a variety of novel extraterritorial taxes (such as digital services taxes, diverted profits taxes, or equalization levies).<sup>19</sup> The Treasury Department then indicated that these taxes diverge significantly from traditional norms of international taxation and thus raise considerable policy concerns as to whether they represent “an income tax in the U.S. sense.”<sup>20</sup> The Treasury Department repeated this concern in the preamble to its 2022 final regulations.<sup>21</sup>

Sandwiched between these 2020 and 2022 regulatory statements is a Treasury Department statement from October 2021 where it announced that the United States and its major trading partners had agreed to new international taxation norms for remote sellers in the OECD’s Pillar One proposal.<sup>22</sup> Within one month of the issuance of the 2022 final regulations, the OECD issued a discussion draft for how these new nexus and sourcing rules would reattribute a portion of remote sellers’ profits to the country where their customers were located.<sup>23</sup> Thus, on the one hand, the Treasury Department, in the preamble to its 2022 final regulations, asserts that taxation based on customer location violates existing “international norms,” but on the other hand, the Treasury Department has signed-on to an OECD initiative that reformulates the nexus and sourcing rules to do exactly that.<sup>24</sup>

What is going on? Why has the Treasury Department agreed to extraterritorial taxation under the rubric of the OECD Inclusive

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<sup>19</sup> See Organisation for Economic Co-operation and Development [OECD], *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint*, at 10–14 (Oct. 14, 2020), <http://www.oecd-ilibrary.org/docserver/beba0634-en.pdf?expires=1666631763&id=id&acname=guest&checksum=72749C5140A63099682195613659B9F1> [<http://perma.cc/C4WB-BYKW>].

<sup>20</sup> See Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72078, 72088 (Nov. 12, 2020).

<sup>21</sup> See T.D. 9959, 87 Fed. Reg. 276, 288 (Jan. 4, 2022).

<sup>22</sup> See *Joint Statement of United States, Austria, France, Italy, Spain and the United Kingdom, Regarding a Compromise on a Transitional Approach to Existing Unilateral Measures During the Interim Period Before Pillar 1 is in Effect*, U.S. DEP’T OF THE TREASURY (Oct. 21, 2021), <http://home.treasury.gov/news/press-releases/jy0419> [<http://perma.cc/26VH-7NB4>].

<sup>23</sup> See *Public Consultation Document: Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing*, *supra* note 6, at 2.

<sup>24</sup> This observation has been pointedly made by a large group of U.S. multinational companies. See Letter from All. for Competitive Tax’n to Sec’y Janet Yellen, Dep’t of the Treasury (Feb. 24, 2022), [http://www.actontaxreform.com/media/gpuh55nj/act-letter-to-treasury-2021-final-ftc-regs\\_20220224-final.pdf](http://www.actontaxreform.com/media/gpuh55nj/act-letter-to-treasury-2021-final-ftc-regs_20220224-final.pdf) [<http://perma.cc/9YF5-8HHB>].

Framework on the one hand, but then issued 2022 final regulations that, on the other hand, deny foreign tax credit relief for such assertions of extraterritorial taxation over remote sellers by market jurisdictions? It has been speculated that the Treasury Department is using its regulatory authority to pressure other countries into joining the OECD framework as a precondition for the United States to provide foreign tax relief.<sup>25</sup> This view is given some credence due to the fact that Treasury Department officials and the Treasury Department's preamble explanation both have stated that implementation of the Pillar One framework would likely require an immediate amendment to its newly issued 2022 final regulations.<sup>26</sup> If this is the explanation, then this raises the prospect that the 2022 final regulations are being used as a bargaining chip to promote policy goals other than those of the statutory provision to which they were promulgated under. Congress has endorsed neither the OECD initiative<sup>27</sup> nor the Treasury Department's usage of the foreign tax credit eligibility standards of Section 901 as a bargaining chip in that broader multilateral negotiation.<sup>28</sup> As a result, significant commentary has already questioned whether these regulations would pass muster under *Chevron's* deference standards,<sup>29</sup> and, in fact, it appears

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<sup>25</sup> See, e.g., Mindy Herzfeld, *The Problematic New FTC Regs*, 105 TAX NOTES INT'L 985, 985–86, 989 (2022).

<sup>26</sup> See, e.g., Stephanie Soong Johnston, *U.S. to Mull Credit for Qualified Domestic Minimum Taxes*, 105 TAX NOTES INT'L 1572 (Mar. 24, 2022) <http://www.taxnotes.com/tax-notes-today-federal/credits/us-mull-credit-qualified-domestic-minimum-taxes/2022/03/24/7d9r8>. Moreover, the preambles to both the proposed and final regulations make clear that countries that adopt virtual taxation under the OECD Inclusive Framework may necessitate amendment of the jurisdictional nexus standards. See T.D. 9959, 87 Fed. Reg. 276, 288 (Jan. 4, 2022); see also Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72078, 72089 (Nov. 12, 2020) (“If an agreement [on the OECD Inclusive Framework] is reached that includes the United States, the Treasury Department recognizes that changes to the foreign tax credit system may be required at that time.”).

<sup>27</sup> In fact, at present, there is significant concern among some in Congress that the OECD framework, as currently formulated, does not adequately address the U.S. fiscal interests and that it would place the United States at a competitive disadvantage. See Letter from Assemb. Kevin Hern et al., to Sec'y Janet Yellen, Dep't of the Treasury (Jan. 19, 2022), <http://hern.house.gov/uploadedfiles/hern-oecd-letter.pdf> [<http://perma.cc/WD7P-45D4>]; see also Letter from U.S. Senate Comm. on Fin. to Sec'y Janet Yellen, Dep't of the Treasury (Feb. 16, 2022), [http://www.finance.senate.gov/imo/media/doc/finance\\_republicans\\_oecd\\_follow-up.pdf](http://www.finance.senate.gov/imo/media/doc/finance_republicans_oecd_follow-up.pdf) [<http://perma.cc/R9CL-E2BM>].

<sup>28</sup> See Robert E. Culbertson, *Sense and Sensibility and Creditability: Redefining an Income Tax 'in the U.S. sense,'* 102 TAX NOTES STATE 185, 190–203 (2021).

<sup>29</sup> See *Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (stating that “if the intent of Congress is clear, that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguous expressed intent of Congress” [so-called *Chevron* Step 1]; but, if Congress has left a gap to fill then the Court looks to whether the regulation is a permissible construction of the statute [so-called *Chevron* Step Two]); see also Gary B. Wilcox & Lucas Giardelli, *Will Jurisdictional Nexus Survive Chevron Step 1?*, 174 TAX NOTES FED. 1379, 1380 (2022).



that at least one firm is proceeding to make such a challenge.<sup>30</sup> In response to these deference concerns, the Treasury Department has strongly denied that the OECD initiative had any bearing on its decision to issue its 2022 final regulations, and the Treasury Department has reaffirmed its belief that its regulatory revisions represent a faithful interpretation of Section 901's eligibility requirements.<sup>31</sup> In this part of the article, a singular question is addressed: do the amendments made in the 2022 final regulations represent a faithful interpretation of Section 901's eligibility requirements? After addressing this question, this article then addresses the appropriate reform that remains to be done with respect to the U.S. foreign tax credit in Part II.

#### A. Text, Purpose, and Policy Goals of Section 901

In the preamble to its 2022 final regulations, the Treasury Department provided multiple justifications for its issuance of its 2022 final regulations.<sup>32</sup> One asserted justification is that the statutory text, purpose, and policy goals of Section 901 support the issuance of its new 2022 final regulations, as demonstrated by the following excerpt:

[T]he Treasury Department and the IRS's determination that regulations are necessary and appropriate to ensure that the U.S. fisc does not bear the costs of such taxes derives from the text, purpose, and policy of section 901, and not from any foreign policy goals. The Treasury Department and the IRS have concluded that these novel extraterritorial taxes (some of which are currently in force and being levied on U.S. taxpayers) are contrary to the text and purpose of section 901 and therefore must be addressed now.<sup>33</sup>

The above statement makes clear that it is the Treasury Department's position that its 2022 final regulations are a faithful interpretation of the law derived from the text, purpose, and policy

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<sup>30</sup> See Letter from Leslie J. Schneider, Partner, Ivins, Phillips & Barker, to the Comm'r of Internal Revenue, Internal Revenue Serv. (June 3, 2022), <http://www.taxnotes.com/research/federal/other-documents/public-comments-on-regulations/ivins-phillips-seeks-reconsideration-of-ftc-arm's-length-requirement/7dlg9> [<http://perma.cc/2L4A-J3XV>].

<sup>31</sup> The preamble to its final regulations includes this rebuttal:

The Treasury Department and the IRS agree that international forums can be an effective way of discouraging foreign jurisdictions from enacting extraterritorial taxes; indeed, the Treasury Department is actively engaged in and supporting negotiations under the auspices of the Inclusive Framework that would result in their elimination. However, contrary to the comments' assertion, the Treasury Department and the IRS's determination that regulations are necessary and appropriate to ensure that the U.S. fisc does not bear the costs of such taxes derives from the text, purpose, and policy of section 901, and not from any foreign policy goals.

T.D. 9959, 87 Fed. Reg. 276, 288 (Jan. 4, 2022).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

goals of Section 901, but the statement goes further by asserting a clear priority rule: if there is a risk of double taxation arising from tax levies that are inconsistent with jurisdictional nexus and sourcing conformity norms of the United States, then the protection of the United States fisc takes precedence over the goal of mitigating against double international taxation. Is this prioritization consistent with the prioritization that Congress intended when it enacted Section 901? To answer that question, the text, purpose, and policy goals of Section 901 must be examined. This article addresses that inquiry in this part.

The Treasury Department also offered the following additional rationale for its new jurisdictional nexus and sourcing conformity requirement:

The foreign tax credit is not intended to subsidize foreign jurisdictions at the expense of the U.S. fisc.

...

[T]he fundamental purpose of the foreign tax credit—to mitigate double taxation with respect to taxes imposed on income—is served most appropriately if there is substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax. This conformity extends not just to ascertaining whether the foreign tax base approximates U.S. taxable income determined on the basis of realized gross receipts reduced by allocable costs and expenses, but also to whether there is a sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax. Therefore, the final regulations retain the requirement in the 2020 FTC proposed regulations that for a foreign tax to qualify as an income tax, the tax must conform with established international jurisdictional norms, reflected in the Internal Revenue Code and related guidance, for allocating profit between associated enterprises, for allocating business profits of nonresidents to a taxable presence in the foreign country, and for taxing cross-border income based on source or the situs of property.<sup>34</sup>

This jurisdictional nexus and sourcing conformity requirement will be addressed concurrently with the analysis of the text, purpose, and policy goals of Section 901 in this part.

The Treasury Department, in the alternative, also argued that its regulatory changes are supported by the evolving case law that has interpreted Section 901, as the following statement so indicates:

Judicial decisions and administrative guidance over the past century have interpreted the term “income, war profits, and excess profits tax,” which is not defined in section 901 or by the limited initial explanation in the early legislative history. These interpretations have consistently followed the principle, introduced by the *Biddle* court, that the determination of whether a foreign tax is creditable under section 901 is

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<sup>34</sup> *Id.* at 284–85.

made by evaluating whether such tax, if enacted in the United States, would be an income tax (in other words, whether the foreign tax is “an income tax in the U.S. sense”). See *PPL Corp. v. Comm’r*, 569 U.S. 329, 335 (2013). See also *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 325 (1982) (“Whether a foreign tax is an income tax under I.R.C. 901(b)(1) is to be decided under criteria established by United States revenue laws and court decisions.”).

...

[I]t is appropriate for the definition of a creditable tax to incorporate the concept of jurisdictional nexus from the U.S. tax law. The fact that U.S. tax rules have changed since the foreign tax credit provisions were first enacted does not preclude an interpretation of the term “income tax” to reflect U.S. norms, because the principle of “an income tax in the U.S. sense” incorporates an evolving standard of what constitutes an income tax in the U.S. sense.<sup>35</sup>

So, are the changes made by the 2022 final regulations a faithful distillation of the holdings in the case law as interpreted in *Biddle*, *PPL*, and *Inland Steel* as the Treasury Department has asserted, or do these regulatory changes repudiate those holdings?<sup>36</sup> The principles utilized in the case law and how those principles align with the principles set forth in the regulations are addressed in Part I.B. This article then addresses the U.S. treaty implications arising from the 2022 final regulations in Part I.C.

As introduced in the Introduction, the 2022 final regulations set forth a jurisdictional nexus and sourcing conformity requirement under the rubric of a so-called attribution requirement.<sup>37</sup> Under the attribution requirement, the foreign tax base, as applied to a nonresident person, must be limited to the activities conducted from within the foreign country (including functions, assets, and risks located in foreign country) without taking into account destination-based criteria (e.g., location of customers, users, or persons from whom a nonresident person makes purchases in the foreign country).<sup>38</sup> In addition, the foreign tax base, as applied to a nonresident person, must be limited in its taxation of gains to only those gains that arise from the sale or disposition of real property located in the foreign country (or interest in resident corporation or other entity that owns such property) under rules similar to those of the Foreign Investment in Real Property Tax Act (“FIRPTA”). Alternatively, the tax base must be limited to the taxation of business property that is part of

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<sup>35</sup> *Id.* at 283.

<sup>36</sup> See generally *Biddle v. Comm’r*, 302 U.S. 573 (1938); *PPL Corp. v. Comm’r*, 569 U.S. 329 (2013); *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982).

<sup>37</sup> See Treas. Reg. § 1.901-2(b)(5) (as amended in 2022); see also Treas. Reg. § 1.903-1(c)(2)(iii) (as amended in 2022).

<sup>38</sup> Treas. Reg. § 1.901-2(b)(5)(i)(A) (as amended in 2022).

taxable presence in the foreign country (including interests in partnership or pass through entity attributable to such property) as determined under principles similar to those of Section 864(c).<sup>39</sup> In addition, in order for a foreign tax to qualify as an “in lieu of” tax under Section 903, the foreign jurisdiction must have an income tax that utilizes jurisdictional nexus and sourcing rules that closely conform to existing U.S. law, and the imposition of the “in lieu of” tax must separately utilize sourcing rules that closely conform to the sourcing rules found in existing U.S. tax laws.<sup>40</sup> As a result of these new jurisdictional and sourcing conformity requirements, a withholding tax on services or royalties based on the residence of the payor would fail to be creditable as that sourcing rule does not conform to the U.S. sourcing rule for services or for royalties.<sup>41</sup>

This is so whether or not services were actually performed outside that foreign jurisdiction.<sup>42</sup> Furthermore, because several countries attempt to impose taxation on capital gains of nonresident persons other than gains attributable to real property, their foreign tax levies would not be eligible for foreign tax credit relief under the 2022 final regulations.

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<sup>39</sup> See Treas. Reg. § 1.901-2(b)(5)(i)(B)(3) (as amended in 2022); Treas. Reg. § 1.901-2(b)(5)(i)(C) (as amended in 2022); Treas. Reg. § 1-864-4 (as amended in 2005).

<sup>40</sup> See Treas. Reg. § 1.903-1(c)(2)(iii) (as amended in 2022).

<sup>41</sup> See Treas. Reg. § 1.901-2(b)(5)(i)(B)(1)–(2) (as amended in 2022). The sourcing for income derived from services is the place of service whereas income from royalties is generally sourced by the place of use of the intangible asset. *Id.*; see also Treas. Reg. § 1.903-1(c)(2)(iii) (as amended in 2022). The Treasury Department, in proposed regulations, has provided a limited exception to this sourcing conformity requirement for withholding taxes on royalties when those withholding taxes are paid pursuant to a single-country license agreement. See Prop. Treas. Reg. § 1.903-1(c)(2). Under this single-country license agreement exception, a withholding tax on gross royalties imposed on a nonresident remains a covered tax eligible for U.S. foreign tax credit relief if the income is earned pursuant to a single country license agreement. See *id.* The proposed regulations contemplate two varieties of a single-country license agreement that can satisfy this standard. Under the first variation, a royalty payment made under a single country license agreement could qualify if each of the following requirements are satisfied: (i) the royalty payment is made pursuant to a license agreement, (ii) the royalty payment is characterized as a royalty in the foreign tax jurisdiction, and (iii) the license agreement limits the territory of use for the intangible property to the country that imposes the withholding tax for the royalty subject to taxation in that jurisdiction. See *id.* Under a second variation, a multi-jurisdictional license agreement could satisfy the single-country license exception if requirements (i) and (ii) in the immediately preceding sentence were satisfied and the agreement does not misstate the territory of use for the intangible property and the amount of the royalty under the license agreement complies with the arm's length standard. *Id.* § 1.903-1(c)(2)(iv)(B). For a further analysis of this limited concession to one category of income (namely, royalty income), see JOSEPH ISENBURG & BRET WELLS, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶¶ 56.11.4 (Wolters Kluwer 6th ed. 2024) (forthcoming) (on file with author).

<sup>42</sup> It should be noted that this aspect of the regulations has created considerable public comment. The Treasury Department has indicated that it may ameliorate this outcome in future guidance, but as of this article's submission, such guidance had not been provided.

In this part, the text, purpose, and policy goals of Section 901 are considered in light of this newfound jurisdictional nexus and sourcing conformity requirement. As previously mentioned in the Introduction, the government in its preamble asserted that the text, purpose, and policy goals of Section 901 support the Treasury Department's imposition of a jurisdictional nexus and sourcing conformity requirement into its 2022 final regulations. However, it is important to understand that the preamble to the 2022 final regulations contains a contradictory statement on this score. In this regard, the Treasury Department made the following admission about the text, purpose, and policy goals of Section 901 elsewhere in the very same preamble explanation:

Congress has not explicitly addressed jurisdictional nexus with respect to the foreign tax credit. There is no statutory provision that addresses whether the foreign tax credit should be allowed for taxes imposed outside of traditional U.S. taxing norms. . . . The statute is silent with respect to jurisdictional nexus, and it is reasonable and appropriate for regulations to apply U.S. tax concepts in addressing the creditability of extraterritorial foreign levies that Congress could not have anticipated when the foreign tax credit provisions were first enacted.<sup>43</sup>

A court will need to determine what weight, if any, should be placed on the Treasury Department's reliance on the text, purpose, and policy goals of Section 901 as the asserted justification for its regulatory changes when the Treasury Department elsewhere makes the contradictory statement that the statutory text and the legislative purpose are silent with respect to these elements of its 2022 final regulations.

But even so, this still leaves unanswered the question of whether or not the actual statutory text and legislative history are in fact silent on this question. The Treasury Department indeed is correct in its observation that Section 901 in its current form has no explicit jurisdictional nexus or sourcing conformity requirement. So, is this omission because Congress did not want to impose one, or is this omission explained (as the Treasury Department has alleged) by the fact that "Congress could not have anticipated" this matter? To resolve that question, one must look to the facts and circumstances that existed at the time of Section 901's enactment.

To begin, it is important to note that the U.S. tax laws initially did not provide for foreign tax credit relief under the tax laws of 1909 and 1913,<sup>44</sup> but the income tax rates were substantially lower in that era, so the cost of not providing foreign tax credit relief was

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<sup>43</sup> T.D. 9959, 87 Fed. Reg. 276, 284 (Jan. 4, 2022).

<sup>44</sup> See generally Revenue Act of 1909, ch. 6, 36 Stat. 11, 112–15; Revenue Act of 1913, ch. 16, 38 Stat. 114, 172.

insignificant.<sup>45</sup> However, with the advent of World War I, tax rates increased sharply in the United States and other countries.<sup>46</sup> With increasing tax rates in both foreign countries and the United States, the cost of international double taxation became significant to U.S. multinationals and represented a threat to international trade.<sup>47</sup> International double taxation would be the result if both the host country and the United States asserted simultaneous taxing jurisdiction over the same foreign income.<sup>48</sup>

When Section 901 was enacted in 1918 (effective starting in 1919), it read as follows: “the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, *upon income derived from sources therein*, or to any possession of the United States . . . .”<sup>49</sup> Prior to 1921, the United States had not articulated a comprehensive concept of source, but the above italicized language suggests that a jurisdictional nexus and sourcing conformity requirement initially was part of the foreign tax credit eligibility requirements, but not for long.<sup>50</sup> In 1921, Congress enacted the foreign tax credit limitation regime as the means to address the over-crediting of foreign tax credits so that the foreign tax credit could not be used against U.S. source income but could be used against any foreign source income.<sup>51</sup> Simultaneously with the

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<sup>45</sup> See Stanley S. Surrey, *The United States Taxation of Foreign Income*, 1 J.L. & ECON. 72, 73 n.3 (1958) (noting that in 1917, war time income tax rate increases were adopted).

<sup>46</sup> See *id.* Thomas Sewell Adams, viewed as the architect of the foreign tax credit, stated: “[i]n the midst of the war, when the financial burden upon the United States was greater than it had ever been, I proposed to the Congress that we should recognize the equities . . . by including in the federal income tax the so-called credit for foreign taxes paid . . . .” Thomas S. Adams, *International and Interstate Aspects of Double Taxation*, 22 NAT’L TAX ASS’N PROC. 193, 198 (1929).

<sup>47</sup> See Surrey, *supra* note 46, at 73; see also H.R. Rep. No. 65-767 (1918), 1939-2 C.B. 86 (explaining the rationale and legislative history for a foreign tax credit); see also *id.* at 93 (“With the corresponding high rates imposed by certain foreign countries that taxes levied in such countries in addition to the taxes levied in the United States upon citizens of the United States place a very severe burden upon such citizens.”).

<sup>48</sup> Such a result was viewed as manifestly unfair and harmful to international free trade. See Michael J. Graetz & Michael M. O’Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L.J. 1021, 1027–28 (1996); Thomas S. Adams, *The Taxation of Business*, 11 NAT’L TAX ASS’N PROC. 185, 186 (1917); Thomas S. Adams, *Fundamental Problems of Federal Income Taxation*, 35 Q.J. ECON. 527, 542 (1921).

<sup>49</sup> Revenue Act of 1918, Pub. L. No. 65-254, § 222(a), 40 Stat. 1057, 1073 (emphasis added).

<sup>50</sup> See *id.*

<sup>51</sup> See Revenue Act of 1921, Pub. L. No. 67-98, §§ 222(a)(5), 238(a), 42 Stat. 227, 249, 258. Although not further discussed in this article, this limitation regime has taken various forms. In 1932, Congress decreed that taxpayers were required to use the lesser of an overall or per-country limitation. See Revenue Act of 1932, Pub. L. No. 72-154, ch. 209, § 131(b), 47 Stat. 169, 211. In 1954, the overall limitation was repealed and only the per-country limitation regime existed. See I.R.C. § 904 (West). In 1960, taxpayers were given the option to use either a per-country or an overall limitation computation. See Act of Sept. 14, 1960, Pub. L. No. 86-780, § 1(a), 74 Stat. 1010. In 1976, the per-country limitation was

enactment of Section 904's predecessor, Congress removed any jurisdictional nexus or sourcing conformity requirement from Section 901's predecessor so that it would read as follows: "the amount of any income, war-profits and excess-profits taxes paid during the same taxable year to any foreign country, or to any possession of the United States."<sup>52</sup>

Finally, Congress' decision to affirmatively remove any reference to sourcing or jurisdictional nexus from Section 901(b)(1)'s predecessor occurred at the very same time that Congress, elsewhere in the 1921 Tax Act, expanded the complexity and specificity of the United States' own sourcing rules and directed the Commissioner of Internal Revenue to develop apportionment rules for U.S. expenses.<sup>53</sup> In 1932, Congress made it explicitly clear that the rules for allocating and apportioning U.S. expenses between U.S. source income and foreign source income must be utilized in order to determine the foreign tax credit limitation so that it applied on a foreign source *net* income basis.<sup>54</sup> Thus, Congress thought a lot about the interaction of sourcing rules, the foreign tax credit limitation, and the scope of the foreign tax credit eligibility criteria during this era. Additionally, Congress affirmatively walked back any indication that it would require a jurisdictional nexus and sourcing conformity requirement for foreign tax credit eligibility purposes even though the original statutory provision had such a requirement. Instead of continuing to impose a jurisdictional nexus and sourcing conformity rule, Congress confined its income

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repealed, and the law had come full circle to the position of 1921. See Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 1031, 904, 90 Stat. 1610, 1620–24. In 1986, the foreign tax credit basket rules were instituted along with an overall limitation regime to form the basis of current law. See Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1201, 904(d), 100 Stat. 2085, 2520–28. Effective for years beginning in 2006, the American Jobs Creation Act of 2004 reduced the number of foreign tax credit baskets down to two baskets: the "passive" basket and the "general" basket. See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 404, 118 Stat. 1418, 1494.

<sup>52</sup> Revenue Act of 1921, Pub. L. No. 67-98, §§ 222(a)(1), 238(a), 42 Stat. 227, 249, 258.

<sup>53</sup> See Revenue Act of 1921, Pub. L. No. 67-98, §§ 217(d)–(e), 42 Stat. 227, 244; *Internal Revenue: Hearings Before the Comm. on Fin. of the U.S. S. on H.R. 8245*, 67th Cong 66–68 (1921). Minor clerical changes were made in 1924. See Revenue Act of 1924, Pub. L. No. 68-176, §§ 217(d)–(e), 43 Stat. 253, 274. The provision that addressed the allocation and apportionment of deductions was later moved to former Section 119 in the 1934 Tax Act. See Revenue Act of 1934, Pub. L. No. 73-216, §§ 119(b), (d)–(e), 48 Stat. 680, 717–18. The allocation and apportionment of U.S. expenses was later recodified as Section 861 through Section 863 as part of the recodification of the Internal Revenue Code in 1954. See Internal Revenue Code of 1954, Pub. L. No. 83-591, §§ 861–863, 68A Stat. 275–78.

<sup>54</sup> See Revenue Act of 1932, Pub. L. No. 72-154, § 131(e), 47 Stat. 169, 212 (adding an explicit cross-reference to the sourcing rules of former Section 119, which was the predecessor to Section 861). Courts have held that the sourcing rules are utilized to determine the foreign tax credit limitation. See, e.g., *Int'l Standard Elec. Corp. v. Comm'r*, 1 T.C. 1153 (1943), *aff'd*, 144 F.2d 487 (2d Cir. 1944).

sourcing and expense apportionment rules to the foreign tax credit limitation computation.

The removal of any jurisdictional nexus and sourcing rule, along with the concurrent adoption of the predecessor to Section 904 and the concurrent enactment of detailed sourcing rules all at the same time, demonstrates that Congress recognized that its sourcing rules were important but limited their application to the foreign tax credit limitation context. The current version of Section 901 contains the added words “or accrued,” but otherwise Section 901 has remained unchanged in relevant part since 1921<sup>55</sup> as can be seen in the following redline version: “the amount of any income, war profits, and excess profits taxes paid or accrued during the same taxable year to any foreign country, ~~upon income derived from sources therein,~~ or to any possession of the United States.”<sup>56</sup>

Thus, the evolution of the statutory text makes it clear that Congress originally included a jurisdictional sourcing conformity requirement, but Congress soon thereafter eliminated that requirement as an affirmative change in the statutory text. Prior to 2022, the Treasury Department accepted the premise that no sourcing conformity requirement existed under Section 901 as the Treasury Department’s prior 1983 final regulations explicitly granted foreign tax credit relief to a foreign levy that would have failed a sourcing conformity requirement.<sup>57</sup> Thus, at least two conclusions from the statutory text become clear. First, the text and legislative history demonstrate that Congress thought about sourcing in the context of Section 901, and when it did so it removed it from Section 901 as an affirmative action. And second, the Treasury Department’s prior regulations explicitly recognized that Section 901 had no sourcing conformity requirement through the end of 2021.

The Treasury Department’s preamble to its 2022 amendments attributes the statutory silence on jurisdictional nexus to the fact that Congress could not have anticipated objectionable assertions of jurisdictional nexus in the circa 1918-

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<sup>55</sup> See I.R.C. § 901(b) (West 2022).

<sup>56</sup> A hat tip is owed to Robert Culbertson who first provided this redline version of Section 901 to demonstrate how it was amended in relevant part since its inception. See Culbertson, *supra* note 28, at 186 n.6 (emphasis in original).

<sup>57</sup> See Treas. Reg. 1.903-1(b)(3) (example 3), 48 Fed. Reg. 46272, 46296 (Oct. 12, 1983). In the regulatory example, a withholding tax was applied on technical services performed outside the jurisdiction that applied the withholding tax. Nevertheless, the 1983 regulations concluded that the withholding taxes were creditable. For a further discussion of this example, see Wilcox & Giardelli, *supra* note 29, at 1157.



1921 era.<sup>58</sup> As previously discussed, this assertion is contradicted by the actual legislative history attendant with the original enactment and subsequent amendment of Section 901's predecessor in 1918 and 1921, respectively, and by Congress' attention to source rules in that era. In addition, this assertion is contradicted by the jurisdictional practices that existed at the time of Congress' enactment of Section 901's predecessor. In this regard, the foreign tax credit was enacted into U.S. law during a turbulent period when international taxation norms were not agreed on, to say the least. In the post-World War I era, nations faced crushing war debt, and, at that time, there was a substantial increase in income taxation measures around the world that threatened international trade. Formulary apportionment among nations, without the prerequisite of a permanent establishment, was the treaty norm at that time.<sup>59</sup> There was no shared understanding of jurisdictional norms, nor was there any shared understanding of commonly accepted transfer pricing methods.<sup>60</sup> Prior to the work of the League of Nations, there was a divergence in how nations asserted taxation over profits arising from economic activities that had some connection to more than one jurisdiction. It was for this reason that the League of Nations commenced its work in 1923 to develop standards for how international taxation should occur.<sup>61</sup> A consensus on jurisdictional norms and on transfer pricing practices was not

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<sup>58</sup> Specifically, the Treasury Department made this assertion in its preamble to the final regulations: "[t]he statute is silent with respect to jurisdictional nexus, and it is reasonable and appropriate for regulations to apply U.S. tax concepts in addressing the creditability of extraterritorial foreign levies that Congress could not have anticipated when the foreign tax credit provisions were first enacted." T.D. 9959, 87 Fed. Reg. 276, 284 (Jan. 4, 2022).

<sup>59</sup> See Mitchell B. Carroll, *A Brief Survey of Methods of Allocating Taxable Income Throughout the World*, in LECTURES ON TAXATION 131, 151–53, 168–70 (Roswell Magill ed., 1932) (stating that fractional apportionment was the primary method of resolving double taxation for Spain and Switzerland and was also used by France; also providing an analysis of how Austria, Czechoslovakia, Hungary, and Poland had all formulated significant apportionment methodologies); see also JOHN G. HERNDON, RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCITY FOR THE PREVENTION OF DOUBLE INCOME TAXATION 15 (1932) (describing a pre-existing German-Holland treaty where income apportionment was used for a railroad between the two countries); see also EDWIN A. SELIGMAN, DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION 138 (1928) (recognizing that Great Britain had employed formulary apportionment methods with respect to its colonies).

<sup>60</sup> See League of Nations Econ. & Fiscal Comm., *Report on Double Taxation Submitted to the Financial Comm.*, League of Nations Doc. E.F.S.73.F.19 at 39–41, 48–49 (1923); see also SELIGMAN, *supra* note 59, at 14–15.

<sup>61</sup> This author has elsewhere discussed in depth the development of international norms during this era which can be reviewed for further detail on topics that support this understanding of the historical evolution of international taxation among nations. See Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2012) [hereinafter Wells & Lowell, *Linchpin*]; Bret Wells & Cym Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 COLUM. J. TAX L. 1 (2013).

reached until the mid-1930s. The concept of limiting a jurisdiction's taxation to business profits attributable to a permanent establishment was not an accepted norm until the League of Nations model treaty released in draft form in 1935.<sup>62</sup> The League of Nations work transformed the world,<sup>63</sup> but that transformation happened in the decades *after* the U.S. foreign tax credit had been enacted into U.S. law.<sup>64</sup>

Rather, it was in the midst of the chaos, not after an international consensus had been formed, when Congress enacted the foreign tax credit.<sup>65</sup> The foreign tax credit came into U.S. law as a measure to bolster international trade and protect U.S. persons from the threat of international double income taxation in an era when it was unclear whether or not an international consensus on jurisdictional taxation norms could be forged. The foreign tax credit is a unilateral measure adopted by the U.S. tax system. Although the credit represents a deference by the U.S. Treasury to the taxing power of foreign countries, it does not arise by treaty. On the surface at least, the U.S. tax system asks nothing from foreign treasuries in return for the credit. The case law has long recognized the Congressional goal of Section 901: the foreign tax credit should prevent worldwide double income taxation on the same foreign profits.<sup>66</sup> The U.S.

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<sup>62</sup> The League of Nations Model Treaty that set forth a definition of a permanent establishment, withholding regimes, and transfer pricing standards was officially adopted in 195 after a multi-decade process. See League of Nations Fiscal Comm., *Report to the Council on the Fifth Session of the Comm.*, League of Nations Doc. C.252M.124.1935.II.A. at 3, 5–7 (1935). For a further discussion of the process that resulted in the model treaty, see Wells & Lowell, *Linchpin*, *supra* note 61, at 545–61.

<sup>63</sup> See HERNDON, *supra* note 59, at 42.

<sup>64</sup> This historical evolution is addressed in detail in Wells & Lowell, *Linchpin*, *supra* note 61.

<sup>65</sup> T.S. Adams would later make these prescient observations:

In the midst of the war, when the financial burden upon the United States was greater than it had ever been, I proposed to the Congress that we should recognize the equities which I have just noted, by including in the federal income tax the so-called credit for foreign taxes paid . . . I had no notion, ladies and gentlemen, when I proposed it, that it would ever receive serious consideration. I expected it to be turned down with the reply which I have received so often from legislative committees: "Oh, yes, Doctor, that is pretty good, but the finances won't permit it." But to my surprise, the credit for foreign taxes was accepted and approved, because it touched the equitable chord or sense, and because double taxation under the heavy war rates might not only cause injustice but the actual bankruptcy of the taxpayer.

See Adams, *supra* note 46, at 198.

<sup>66</sup> See *Comm'r v. Chi. Portrait Co.*, 285 U.S. 1, 7 (1932) (noting the foreign tax credit is designed to "mitigate the evil of double taxation"); *Am. Chiclé Co. v. United States*, 316 U.S. 450, 452 (1942) (explaining "the purpose [of the foreign tax credit] is to obviate double taxation."); *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 139 (1989) ("The [legislative] history of the indirect credit clearly demonstrates that the credit was intended to protect a domestic parent from double taxation of its income."); *Comm'r v. Am. Metal Co.*,

foreign tax credit provides relief for any income and excess profits<sup>67</sup> taxes paid or accrued to a foreign country. Providing a credit against the U.S. tax liability ensures that U.S. taxation would not be applied to the extent that a foreign country already asserted taxation over that income, so that a single level of international taxation would apply. For example, in 1892, the Netherlands adopted a tax credit for traders deriving income from the then Dutch East Indies.<sup>68</sup> “The United Kingdom in 1916 granted a partial tax credit to traders who had paid taxes to other territories of the [British] empire.”<sup>69</sup> However, the United States apparently was the first country to adopt a broad-based foreign tax credit that would be granted to any nation’s income tax.<sup>70</sup> The creation of a broad-based foreign tax credit was principally the invention of Thomas S. Adams, an economic advisor to the Treasury Department at the time.<sup>71</sup> T.S. Adams explained the rationale for the enactment of Section 901 in the following terms:

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221 F.2d 134, 137 (2d Cir. 1955) (“The primary objective of [the foreign tax credit regime] is to prevent double taxation and a secondary objective is to encourage American foreign trade.”). The legislative history is consistent and longstanding. *See also* H.R. REP. NO. 83-1337, at 76 (1954) (“The [foreign tax credit] provision was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or engaged in business abroad.”); S. REP. NO. 73-558, at 39 (1934) (“The present [foreign tax] credit . . . does relieve the taxpayer from a double tax upon his foreign income.”); H.R. REP. NO. 65-767, at 11 (1918) (explaining the rationale for a foreign tax credit, the legislative history stated as follows: “[w]ith the corresponding high rates imposed by certain foreign countries that taxes levied in such countries in addition to the taxes levied in the United States upon citizens of the United States place a very severe burden upon such citizens.”); JOINT COMM. ON TAX’N, 99th CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 at 852 (Comm. Print 1986).

<sup>67</sup> Excess profits taxes were imposed on only a portion of total income in excess of a given rate of return. *See Income, Excess Profits, and Estate Taxes: Hearings Before the H. Comm. on Ways and Means*, 65th Cong. 15 (1918) (statement of W.G. McAdoo, Treasury Secretary) (“By an excess-profits tax we mean a tax upon profits in excess of a given return on capital.”); *see also* GEORGE E. HOLMES, FEDERAL INCOME TAX, WAR-PROFITS AND EXCESS-PROFITS TAXES 136 (1919) (stating excess profits taxes were imposed on only a portion of total income). The statute also refers to “war profits” taxes. *See* I.R.C. § 901 (West 2022). For a historical definition of a war profits tax, *see Income, Excess Profits, and Estate Taxes: Hearings Before the H. Comm. on Ways and Means*, 65th Cong. 15 (1918) (statement by W.G. McAdoo, Treasury Secretary) (“By a war-profits tax we mean a tax upon profits in excess of those realized before the war.”). By World War II, war-profits taxes were viewed as simply a subcategory of excess profits taxes. *See* KENNETH JAMES CURRAN, EXCESS PROFITS TAXATION 2 (American Council on Public Affairs 1943) (stating that “the term ‘excess profits tax’ [today is used] to describe any levy that is confined to a segment of a taxpayer’s income that is considered excessive, no matter by what standard of measurement it is determined”). Thus, for clarity to the modern reader, this paper discusses income taxes and excess profits taxes.

<sup>68</sup> *See* Stanley S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 818 n.4 (1956).

<sup>69</sup> *Id.*

<sup>70</sup> *See id.*

<sup>71</sup> *See* Graetz & O’Hear, *supra* note 48, at 1038–39 n.71; Bret Wells, *The Foreign Tax Credit War*, 2016 BYU L. REV. 1895, 1900 n.11 [hereinafter Wells, *Foreign Tax Credit War*] (2016); Culbertson, *supra* note 28, at 170.

There is something in the legislative mind which recognizes that if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, something wrong or inequitable is being done which, other things being equal, the legislator should correct if he can.<sup>72</sup>

Imposing a close conformity requirement would have impeded, not promoted, the purpose and policy goals of the foreign tax credit in the very era in which the U.S. enacted the foreign tax credit. The adoption of the foreign tax credit afforded deference to developing and developed nations alike, as it recognized the foreign jurisdiction's primary right to assert taxation over foreign income first at a time when there was no consensus on international taxation norms. As T.S. Adams observed,

The explanation is simple. Every state insists upon taxing the non-resident alien who derives income from sources within that country, and rightly so, or at least inevitably so. . . . But [the average state] refuses to recognize when one of its own citizens or nationals gets income from a foreign source that he inevitably will be taxed abroad. As a necessary corollary of the principle of taxing at source or origin which it has adopted, the home state owes an exemption of some kind to its own citizen or resident who derives income from a foreign source or sources.<sup>73</sup>

Prevention of double taxation, in short, calls for a self-denying ordinance in the home state — rather than concessions from a foreign state. The state of domicile must protect its own residents.<sup>74</sup>

It is important to note where T.S. Adams indicated protection was needed. The protection that was needed was against double taxation of U.S. persons, not the revenue interests of the U.S. fisc. The revenue consequences to the U.S. fisc were subordinated to the more important priority of protecting against international double income taxation on foreign income earned by U.S. persons.<sup>75</sup> The enactment of Section 901's predecessor placed a higher priority on the goal of avoiding international double taxation and, as a collateral consequence, subordinated the financial interests of the U.S. fisc. Of course, T.S. Adams would work as the U.S. representative to the League of Nations to forge an international consensus on norms of international taxation, but there was no assurance that such a consensus would be obtained and in fact none was obtained during his lifetime.

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<sup>72</sup> Adams, *supra* note 46, at 197.

<sup>73</sup> *Id.* at 192–99.

<sup>74</sup> T.S. Adams, *Interstate and International Double Taxation*, in LECTURES ON TAXATION: COLUMBIA UNIVERSITY SYMPOSIUM 101 (1932).

<sup>75</sup> In the preamble to the 2022 amendments, the Treasury Department reverses the priority ordering rule such that it places a higher priority for protecting the interests of the U.S. fisc over the goal of preventing international double income taxation to U.S. persons. See T.D. 9959, 87 Fed. Reg. 276, 284–85 (Jan. 4, 2022).

Thus, when push came to shove, the most important policy goal that Congress chose to prioritize as of first importance was protecting U.S. persons from international double income taxation. This is seen through Congress' unilateral enactment of Section 901's predecessor and the removal of a sourcing conformity requirement from the statutory text of that provision because the goal of protecting against international double income taxation took priority. The interests of the U.S. fisc took a back seat. Again, this was an amazing act of statesmanship on the part of the United States during an era of great international chaos. At the end of World War I, the United States believed that continued international trade among nations was critical to a future peaceful world and wanted to ensure that international double taxation did not inhibit the return of peaceful trade.<sup>76</sup> A return to international comity was paramount. Instead of using the threat of double taxation as a bargaining chip with other nations in the post-war era, the United States gave a preference to the goal of preventing international double income taxation. Thus, a careful review of the facts and circumstances that existed in the circa 1918-1921 era provide compelling evidence that the 2022 final regulations reverse the priority ordering rule. Through its enactment of Section 901's predecessor, Congress prioritized relief from double international income taxation over the revenue interest of the U.S. fisc when there was no consensus on international taxation norms at that time and countries were rapidly expanding their income taxation around the world. In contrast, instead of protecting against international double income taxation as its first priority, the 2022 final regulations protect the interest of the U.S. fisc as its first priority. As a general rule, the 2022 final regulations deny foreign tax relief to any foreign tax levy that fails to satisfy the attribution requirement in the regulations, which is a requirement that determines whether the foreign levy satisfies appropriate jurisdictional nexus and sourcing conformity requirements.<sup>77</sup>

When one juxtaposes the text, purpose, and policy goals that accompany the enactment of Section 901's predecessor with the text, purpose, and policy goals of the 2022 regulatory changes, a remarkable contrast becomes evident. The following table sets forth the divergence of the text, purpose, and policy goals that guided the original enactment of the foreign tax credit as compared to the text, purpose, and policy goals of the 2022 final regulations.

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<sup>76</sup> See *supra* note 66 and accompanying text.

<sup>77</sup> See Treas. Reg. §1.901-2(b)(5) (as amended in 2022).

	<b>Circa 1918-1921</b>	<b>2022 Final Regulations</b>
<b>Text</b>	The plain text of the statute eschews a nexus requirement. The original 1919 version had language that would mandate a nexus requirement, but it was affirmatively removed in 1921.	Notwithstanding the lack of textual authority, the plain text of the final regulations sets forth a jurisdictional nexus and sourcing conformity requirement.
<b>Purpose</b>	Prioritized avoidance of international double income taxation of U.S. persons over the revenue needs of the United States.	Prioritizes the revenue interest of the U.S. fisc over the interest of preventing U.S. double taxation of U.S. persons.
<b>Policy Goals</b>	Promoted international trade in the post-World War era in an effort to preserve global comity in advance of any actual agreement on international taxation norms. Such an agreement would only come decades later and was uncertain at the time of the credit's enactment.	Protects the U.S. fisc by denying a foreign tax credit until an agreement on international taxation norms comes into existence, at which point the Treasury Department has indicated it would then revisit its eligibility requirements in light of a subsequent agreement on new norms.

In the end, the Treasury Department's effort to impose a jurisdictional nexus and sourcing conformity requirement is contrary to the statutory changes (the text), the purpose, and the policy goals of the foreign tax credit as derived from the facts and circumstances that existed at the time of its original enactment. The foreign tax credit was a provision designed to restore peaceful trade before a broad agreement had been forged on international taxation norms. Instead of promoting the text, purpose, and policy goals of the statutory provision, the 2022 final regulations repudiate the historical text, purpose, and policy goals that prompted its original enactment.

At a more fundamental level, even if one were to believe that a jurisdictional nexus and sourcing conformity requirement should be imposed under Section 901, it is difficult to accept the Treasury Department's assertion that a market jurisdiction's taxation of remote sellers violates today's international norms. As previously discussed, the OECD Inclusive Framework envisions that such taxation is allowed under its framework, and over 141 nations signed-on to that agreement.<sup>78</sup> The United States also signed onto this agreement.<sup>79</sup> Thus, as measured by international norms, taxation of remote sellers by market jurisdictions is consistent with the agreement forged by the OECD to which the Treasury Department has itself endorsed. The World Bank Group's staff

<sup>78</sup> See *International collaboration to end tax avoidance*, *supra* note 2.

<sup>79</sup> See sources cited *supra* note 8.

recently stated that the development of Article 12B in the U.N. Model Treaty “provides an agreed international framework within which jurisdictions can adopt aligned approaches, leading to international consistency of treatment.”<sup>80</sup> Thus, it is becoming increasingly less plausible for the United States to contend that it is outside the norms of international consensus for market jurisdictions to assert taxation over digital activities conducted within their jurisdiction.

But even setting all of this aside, the U.S. Supreme Court has indicated that extraterritorial taxation over remote sellers is not inconsistent with U.S. jurisdictional norms in the state taxation case of *South Dakota v. Wayfair, Inc.*<sup>81</sup> In that case, the state of South Dakota attempted to assert taxation over remote sellers that had no physical connection in the state. The taxpayer’s principle argument was that nonresident taxpayers could not be taxed in South Dakota if the nonresident did not have a substantial physical nexus within the taxing state. The Supreme Court upheld South Dakota’s right to tax remote sellers that had no physical presence. The Court, therefore, rejected the notion that the U.S. Constitution requires a physical nexus for a state to assert jurisdiction over remote economic activity connected to its taxing jurisdiction. The following statement indicates this rejection:

The physical presence rule has “been the target of criticism over many years from many quarters.” *Direct Marketing Assn. v. Brohl*, 814 F.3d 1129, 1148, 1150–1151 (C.A.10 2016) (Gorsuch, J., concurring). *Quill*, it has been said, was “premised on assumptions that are unfounded” and “riddled with internal inconsistencies.” Rothfeld, *Quill*: Confusing the Commerce Clause, 56 Tax Notes 487, 488 (1992). *Quill* created an inefficient “online sales tax loophole” that gives out-of-state businesses an advantage. A. Laffer & D. Arduin, Pro–Growth Tax Reform and E–Fairness 1, 4 (July 2013). And “while nexus rules are clearly necessary,” the Court “should focus on rules that are appropriate to the twenty-first century, not the nineteenth.” Hellerstein, Deconstructing the Debate Over State Taxation of Electronic Commerce, 13 Harv. J.L. & Tech. 549, 553 (2000). Each year, the physical presence rule becomes further removed from economic reality and results in significant revenue losses to the States. These critiques underscore that the physical presence rule, both as first formulated and as applied today, is an incorrect interpretation of the Commerce Clause.

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<sup>80</sup> U.N. Department of Economic and Social Affairs, World Bank Group Staff Comments on U.N. Article 12B of the U.N. Model Tax Convention, <http://www.un.org/development/desa/financing/document/world-bank-group-staff-comments-proposed-un-article-12b-un-model-tax-convention-automated> [<http://perma.cc/4V58-68SR>] (last visited Dec. 15, 2022).

<sup>81</sup> 138 S. Ct. 2080, 2097 (2018).

The physical presence rule as defined and enforced in *Bellas Hess* and *Quill* is not just a technical legal problem—it is an extraordinary imposition by the Judiciary on States’ authority to collect taxes and perform critical public functions. Forty-one States, two Territories, and the District of Columbia now ask this Court to reject the test formulated in *Quill*. See Brief for Colorado et al. as *Amici Curiae*. *Quill*’s physical presence rule intrudes on States’ reasonable choices in enacting their tax systems. And that it allows remote sellers to escape an obligation to remit a lawful state tax is unfair and unjust. It is unfair and unjust to those competitors, both local and out of State, who must remit the tax; to the consumers who pay the tax; and to the States that seek fair enforcement of the sales tax, a tax many States for many years have considered an indispensable source for raising revenue.<sup>82</sup>

The fact that the vast majority of U.S. states joined in the suit and indicated that a virtual presence is a “sufficiently close connection” to a jurisdiction for it to assert taxation over those remote participants contradicts against the Treasury Department’s assertion in Treas. Reg. §1.901-2(b)(5) that a physical presence must exist in order for U.S. notions of nexus to exist. The Supreme Court further opined in *Wayfair* that any notion of a physical presence nexus requirement must give way to the “far-reaching systemic and structural changes in the economy” and “many other societal dimensions” caused by the Cyber Age.<sup>83</sup> As a result, the Treasury Department’s assertion that a physical presence is required directly contradicts the Supreme Court’s statement that “[m]odern e-commerce does not align analytically with a test that relies on the sort of physical presence” and that “[t]his Court should not maintain a [physical presence] rule that ignores these substantial virtual connections to the State.”<sup>84</sup>

In response to this argument, the Treasury Department stated simply that the manner in which states determine their tax base has no bearing on the question for how the federal government should address that question.<sup>85</sup> This manner of distinguishing *South Dakota v. Wayfair* fails to acknowledge that the Supreme Court articulated the contours of nexus in the U.S. sense and found that the assertion of virtual nexus is within the norms of what a U.S. taxing jurisdiction may impose. To restrict the reasoning applied in *Wayfair* to simply an expression of state taxation norms repudiates the public policy and economic commerce arguments that guided the Supreme Court’s decision.

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<sup>82</sup> *Id.* at 2092, 2095–96.

<sup>83</sup> *Id.* at 2097.

<sup>84</sup> *Id.* at 2095.

<sup>85</sup> T.D. 9959, 87 Fed. Reg. 276, 287 (Jan. 4, 2022). The Treasury Department cited to *Heiner v. Mellon*, 304 U.S. 271 (1937). The Treasury Department’s omission of a direct citation to *Wayfair* is telling.



Thus, the Treasury Department's position appears to be that an international norm cannot exist unless the U.S. Congress has enacted a comparable tax provision into U.S. law. That position is a decidedly nationalistic view of what constitutes an "international norm" and is dismissive of the Supreme Court's own statements about jurisdictional nexus under the U.S. Constitution. Section 901 purports to provide a foreign tax credit to any foreign tax that is an income tax in the U.S. sense, and Congress early-on removed any language that would have augured for a jurisdictional nexus and sourcing conformity requirement. The U.S. Constitution does not restrict Congress' jurisdictional nexus prerogatives in the manner contemplated by the 2022 final regulations, and a broad international consensus has reached agreement on extraterritorial taxation of remote sellers under the OECD's Pillar One proposal. In light of all of the above, the Treasury Department's position appears to be one that is a negotiating tactic and not one based on a principled position.

B. Does the Case Law Under Section 901 Support a Close Conformity Requirement as a Prerequisite to a Foreign Levy's Eligibility for the Foreign Tax Credit?

Earlier in Part I.A., this article addressed the legislative history and the statutory text, purpose, and policy of the foreign tax credit to consider whether the Treasury Department's regulations are consistent with those principles. However, the Treasury Department separately argued that an independent basis for its regulatory action is the judicial case law that has interpreted Section 901. In this Part I.B., this article considers whether the existing case law supports the 2022 regulatory amendments.

1. Biddle Doctrine and Early Cases

From the beginning, a central problem of the foreign tax credit has been to determine the contours of the foreign taxes for which it lies. The description of creditable taxes in Section 901(b)(1) is "any income . . . taxes paid . . . to any foreign country."<sup>86</sup> At the core of the complex statutory system governing the credit is a reference to foreign "income taxes," a category later enlarged by the addition of foreign taxes "in lieu of" income taxes.<sup>87</sup> Beyond its use of the two operative words, "income . . . taxes," the Code says

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<sup>86</sup> I.R.C. § 901(b) (West 2022).

<sup>87</sup> I.R.C. §§ 901(b), 903 (West 2022). For a more extensive discussion of creditable taxes and the relevant Treasury regulations, see Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 TAX L. REV. 227 (1984); Wells, *Foreign Tax Credit War*, *supra* note 71, at 1960–62 (2016).

almost nothing more about creditable taxes.<sup>88</sup> The bare terms do reveal, at a minimum, that the credit lies for “taxes” (rather than some other kind of payment) imposed on “income” (rather than some other base).<sup>89</sup>

In deciding what foreign taxes represent income taxes eligible for U.S. foreign tax credit relief, two sentences of dictum in *Biddle v. Commissioner*<sup>90</sup> have taken center stage.<sup>91</sup> *Biddle* dealt with whether a U.S. shareholder of a British corporation subject to an integrated British corporate tax could be treated as having “paid” the taxes imposed on the corporation.<sup>92</sup> In its discussion of the issue of whether taxes had actually been paid, the Court offered the following thought as to the analysis that should apply to determine whether the tax (if paid) was an income tax: “[I]ncome taxes paid,’ as used in our own revenue laws, has for most practical purposes a well understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes. It is that meaning which must be attributed to it . . . .”<sup>93</sup> This assertion that U.S. principles guide the determination of whether or not a foreign levy is an income tax has been warmly embraced in subsequent cases that address whether a foreign levy is creditable as a foreign income tax.<sup>94</sup>

The *Biddle* dictum states, rather than resolves, the problem. The notion of an “income tax” that emerges from U.S. principles is itself none too clear. The U.S. income tax is not a static creation. It evolves and is amended almost on an annual basis. Even if a foreign jurisdiction had a tax regime that was identical to the U.S. income tax at some point in time, it would be hard to imagine that it would remain so. In terms of applying U.S. principles to the rich variety of foreign levies to determine their status as an income tax,<sup>95</sup> early cases and I.R.S. rulings had held

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<sup>88</sup> See generally I.R.C. § 901 (West 2022).

<sup>89</sup> For a further discussion of the controversy regarding whether a payment was a tax applied on net income, see JOSEPH ISENBERGH & BRET WELLS, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶¶ 56.13–14 (Wolters Kluwer 6th ed. 2022).

<sup>90</sup> 302 U.S. 573, 579 (1938) (dictum).

<sup>91</sup> See ISENBERGH & WELLS, *supra* note 89, ¶ 56.10.2.

<sup>92</sup> *Biddle v. Comm’r*, 302 U.S. 573, 579 (1938)

<sup>93</sup> *Id.* The context of this passage indicates that the Supreme Court was asking whether the British tax had been *paid* within the meaning of U.S. tax concepts, and not whether the tax was imposed on “income.” On the latter question, therefore, the statement is *dictum* (not a holding). *Id.*

<sup>94</sup> Although *Biddle* dealt with whether U.S. or foreign law should be used to determine the identity of the technical taxpayer of the foreign tax, subsequent cases used the Supreme Court’s statement that U.S. law, not foreign law, should broadly be used for purposes of applying the U.S. foreign tax credit rules including with respect to the question of whether a foreign levy was an income tax. See *Comm’r v. Am. Metal Co.*, 221 F.2d 134 (2d Cir. 1955).

<sup>95</sup> Some have called for a broader allowance of creditability of taxes beyond foreign income taxes. See Isenbergh, *supra* note 87, at 229.

that taxes levied on “imputed income” could be eligible for U.S. foreign tax credit relief if net income is what was attempted to be taxed and was so taxed.<sup>96</sup> In general, these cases and early I.R.S. rulings took an expansive view of credit eligibility, allowing considerable latitude to the foreign country to define the manner in which a tax arrived at the net income it intended to tax.<sup>97</sup> The case law did not accept the foreign law characterization of their own foreign levy. Instead, U.S. principles would determine whether the foreign levy was in substance an income tax. Thus, although the diversity of foreign taxes made the pre-1983 case law inconsistent at the outer edges, the substantive law was one that was based on a principle-based approach: if the foreign tax was designed to tax some amount of net income and predominantly did in fact tax some amount of net income in practice, then U.S. foreign tax credit relief was appropriate in order to prevent international double income taxation.<sup>98</sup>

## 2. *Bank of America* Standard

An important articulation for how to harmonize these decisions came in *Bank of America v. United States*.<sup>99</sup> In the *Bank of America* case, the Court of Claims offered a cogent formulation of the *Biddle* standard for creditable income taxes.<sup>100</sup> At issue in *Bank of America* was credit for foreign taxes imposed on the gross income of a U.S. bank.<sup>101</sup> The Court of Claims declared that the standard for determining the foreign tax credit eligibility was as follows: “a direct income tax is creditable, even though imposed on gross income, if it is very highly likely, or was reasonably intended, always to reach

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<sup>96</sup> See *Keen v. Comm’r*, 15 B.T.A. 1243, 1246 (1929) (a tax on presumed income was calculated on nondomiciled persons who maintained a residence in France; income was presumed to be a minimum of seven times the rental value of their residence; held, French tax was an income tax eligible for U.S. foreign tax credit relief); see also *Hatmaker v. Comm’r*, 15 B.T.A. 1044, 1045 (1929) (same); see also *Burke Brothers v. Comm’r*, 20 B.T.A. 657, 660 (1930) (Indian tax on goat skins based on the difference between the average sales price of goat skins in their destination from the average sales price in Calcutta and reduced by certain transportation expenses; held, the presumptive tax was an income tax entitled to U.S. foreign tax credit relief); see also Rev. Rul. 53-272, 1953-2 C.B. 56 (Haitian tax imposed on business income computed by multiplying the rental value of the land and buildings by five and assessing an income tax on this imputed income; I.R.S. held this was an attempt to tax presumed income and was eligible for U.S. foreign tax credit relief); see also Rev. Rul. 56-658, 1956-2 C.B. 501 (Cuban tax on sugar mill operators assessed based on the amount of sugar produced times the average price for sugar and reduced by 60% for “deemed expenses;” held that this presumptive tax was creditable as an attempt to tax income).

<sup>97</sup> See ELISABETH A. OWENS, *THE FOREIGN TAX CREDIT: A STUDY OF THE CREDIT FOR FOREIGN TAXES UNDER UNITED STATES INCOME TAX LAW* 43–46 (Law School of Harv. Univ. Cambridge, 1961).

<sup>98</sup> See *id.*; see also ISENBERGH & WELLS, *supra* note 89, ¶ 56.10.

<sup>99</sup> *Bank of Am. Nat’l Trust & Sav. Ass’n v. United States*, 459 F.2d 513, 519–20 (Ct. Cl. 1972).

<sup>100</sup> See *id.* at 518.

<sup>101</sup> See *id.* at 514–15.

some net gain in the normal circumstances in which it applies . . . .”<sup>102</sup> This standard, known as the *Bank of America* standard, operates within the constraints of *Biddle*, but it also countenances departures from strict conformity with U.S. tax norms. A tax can reach “some net gain” in the normal circumstances in which it applies without being strictly based on the same amount of net income as defined in the Internal Revenue Code.

As with the *Biddle* standard, the *Bank of America* standard is not simply a statement of the literal holding in the case. In fact, all the taxes actually under review in *Bank of America* were found *not* to be creditable.<sup>103</sup> Those taxes, from several different countries, were imposed on the gross income of enterprises engaged in the active conduct of business.<sup>104</sup> Because no deductions were allowed for the cost of producing the income, while the underlying business activity necessarily entailed expenses, the taxes were held non-creditable.<sup>105</sup> The statement of principle, however—that a foreign tax is creditable if designed to reach *some* net gain—is generally favorable to taxpayers.<sup>106</sup> Indeed, the government argued for a much stricter standard.<sup>107</sup> The first case on creditable taxes after *Bank of America*, *Inland Steel Co. v. United States*, largely reasserts the same standard.<sup>108</sup> *Inland Steel* concerns the creditability of an Ontario mining tax imposed on a tax base from which only operating expenses were allowed as deductions but not interest, depletion, royalty payments to private owners, or depreciation.<sup>109</sup> The tax was imposed whether or not the ore produced by the taxpayer was sold. This tax was essentially similar to the one imposed in *Keasbey*,<sup>110</sup> and the outcome was the same:

[W]hen the mass of the omitted items in the [Ontario tax] are considered together and in combination as applied to plaintiff's mining business, it is clear to us that tax does not seek to reach, or necessarily reach, any concept of net gain from the mining business which would be recognized as such in this country. . . . The exclusions are far too widespread and important to permit the conclusion that some net gain is sure to be reached.<sup>111</sup>

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<sup>102</sup> *Id.* at 519-20.

<sup>103</sup> *See, e.g., id.* at 524-25 (deciding that the foreign taxes levied on gross income from the taxpayer's banking business were not creditable).

<sup>104</sup> *See id.*

<sup>105</sup> *See id.* at 524.

<sup>106</sup> *See id.* at 523.

<sup>107</sup> *See id.* at 523 n.20 (noting the I.R.S. position that any denial of cost recovery, even slight, should prevent creditability).

<sup>108</sup> *Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982).

<sup>109</sup> *See id.* at 79, 82.

<sup>110</sup> *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894 (3d Cir. 1943). A further discussion of *Keasbey* is set forth in ISENBERGH & WELLS, *supra* note 89, ¶ 56.10.3.

<sup>111</sup> *Inland Steel Co.*, 677 F.2d at 85. The same Ontario tax was found creditable in a

The *Bank of America* standard, as expressed in *Bank of America* and *Inland Steel*, thus looked at whether the foreign tax was likely to reach some amount of net gain. When that standard could not be met using U.S. principles, the foreign tax was not considered to be an income tax in the U.S. sense. The Tax Court also endorsed the *Bank of America* standard as the correct application of the *Biddle* doctrine.<sup>112</sup> These cases obtained prominent attention in the preamble to the 1983 regulations because of their particular articulations of the *Biddle* doctrine.<sup>113</sup>

### 3. The 1983 Final Regulations and The Grafting of Formal Requirements onto the Bank of America Standard

The regulations on creditable foreign taxes under Section 901 purport to be—and probably are—a comprehensive statement of doctrine. The oil crises of the 1970s forced a systematic scrutiny of whether payments to foreign countries were foreign taxes or were disguised oil royalties.<sup>114</sup> After successive generations of

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later case decided after the issuance of the 1983 regulations. See ISENBERGH & WELLS, *supra* note 89, ¶ 56.13.4 n.311.

<sup>112</sup> The Tax Court endorsed and explained the *Bank of America* standard in *Bank of America National Trust & Savings Ass'n v. Commissioner*. In that case, the Tax Court explained the controlling standard in the following terms:

Perhaps the test which we and the Court of Claims have articulated will not provide that magic touchstone whereby every situation in this area can be precisely located in the spectrum of foreign taxes ranging from pure net income taxes on one end to pure excise, sales, or privilege taxes on the other. But we are convinced that the test is not 'manufactured out of whole cloth,' as petitioner would have us believe, and that it provides a rational and manageable basis for interpretation of section 901(b)(1).

See *Bank of Am. Nat'l Tr. & Sav. Ass'n v. Comm'r*, 61 T.C. 752, 762–63 (1974).

<sup>113</sup> See T.D. 7918, 48 Fed. Reg. 46271, 46272 (Oct. 12, 1983).

<sup>114</sup> In this regard, petroleum taxes often were at least in part determined on a formulary basis. See, e.g., Rev. Rul. 69-388, 1969-2 C.B. 154, *revoked by* Rev. Rul. 76-215, 1976-1 C.B. 194; Rev. Rul. 55-296, 1955-1 C.B. 386 (holding that Saudi Arabia's imposed surtax equal to a percentage of the posted price per barrel of oil was a creditable income tax), *revoked by* Rev. Rul. 78-63, 1978-1 C.B. 228; 68-552, 1968-2 C.B. 306 (holding that a surtax imposed by Libya based on a posted price per barrel on holders of petroleum concessions was a creditable income tax Rev. Rul. ), *revoked by* Rev. Rul. 78-63, 1978-1 C.B. 228. This effort to amend the foreign tax credit eligibility standards as a means to address the disguised oil royalty problem was discussed in several contemporaneous testimony and articles. See *Foreign Tax Credit for Oil and Gas Extraction Taxes: Hearings Before the H. Comm. on Ways & Means*, 96th Cong. 10–11 (1979) (stating that the proposed regulatory changes and proposals to tighten I.R.C. Section 907 limitations were "parallel but independent efforts serving the same broad objective"); D. Kevin Dolan, *Foreign Tax Credit Regulations as They Affect Petroleum Income—Post Mortem and Analysis*, 83 TAX MGMT. INT'L. J. 1, 3–6 (1983) [hereinafter *Petroleum Income*] ("Those outside of the petroleum industry must first understand that the [1980 and 1983 amendments to the] foreign tax credit regulations represent an administrative effort by the IRS and Treasury to limit the creditability of high rate foreign extraction taxes and that, absent concerns related to extraction taxes, the regulation project would probably not have been undertaken."). For a discussion of this parallel effort, see Glenn E. Coven, *International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes*, 4 FLA. TAX REV. 83, 114–16 (1999).

regulations,<sup>115</sup> the Treasury Department in 1983 issued a set of regulations on creditable foreign taxes under Sections 901 and 903.<sup>116</sup> Much of the explosion of complexity is attributable to the Service's efforts, since 1983, to redefine the scope of the foreign tax credit eligibility rules to outright disallow the availability of foreign tax credits generated in "inappropriate transactions."<sup>117</sup> Although Congress' intent with respect to formulary taxes may be in doubt, there is no doubt that the Treasury Department wanted to overturn prior case law<sup>118</sup> to the extent that prior case law had granted

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<sup>115</sup> On November 17, 1980, the Treasury Department issued temporary regulations that articulated formal criteria that a foreign tax would be eligible for U.S. foreign tax credit relief if and only if the foreign tax was equivalent to an income tax in the U.S. sense, and for this test to be met the foreign tax must meet three formalistic tests (the gross receipts test, the realization test, and the net income test). Treas. Reg. § 4.901-2(c) (1980). For an analysis of these temporary regulations and their impact on prior law, see *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256, 285 (1995). The effect of the 1980 regulations was that a levy paid by a petroleum company to a mineral-owning foreign government could be denied in its entirety if the effective tax rates for petroleum taxpayers were significantly higher than those imposed on nonpetroleum taxpayers. Treas. Reg. § 4.901-2(d) (1980). Prior case law had determined that foreign taxes represented income tax if they were "substantial[ly] equivalent" in nature to the U.S. income tax regime. See, e.g., *N.Y. & Hond. Rosario Mining Co. v. Comm'r*, 168 F.2d 745, 747 (2d Cir. 1948), *rev'g. and remanding* 8 T.C. 1232 (1947). However, on April 5, 1983, the Treasury Department stated that a foreign levy would be eligible for U.S. foreign tax credit relief if and only if the "predominant character" of the foreign levy was that of an income tax in the U.S. sense, and these final regulations left the underlying formalistic three-pronged test for creditability essentially unchanged. See Notice of Proposed Rulemaking, 48 Fed. Reg. 14641 (Apr. 5, 1983); see also D. Kevin Dolan, *General Standards of Creditability Under §§ 901 and 903 Final Regulations—New Words, Old Concepts*, 13 TAX MGMT. INT'L J. 167, 168 (1984) [hereinafter *New Worlds, Old Concepts*] ("One can only guess whether there is any difference between those general standards [predominant character versus substantially equivalent standard in earlier case law] in terms of the degree to which foreign law must conform to U.S. tax principles"). These 1983 proposed regulations also set forth detailed guidance on dual capacity taxpayers that granted partial foreign tax credit relief for dual capacity taxpayers if the foreign jurisdiction had a generally imposed income tax that applied outside the extraction industry. For an analysis of this regulatory evolution through the issuance of the 1983 proposed regulations, see *Petroleum Income*, *supra* note 114, at 7–8. The final regulations issued on October 12, 1983, softened this dual capacity standard by providing that partial foreign tax credit relief would be available for dual capacity taxpayers even if the foreign country did not have a generally applicable income tax that was imposed on non-extraction taxpayers. See *id.* at 3–6.

<sup>116</sup> T.D. 7918, 48 Fed. Reg. 46272, 46276 (Oct. 12, 1983).

<sup>117</sup> The prior 1983 final regulations effort to impose more formality than simply the *Bank of America* standard is addressed in further detail in Wells, *Foreign Tax Credit War*, *supra* note 71, at 1960–62.

<sup>118</sup> For an example of a pre-1983 case that the 1983 final regulations intended to overrule, see *Seatrains Lines Inc. v. Commissioner*, 46 B.T.A. 1076 (1942), *nonacq.*, 1942-2 C.B. 31. In *Seatrains*, Cuba had imposed a formulary tax upon realized gain. In order to resolve a dispute over the amount of deductible expenses, the Cuban government substituted a three percent tax on gross shipping income for a six percent tax on net profits. The Board of Tax Appeals held that the tax was creditable because the tax was imposed on gain realized under U.S. standards and because the intent of the lower gross tax was to simulate the earlier net income tax at that higher rate. *Id.* For a discussion of this more lenient line of authority, see OWENS, *supra* note 97, at 46. For an excellent summary of the prior case law and the efforts made in the 1983 final regulations to tighten up the standards for allowing foreign tax credit relief, see *Petroleum Income*, *supra* note 114, at 8; see also Coven, *supra* note 114, at 115–16.

foreign tax credit relief for a gross formulary tax that did not provide for sufficient cost recovery.<sup>119</sup> Consequently, whereas the pre-1983 case law had utilized a substance over form holistic approach to determine whether a foreign levy was assessed on some amount of net income,<sup>120</sup> commentators<sup>121</sup> and the courts<sup>122</sup> recognized that the Treasury Department's final regulations represented an effort to impose stricter conformity in terms of the actual formal design of foreign law. To ensure nobody missed this conclusion, after issuing the 1983 final regulations, the I.R.S. revoked fifty years of prior Section 901 revenue ruling positions<sup>123</sup> and reversed long-standing I.R.S. acquiescence in prior Section 901 cases<sup>124</sup> whenever those prior rulings were inconsistent with the government's regulatory formalistic standard for credit eligibility.<sup>125</sup> The additional changes made in 2022 simply heighten the reliance on the existence in the foreign tax law of formalistic

<sup>119</sup> See T.D. 9959, 87 Fed. Reg. 276, 296 (Jan. 4, 2022).

<sup>120</sup> See *Bank of Am. Nat'l Tr. & Sav. Ass'n v. United States*, 459 F.2d 513, 519 (Ct. Cl. 1972).

<sup>121</sup> See *New Worlds, Old Concepts*, *supra* note 115, at 168–69 (“Fortunately, the regulations provide specific tests for determining whether the general *Bank of America* standard is satisfied.”). Mr. Dolan was in the government and played an active role in drafting the 1983 regulations. See Wells, *Foreign Tax Credit War*, *supra* note 71, at 1916 n.66.

<sup>122</sup> See *Texasgulf, Inc. v. Comm’r*, 107 T.C. 51, 73 n.3 (1996), *aff’d*, 172 F.3d 209 (2d Cir. 1999) (quoting Dolan commentary cited in note 115 with approval). In discussing the import of the 1983 final regulations, the Tax Court observed as follows:

The preamble states that the regulations adopt the creditability criterion from certain cases to use in deciding whether the predominant character of a foreign tax is likely to reach net gain for purposes of section 1.901-2(a)(3)(i), Income Tax Regs. The preamble states that a tax is likely to reach net gain if it meets three tests provided in the regulations. The regulations provide objective and quantitative standards *that were not used in cases which decided creditability of foreign taxes before the regulations became final*. Regulations can supersede prior case law to the extent that they provide requirements and definitions not found in prior case law.

*Id.* at 68–69 (emphasis added); see also, e.g., *Bowater Inc. v. Comm’r*, 101 T.C. 207, 212 (1993); *Nissho Iwai Am. Corp. v. Comm’r*, 89 T.C. 765, 776–77 (1987).

<sup>123</sup> Initially, the I.R.S. did not challenge the foreign tax credit generator aspects of foreign taxes paid under production-sharing agreements that generated inflated amounts of U.S. foreign tax credits. See Rev. Rul. 69-388, 1969-2 C.B. 154 (discussing how Indonesia imposed a special tax by contract for companies operating in oil and gas producing regions in Indonesia held to be a creditable “in lieu of” tax under Section 903; this ruling was colloquially known as “Indonesia I” in the industry). The I.R.S. subsequently revoked Indonesia I. See Rev. Rul. 76-215, 1976-1 C.B. 194, 10–13 (stating that the payment was, in substance, a royalty, not a tax, and therefore not eligible for U.S. tax credit relief under either Section 901 or Section 903; this ruling was colloquially known as “Indonesia II” in the industry). But, by the mid-1970s, the I.R.S. decided to launch an assault on these “disguised oil royalty arrangements” even as Congress added a new foreign tax credit basket to address this same phenomenon. See Coven, *supra* note 114, at 100–05 (analyzing reversal of the historic I.R.S. position as set forth in its prior rulings).

<sup>124</sup> See Rev. Rul. 84-172, 1984-2 C.B. 315 (declaring each of the following rulings obsolete after adoption of final regulations: Rev. Rul. 76-215, 1976-1 C.B. 194; Rev. Rul. 78-61, 1978-1 C.B. 221; Rev. Rul. 78-62, 1978-1 C.B. 226; Rev. Rul. 78-63, 1978-1 C.B. 228); see also Coven, *supra* note 114, at 101–03.

<sup>125</sup> See Coven, *supra* note 114, at 101–03.

design hallmarks that conform to those found in the U.S. income tax laws as a prerequisite for foreign tax credit relief.<sup>126</sup>

This was and is a fundamentally different approach than the one utilized under the *Bank of America* standard, where the determination was simply whether a foreign tax was designed to impose a tax on some amount of net income. Thus, this effort to impose formal design requirements into the eligibility rules adds complexity and invites considerable dispute.<sup>127</sup> In 1983, the Treasury Department attempted to adopt the *Bank of America* standard and graft onto it further formal design requirements at the same time. Thus, on the one hand, in the midst of this 1983 revision of the Treasury Department's regulations, the Treasury Department lauded *Bank of America* and *Inland Steel* as enlightened articulations for how U.S. principles should be applied.<sup>128</sup> The prior 1983 final regulations adopted the "predominant character standard" that was articulated in the *Bank of America* case, which in turn focused on whether or not a foreign levy must reach some amount of net gain in the normal circumstances in which it applied. But then, on the other hand, the prior 1983 final regulations grafted onto this *Bank of America* standard the additional requirement that a foreign levy also must possess familiar design hallmarks of the U.S. tax system (realization, gross receipts, and net income) in order to be eligible for foreign tax credit relief.<sup>129</sup>

#### 4. The 2022 Final Regulations Close Conformity Standard

In 2022, the Treasury Department amended its regulations to impose even stricter formal conformity requirements in how the foreign tax is designed. The heightened design formality imposed in 2022 was motivated by a desire to deny foreign tax credit relief for novel extraterritorial taxation regimes where the foreign jurisdiction imposed a tax in a manner that does not closely conform to how the United States determines nexus, income sourcing, and/or does not closely conform to how the United States determines the amount of gain subject to taxation.<sup>130</sup> Thus, in an effort to deny credit relief for novel extraterritorial taxes, the

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<sup>126</sup> See Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72078, 72088 (Nov. 12, 2020); T.D. 9959, 87 Fed. Reg. 276, 292-99 (Jan. 4, 2022).

<sup>127</sup> At least one respected commentator, who was personally involved in the actual drafting of the 1983 regulations, has expressed the view that the Service's efforts to apply and amend the 1983 regulations go in a different direction than the decided case law or the drafters of the regulations would have envisioned. See generally Kevin Dolan, *Foreign Tax Credit Generator Regs: The Purple People Eater Returns*, 115 TAX NOTES 1155 (June 18, 2007).

<sup>128</sup> See T.D. 7918, 48 Fed. Reg. 46272, 46273 (Oct. 12, 1983).

<sup>129</sup> See Former Reg. § 1.901-2(b)(1) in T.D. 7918, 48 Fed. Reg. 46272, 46273 (Oct. 12, 1983).

<sup>130</sup> See Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72078, 72087-92 (Nov. 12, 2020); T.D. 9959, 87 Fed. Reg. 276, 282-99 (Jan. 4, 2022).



Treasury Department now requires the foreign tax law to closely conform in its formal design structure to how the U.S. income tax laws are designed. This close conformity requirement is imposed under the regulations without any intervening statutory change to Section 901. The heightened close conformity requirement raises the question of whether the regulations fulfill the core policy goal of preventing double income taxation as envisioned by Section 901. The fundamental goal of the foreign tax credit regime is to mitigate the evils of international double taxation.<sup>131</sup> And, the statutory provision contains no restriction in terms of credit eligibility by reason of the sourcing conventions or nexus principles utilized by a foreign jurisdiction.

What is more, the 2022 final regulations outright repudiate the *Bank of America* standard that considered whether or not a foreign tax was assessed on some amount of net gain. In its place, the 2022 final regulations require the foreign tax to utilize a tax base to determine the amount of gain subject to tax that closely conforms to how the United States determines the amount of gain subject to taxation under U.S. tax law.<sup>132</sup> The preamble to the 2022 final regulations only cites *Bank of America* for the proposition that a foreign levy must provide cost recovery and not for its predominant character standard, and cites *Inland Steel* for the proposition that U.S. law is applied to determine eligibility.<sup>133</sup> At that point, the 2022 final regulations eschew the manner in which those cases articulated the application of U.S. principles in favor of a restrictive close conformity standard not found in the case law. The 2022 final regulations remove all references to the “predominant character standard” applied in “normal circumstances.”<sup>134</sup> The case law that articulated the use of U.S. principles did so as part of its effort to determine whether or not a foreign law attempted to reach some net gain. That determination would be made using U.S. principles, not foreign law principles.<sup>135</sup>

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<sup>131</sup> See *supra* note 66 and accompanying text.

<sup>132</sup> See Treas. Reg. § 1.901-2(b) (2022).

<sup>133</sup> T.D. 9959, 87 Fed. Reg. 276, 282–99 (Jan. 4, 2022).

<sup>134</sup> See Treas. Reg. § 1.901-2(b) (2022).

<sup>135</sup> The government explained that its regulatory standard based the net gain standard articulated in existing case law, but then attempted to constrict that standard to a formalistic standard. See T.D. 7918, 48 Fed. Reg. 46272, 46273 (Oct. 12, 1983). After endorsing *Bank of America* and *Inland Steel* as authority for mandating that each foreign tax must separately and formalistically satisfy pre-defined formal design features of the gross receipts test in Reg. Section 1.901-2(b)(3)(i), a realization test in Reg. Section 1.901-2(b)(2)(i), and a net income test in former Reg. Section 1.901-2(b)(4)(i), the 1983 final regulations subsequently provided that *each such test must be separately met* in order for a foreign levy payment to qualify for U.S. foreign tax credit relief. *Id.* The Treasury Department was transparent in its desire, stating in the preamble to T.D. 7918:

That was the inquiry. Whether the amount of net gain corresponds to the same amount of net gain that the U.S. tax laws would have calculated was a non sequitur. The government in *Bank of America* argued that a foreign jurisdiction must design its tax base to closely conform to the manner in which U.S. tax base is constructed in order to become eligible for a foreign tax credit, but that position was rejected in *Bank of America*.

The 2022 final regulations require a foreign tax to either satisfy a Platonic idyllic notion of an income tax where exactly the right amount of net gain is determined with all significant expenses allowed as a deduction over some time period, or else the foreign law must deviate away from the Platonic optimum income tax base in a manner that closely adheres to how the United States income tax laws deviate from that Platonic optimum.<sup>136</sup> If the foreign jurisdiction's law deviates from the Platonic optimum income tax in a manner that closely conforms to the deviations found in the U.S. tax laws, then that foreign law must diligently be amended whenever U.S. tax laws are amended to retain that close conformity

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The regulations set forth three tests for determining if a foreign tax is likely to reach net gain: the realization test, the gross receipts test, and the net income test. All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense.

*Id.* The government is adamant in its litigating positions that a foreign tax must meet the formalistic tests set forth in Reg. Section 1.901-2(b) to be eligible for U.S. foreign tax credit relief. See Opening Brief for Respondent at 95, *PPL Corp. v. Comm'r*, 135 T.C. 304 (2010) (No. 25393-07) 2009 WL 6946860; Reply Brief for Respondent at 98, *PPL Corp. v. Comm'r*, 135 T.C. 304 (2010) (No. 25393-07), 2009 WL 6946860 (“The regulation provides . . . specific tests, all of which a foreign tax must satisfy to be deemed an income tax in the U.S. sense, and therefore creditable. These regulatory tests neither permit nor require the application of these tests to the ‘substance’ of the tax.”); Reply Brief for Respondent at 38, *Entergy Corp. v. Comm'r*, 683 F.3d 233 (5th Cir. 2012) (No. 25132-06), 2008 WL 8070871 (“Finally, analysis of pre-regulation case law does not assist in the resolution of this case, since petitioners do not dispute that the U.K. Windfall Tax must satisfy all . . . of the net gain requirements of the regulations to qualify as a creditable tax.”). For additional information, see Opening Brief for Respondent at 95, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07) 2009 WL 6946860, which provides:

If a foreign tax fails to satisfy the “net gain” requirement of the Regulations, it is not creditable for U.S. tax purposes. And the ‘net gain’ requirement requires an analysis of neither the underlying purpose of the foreign tax nor the components of the foreign tax (to determine, for instance, if the Profit-Making Value is a generally accepted method for valuing a Windfall Tax Company). Simply, the “net gain” requirement requires that a foreign tax satisfy each of the objective tests (realization, gross receipts, and net income) to be creditable. The U.K. Windfall Tax fails to satisfy the net gain tests, and therefore it is not a creditable tax.

*Id.* In proposed regulations issued in 2020, the government again relied on this prior case law as the basis for the net gain requirement. See generally Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72078, 72089 (Nov. 12, 2020). But then it asserted that a further tightening of the net gain requirements was appropriate. *Id.* The government adopted this heightened formality in 2022 through significant amendments to those regulations at that time, thus in effect doubling down on the litigating position that it lost in *PPL*. See T.D. 9959, 87 Fed. Reg. 276, 292–99 (Jan. 4, 2022).

<sup>136</sup> Treas. Reg. § 1.901-2(b)(4)(i)(A), (C) (2022).

over time.<sup>137</sup> The 2022 final regulations cite no U.S. judicial case for this new standard because there is none.<sup>138</sup> In terms of determining whether a foreign tax represents the Platonic optimum income tax or deviates in a manner that closely accords with the U.S. deviations, the 2022 final regulations look solely to how foreign law is written without any consideration to the “normal circumstances”<sup>139</sup> in which the tax actually operates.<sup>140</sup>

In terms of defining the Platonic optimum income tax, Treas. Reg. Section 1.901-2 begins in a noncontroversial manner by stating that a foreign tax must meet the regulatory “net gain” requirement in order for the foreign tax to be eligible for U.S. foreign tax credit relief.<sup>141</sup> This “net gain” phraseology harkens back to prior judicial case law that took a holistic, substance over form inquiry into whether the foreign levy was assessed on some amount of net gain. However, it is at this point where the 2022 final regulations eschew the flexibility allowed under prior case law, stating that a tax will be conclusively determined to not meet the net gain requirement unless the foreign tax levy satisfies four specific formal design features.<sup>142</sup> Specifically, the foreign tax must satisfy the realization test,<sup>143</sup> the gross receipts test,<sup>144</sup> the cost recovery test,<sup>145</sup> and the attribution (or jurisdictional nexus

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<sup>137</sup> The regulations require conformity to the existing Internal Revenue Code. See Treas. Reg. § 1.901-2(b)(4)(i)(C) (2022).

<sup>138</sup> See generally *id.*

<sup>139</sup> The regulatory requirement that the practical impact of foreign tax levy must be determined based on a substance over form inquiry was widely interpreted as inviting the use of empirical evidence and other proof to determine the true nature of the foreign levy. See Former Treas. Reg. § 1.901-2(a)(2)(ii)(E)(3) in T.D. 7918, 48 Fed. Reg. 46272, 46277 (Oct. 12, 1983). Consistent with this approach, in *Texasgulf, Inc. v. Commissioner*, the Tax Court held that the Ontario Mining Tax at issue in *Inland Steel* was creditable because, for the taxpayer and others, the processing allowance did in fact “effectively compensate” for the disallowance of other cost recovery. 107 T.C. 51, 70 (1996). It is important to note that the Tax Court in *Texasgulf* accepted empirical evidence to determine whether a processing allowance provided a recovery of all significant expenses for the industry as a whole. See *id.* This decision was subsequently affirmed. See *Texasgulf, Inc. v. Comm’r*, 107 T.C. 51, 69 (1996), *aff’d* 172 F.3d 209 (2d Cir. 1999). The government asserted that the elimination of any need to look at the “normal circumstances” in which a foreign tax operates in practice was justified for administrability reasons as it was a more objective standard. See T.D. 9959, 87 Fed. Reg. 276, 292 (Jan. 4, 2022); Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72078, 72089 (Nov. 12, 2020).

<sup>140</sup> See Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72078, 72087 (Nov. 12, 2020); T.D. 9959, 87 Fed. Reg. 276, 280 (Jan. 4, 2022).

<sup>141</sup> Treas. Reg. § 1.901-2(a)(1)(ii), (a)(3) (2022).

<sup>142</sup> Treas. Reg. § 1.901-2(b)(1) (2022). For an excellent summary of the prior case law and the efforts made in the 1983 final regulations to tighten up the standards for allowing foreign tax credit relief, see *Petroleum Income*, *supra* note 114, at 3–6.

<sup>143</sup> Treas. Reg. § 1.901-2(b)(2)(i) (2022).

<sup>144</sup> Treas. Reg. § 1.901-2(b)(3)(i) (2022).

<sup>145</sup> Treas. Reg. § 1.901-2(b)(4)(i) (2022).

and sourcing conformity) requirement.<sup>146</sup> For present purposes, the cost recovery requirement is of particular interest.

The reader by now has divined that the cost recovery requirement is satisfied if significant costs are recovered. Taxes predicated entirely on gross receipts or gross income do not satisfy the regulatory cost recovery requirement unless “there are no significant costs and expenses attributable to the gross receipts included in the foreign tax base.”<sup>147</sup>

In response to considerable comments, the Treasury Department issued proposed regulations in 2022 that relaxed its cost recovery requirement and provided additional safe harbors to partially address the strict conformity approach that it had promulgated in the 2022 final regulations.<sup>148</sup> Under the proposed regulations, a foreign tax satisfies the cost recovery requirement if it permits a recovery of “substantially all” of each item of significant costs or expense,<sup>149</sup> which is a more lenient standard to the one set forth in the 2022 final regulations that required that all significant costs must be recovered but still one that is significantly higher than the prior case law. The proposed regulations then state that whether a foreign tax permits a recovery of substantially all of each item of significant costs or expense is determined based solely on the terms of the foreign law.<sup>150</sup> However, notwithstanding this statement in the preamble, it is difficult to see how the factual determination of whether or not “substantially all” of the significant expenditures

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<sup>146</sup> Treas. Reg. § 1.901-2(b)(5) (2022).

<sup>147</sup> Treas. Reg. § 1.901-2(b)(4)(i)(A) (2022).

<sup>148</sup> Notice of Proposed Rulemaking, REG-12096-22, 87 Fed. Reg. 71271, 71273–74 (Nov. 22, 2022).

<sup>149</sup> Prop. Treas. Reg. § 1.901-2(b)(4)(i)(A), 87 Fed. Reg. 71271, 71280 (Nov. 22, 2022); Treas. Reg. § 1.901-2(b)(4)(i)(A) (2022). A comparison of the language in the later 2022 proposed regulations with the earlier 2022 final regulations is helpful to clarify the change:

A foreign tax satisfies the cost recovery requirement if the base of the tax is computed by reducing gross receipts (as described in paragraph (b)(3) of this section) to permit recovery of ~~the significant costs and expenses~~ substantially all of each item of significant cost or expense (including ~~capital expenditures~~ each item of cost or expense related to the categories described in section (b)(4)(i)(B)(2) of this section) ~~described in paragraph (b)(4)(i)(C) of this section~~ attributable, under reasonable principles, to such gross receipts.

<sup>150</sup> Prop. Treas. Reg. § 1.901-2(b)(4)(i)(C)(1), 87 Fed. Reg. 71271, 71281 (Nov. 22, 2022). The Treasury Department indicated that the application of the substantially all test outside of the safe harbors would be based solely on the text of foreign law and would not involve a review of empirical evidence. Notice of Proposed Rulemaking, REG-12096-22, 87 Fed. Reg. 71271, 71274 (Nov. 22, 2022). The proposed regulations indicate that whether or not an item of cost or expense, if not designated as a per se significant cost, is significant for purposes of the regulations is determined based on whether, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayer's total costs and expenses. *See* Prop. Treas. Reg. § 1.901-2(b)(4)(i)(B)(1), 87 Fed. Reg. 71271, 71280 (Nov. 22, 2022). This regulatory standard appears to mandate a review of how the tax applies in practice that necessarily requires one to analyze empirical evidence.

under all the relevant facts and circumstances were allowed could be made without looking into empirical evidence for how the foreign levy applied in practice.<sup>151</sup> The safe harbors require one to determine whether the disallowances exceed some threshold of gross receipts or taxable income, and that requires an inspection into how the tax applies in practice in order to apply the safe harbors. Outside the safe harbors, notwithstanding the Treasury Department's repeated assertions to the contrary in the preamble to its regulations, the regulatory provisions impose the requirement for a court to make a factual determination as to whether or not the foreign levy allowed substantially all of the significant costs as a deduction under all the facts and circumstances in which that particular tax applies.<sup>152</sup> That determination logically predestines a court to inquire into whether the practical impact of a particular foreign law disallowance provision was in fact substantial in practice. That inquiry by necessity leads to review empirical evidence for how the foreign law applies in the actual facts and circumstances for the industry involved.

The dividing line between expenditures that are “significant” versus “insignificant” is a key decision point in terms of applying these regulations. The existing regulations provide helpful clarity on the treatment of flat taxes applied on the gross amount of fixed and determinable income.<sup>153</sup> The existing regulations provide that cost recovery is not needed if the foreign gross basis levy applies to wage income or applies to investment income that is not derived from a trade or business.<sup>154</sup> Under this standard, taxes on the gross amount of rents or royalties are on shakier ground, but at least some of them arguably are creditable as the regulations state that cost recovery is not needed if the costs are not significant.

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<sup>151</sup> The proposed regulations indicate that whether or not an item of cost or expense, if not designated as a per se significant cost, is significant for purposes of the regulations is determined based on whether, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayers' total costs and expenses. See Prop. Treas. Reg. § 1.901-2(b)(4)(i)(B)(1), 87 Fed. Reg. 71271, 71280 (Nov. 22, 2022). This regulatory standard appears to mandate a review of how the tax applies in practice that necessarily requires one to analyze empirical evidence.

<sup>152</sup> See Notice of Proposed Rulemaking, REG-12096-22, 87 Fed. Reg. 71271, 71273–74 (Nov. 22, 2022).

<sup>153</sup> The issue of whether Section 901 was intended to provide relief only for net income taxes or for gross income taxes has been the subject of scholarly debate for over sixty years, and there is little indication that the original Congress that adopted the U.S. foreign tax credit gave this issue much thought. See Surrey, *supra* note 68, at 819–22; see also H.R. REP. NO. 65-767, at 11–12 (1918); 56 CONG. REC. 634, 667–78 (1918), <http://www.govinfo.gov/content/pkg/GPO-CRECB-1918-pt12-v56/pdf/GPO-CRECB-1918-pt12-v56-4.pdf>.

<sup>154</sup> Treas. Reg. § 1.901-2(b)(4)(i)(C)(2) (2022); see Treas. Reg. § 1.901-2(b)(4)(iv)(D) (2022) (providing an example of a gross basis wage withholding as a final tax).

Moreover, even if a gross basis levy fails to satisfy the cost recovery requirement,<sup>155</sup> these taxes may qualify as “in lieu of” taxes.<sup>156</sup>

A further exception also is provided for simplified presumptive tax regimes that apply only to “small business[es].”<sup>157</sup> The small business exception now contained in the final regulations requires one to revisit prior guidance that had been given for presumptive tax regimes<sup>158</sup> because the final regulations add a new legally relevant fact into the equation, namely is such a regime applied only to “small businesses.”<sup>159</sup> The scope of this “small business” exception is unclear. The final regulations provide an example involving a simplified presumptive regime that applies to businesses that have gross revenue of less than \$500,000 and declare that this satisfies the “small business” exception.<sup>160</sup> Elsewhere in the U.S. tax law, a small business is defined as a business that has gross receipts of less than \$25 million,<sup>161</sup> but the regulations do not cross-reference this small business definition for purposes of applying its Section 901 regulations, nor do these regulations provide their own definition of a small business. Thus, the outer limits of when a business crosses over the threshold of a “small business” remain unclear.<sup>162</sup>

More fundamentally, the introduction of a small business exception to the cost recovery requirement now creates a new dichotomy for how Section 901 is applied to taxpayers. Prior to the 2022 amendment to the final regulations, the eligibility for credit relief did not depend upon whether the taxpayer was large, small, or medium size. The same rules applied across the board to all foreign levies, regardless of the identity of the particular taxpayer group to which it applied. Moreover, the statutory provision does not indicate that the credit is dependent upon the size of the taxpayer’s business. Rather, Section 901(a) states that the provision applies to “the taxpayer,” and “the taxpayer” is defined

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<sup>155</sup> See Treas. Reg. § 1.901-2(b)(4)(iv)(A) (2022).

<sup>156</sup> See I.R.C. § 903 (West 2022).

<sup>157</sup> See Treas. Reg. § 1.901-2(b)(4)(i)(B)(2) (2022).

<sup>158</sup> See, e.g., Rev. Rul. 76-215, 1976-1 C.B. 194; I.R.S. Gen. Couns. Mem. 38087 (Sept. 12, 1979); I.R.S. Gen. Couns. Mem. 36587 (Feb. 17, 1976); I.R.S. Tech. Adv. Mem. 95-32-003 (May 30, 1995); I.R.S. Tech. Adv. Mem. 97-13-001 (Apr. 26, 1995); I.R.S. Tech. Adv. Mem. 2003-31-001 (Apr. 1, 2003). Presumptive tax regimes had represented income taxes in the U.S. sense only when the courts were convinced that deductions were allowed that compensated for the non-deductibility of significant business expenses. See, e.g., *E Exxon Corp. v. Comm’r*, 113 T.C. 338, 351–52 (1999); *Texasgulf, Inc. v. Comm’r*, 107 T.C. 51, 69 (1996), *aff’d* 172 F.3d 209 (2d Cir. 1999). The regulations relax this requirement.

<sup>159</sup> See Treas. Reg. § 1.901-2(b)(4)(i)(B)(2) (2022).

<sup>160</sup> See Treas. Reg. § 1.901-2(b)(4)(iv)(B) (2022).

<sup>161</sup> See I.R.C. §§ 448(c)(1), 163(j)(3) (West 2022).

<sup>162</sup> I.R.C. § 448(c) (West 2022).

expansively in Section 901(b).<sup>163</sup> Thus, the regulations now differentiate among taxpayers even though the statute does not countenance such a distinction.

For income earned in an active trade or business, the existing regulations provide a heightened standard that requires the foreign jurisdiction to provide cost recovery in a manner that closely conforms to the manner in which cost recovery is allowed under U.S. income tax laws.<sup>164</sup> In this regard, Treasury Regulation Section Reg. Section 1.901-2(b)(4) provides that the regulatory formulation of the cost recovery requirement is satisfied only if the tax allows (1) the recovery of *all*<sup>165</sup> significant costs and expenses (including capital outlays) attributable under reasonable principles to gross receipts, or (2) the recovery of costs and expenses computed under a method that approximates or exceeds the amount of actual costs and expenses.<sup>166</sup> These tests are alternatives. A tax that meets either one is therefore treated as satisfying the cost recovery requirement. Furthermore, although foreign law can allow for a different period for cost recovery than is allowed under U.S. law, the cost recovery requirement is not met if the deferral of cost recovery effectively represents a denial of such recovery.<sup>167</sup> Taken as a whole, the final regulations posit that an income tax in the U.S. sense must allow for recovery of *all*<sup>168</sup> significant business expenditures (or their economic equivalent) in some reasonable period unless there is a similar analogue to a disallowance provision under U.S. tax law.<sup>169</sup> In addition, in the computation of the tax base, the foreign jurisdiction must utilize transfer pricing principles that comply with the arm's length standard without taking destination-based criterion (like customer location) into account.<sup>170</sup>

Given that a disallowance of *any*<sup>171</sup> significant cost with respect to an active trade or business causes the foreign levy to fail as an income tax *in its entirety*, the determination of which costs are “significant” has profound importance. The regulations

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<sup>163</sup> See I.R.C. § 901(a)–(b) (West 2022) (defining taxpayers as citizens, domestic corporations, residents of Puerto Rico, certain nonresident aliens, and certain partnerships and estates without distinction as to size or shape).

<sup>164</sup> See Treas. Reg. § 1.901-2(b)(4)(i)(B)(1) (2022).

<sup>165</sup> The 2022 final regulations seemingly articulate an absolute standard that “all significant cost” must be recovered but the 2022 proposed regulations reduce this threshold to a requirement that “substantially all” of the significant cost must be recovered. See *supra* note 149.

<sup>166</sup> See Treas. Reg. § 1.901-2(b)(4) (2022).

<sup>167</sup> See Treas. Reg. § 1.901-2(b)(4) (2022).

<sup>168</sup> See *supra* note 165 and accompanying text.

<sup>169</sup> See Treas. Reg. § 1.901-2 (2022).

<sup>170</sup> See Treas. Reg. § 1.901-2(b)(5)(ii) (2022).

<sup>171</sup> See *supra* note 165 and accompanying text.

provide that the significance of a particular cost or expenditure is determined based on whether it constitutes a significant portion of the total costs and expenses of all taxpayers subject to the tax.<sup>172</sup> The existing regulations, however, then provide a list of “per se” significant costs and expenses.<sup>173</sup> Included within that group of “per se” significant expenditures are the following: capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation expenditures.<sup>174</sup> To determine whether a payment is made on debt or equity, foreign law (not U.S. law) is utilized.<sup>175</sup> Thus, if a foreign country denies a deduction for a payment made on an instrument that under foreign law is treated as equity, the cost recovery requirement is met because a deduction for dividends is not a “significant cost.”<sup>176</sup> This outcome is the result even if the instrument is treated as debt for U.S. tax purposes and the associated payment is treated as interest (a per se significant cost) for U.S. tax purposes.<sup>177</sup> Again, foreign law categorization of the nature of the expenditure controls for purposes of determining whether it is a significant cost.

However, after articulating a seemingly absolute standard that *all*<sup>178</sup> significant costs must be recovered, the regulations then provide an exception for disallowance provisions that resemble disallowance provisions existing in the U.S. income tax laws.<sup>179</sup> In this regard, a foreign tax is considered to permit the recovery of *all*<sup>180</sup> significant costs and expenses if the foreign tax law limits interest deductions (an otherwise designated “per se” significant cost) based on a regime that is similar to the disallowance regime set forth in Section 163(j).<sup>181</sup> Moreover, a disallowance regime that disallows interest and royalty deductions in connection with hybrid transactions based on principles similar to those underlying Section 267A is also an acceptable variation.<sup>182</sup> Finally, the disallowance of expenses based on public policy considerations similar to those articulated in Section 162 also represents an acceptable disallowance that does not run afoul of the cost recovery

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<sup>172</sup> See Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) (2022).

<sup>173</sup> See Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) (2022).

<sup>174</sup> See *id.*

<sup>175</sup> See *id.*

<sup>176</sup> See Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) (2022).

<sup>177</sup> This helpful clarification was stated in the preamble to the final regulations. See T.D. 9959, 2022-3 I.R.B. 352.

<sup>178</sup> See *supra* note 165 and accompanying text.

<sup>179</sup> See Treas. Reg. § 1.901-2(b)(4)(i)(C) (2022).

<sup>180</sup> See *supra* note 165 and accompanying text.

<sup>181</sup> See Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) (2022). The Treasury Department made some adjustments to this close conformity standard to say that foreign law need only resemble “any principle” of existing U.S. tax law. See T.D. 9959, 87 Fed. Reg. 45018, 45020 (July 27, 2022).

<sup>182</sup> Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) (2022).



requirement.<sup>183</sup> These examples represent a non-exhaustive list.<sup>184</sup> In addition, the existing regulations permit the non-deductibility of provincial income taxes against the national tax.<sup>185</sup> The final regulations state that a disallowance intended to limit base erosion or profit shifting represents an acceptable disallowance provision that does not run afoul of the cost recovery requirement, but then the regulations take pains to provide only examples of base protection measures that are found in existing U.S. tax law.<sup>186</sup>

The proposed regulations issued later in 2022 further ameliorate this close conformity standard by requiring that the foreign disallowance provision only bear some family resemblance to a disallowance provision that exists in the U.S. income tax laws.<sup>187</sup> In this regard, if the foreign law disallowance provision is based on a disallowance that bears a family resemblance to “any principle” for disallowance a deduction in the United States, then it is eligible for a principle-based exception to the cost recovery requirement.<sup>188</sup> Thus, the Treasury Department has given tacit recognition that cost recovery is a flexible standard under an

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<sup>183</sup> *Id.*

<sup>184</sup> *Id.* (noting the use of the term “for example” as illustrating the rule and not limiting the rule).

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*

<sup>187</sup> *See id.*; Prop. Treas. Reg. § 1.901-2(b)(4)(i)(F), 87 Fed. Reg. 71271, 71281–82 (Nov. 22, 2022). The evolution of the regulatory standard here is worth noting. The original 2022 final regulations required the disallowance provisions to be consistent with the principles of the existing United States Internal Revenue Code. *See* T.D. 9959, 87 Fed. Reg. 276, 338 (Jan. 4, 2022). This standard was modified in a technical correction to T.D. 9959 issued shortly thereafter that clarified the foreign law disallowance provision only needed to be consistent with “any” principle underlying United States principles, including principles that seek to limit base erosion and profit shifting and public policy concerns. *See* T.D. 9959, 87 Fed. Reg. 45018, 45020 (July 27, 2022) (correcting T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022)). The proposed regulations move this foreign law disallowance provision exception to the significant cost recovery requirement out of Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) and into a new Prop. Treas. Reg. § 1.901-2(b)(4)(i)(F), and then the proposed regulations further ameliorate the conformity requirement by stating that a disallowance of all or a portion of an item of significant cost or expense does not prevent a foreign tax from satisfying the significant cost recovery requirement if the foreign law disallowance is consistent with any principle underlying the disallowances required under the income tax provisions of the Internal Revenue Code, including the principles of limiting base erosion or profit shifting and addressing non-tax public policy concerns similar to those reflected in the Internal Revenue Code. *See* Prop. Treas. Reg. § 1.901-2(b)(4)(i)(F), 87 Fed. Reg. 71271, 71281 (Nov. 22, 2022). Moreover, the disallowance of expenses based on public policy considerations similar to those articulated in I.R.C. § 162 also represents an acceptable disallowance that satisfies the principle-based exception to the cost recovery requirement.

<sup>188</sup> For example, a disallowance regime that disallows interest and royalty deductions in connection with hybrid transactions based on principles similar to those underlying 26 U.S.C. § 267A satisfies this principle-based exception to the cost recovery requirement. *See* Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) (2023); *see also* Prop. Treas. Reg. § 1.901-2(b)(4)(i)(F), 87 Fed. Reg. 71271, 71281–82 (Nov. 22, 2022). In addition, the disallowance of expenses attributable to exempt income is also consistent with a principle of U.S. tax law and accordingly satisfies the principle-based exception to the cost recovery requirement. *See* Prop. Treas. Reg. § 1.901-2(b)(4)(i)(F), 87 Fed. Reg. 71271, 71281–82 (Nov. 22, 2022).

income tax, but the Treasury Department purports to require any departure from cost recovery to either bear a family resemblance to a corresponding U.S. departure or else the foreign levy must afford substantially all of the significant costs cost recovery in order to be creditable.

This close conformity requirement in the 2022 final regulations or the family resemblance test in the 2022 proposed regulations raises as many questions as they answer. The U.S. tax laws are not static, so the application of any conformity standard requires a year-by-year inquiry. Thus, a foreign tax that limits interest deductions in a manner similar to Section 163(j) or that disallows royalty deductions in a manner similar to Section 267A can deviate along those lines without running afoul of the “all significant costs”<sup>189</sup> requirement because those deviations conform to how existing U.S. tax law deviates from the Platonic ideal income tax.<sup>190</sup> However, even if a foreign jurisdiction did have a regime that conforms to U.S. tax laws at some point in time, Congress or the foreign jurisdiction may amend their respective tax laws at any time thereafter. If one just focused on the United States, one could imagine very different tax laws depending on the political party that is in power. Thus, even if foreign tax law correlated to U.S. tax law at some point in time, it is an open question whether it would remain so over time or at least would remain so over all periods of time. The regulations, if literally applied, would require an annual review of the current design of each country’s tax laws on an annual basis because the question is not simply did the foreign jurisdiction assert taxation over some amount of net gain but rather did the foreign jurisdiction design its tax base in a manner that closely conforms (or, under the proposed regulations, bears a family resemblance) to the cost recovery allowance found in the U.S. tax laws in that particular year. Perhaps due to this reality, the final regulations provide a safe harbor by stating that a foreign levy treated as an income tax under an applicable U.S. income tax treaty qualifies as a “foreign income tax” if paid by a U.S. citizen or resident that elects the benefits under the treaty.<sup>191</sup> Until further administrative guidance is provided, one would expect that the ultimate determination of whether a foreign jurisdiction’s cost recovery mechanisms sufficiently conforms to those of the United States would create significant uncertainty if a U.S. tax treaty is not separately applicable.

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<sup>189</sup> See *supra* note 165 and accompanying text.

<sup>190</sup> *Id.*; Treas. Reg. § 1.901-2(b)(4)(iv)(C) (example 3) (2022) (sets forth an example of a thin capitalization regime that is based on section 163(j) as it existed prior to 2022).

<sup>191</sup> Treas. Reg. § 1.901-2(a)(1)(iii) (2022).

Along these same lines, it is important to keep in mind that a key design challenge is for nations to protect their tax base against profit shifting and base erosion strategies of multinational enterprises.<sup>192</sup> The G20<sup>193</sup> and the G8<sup>194</sup> have each expressed concern over how countries should prevent the artificial shifting of profits to low tax jurisdictions. The OECD has engaged in a multi-year study designed to provide recommendations on how countries should address this profit-shifting phenomenon (the so-called “base erosion and profit shifting” or “BEPS” project).<sup>195</sup> Source countries are actively designing tax base defense mechanisms to supplement their income tax collection efforts.<sup>196</sup> The introduction of such tax base protection measures creates uniquely complex U.S. foreign tax credit issues under the final regulations because the safe harbor afforded to base protection measures leaves significant unanswered questions.<sup>197</sup> In this regard, the only disallowance provisions that are illustrated as satisfying this base protection safe harbor are those that bear a family resemblance to base protection measures found in the U.S. tax laws. It is unclear whether and to what extent this base protection safe harbor exception could extend to base protection regimes that do not contain analogous provisions found in the U.S. tax laws.

Prior to the addition of this newfound exception into the final regulations, the Treasury Department had ruled unfavorably with respect to base protection regimes adopted in other countries. In this regard, as an example, many Latin American countries historically have relied on alternative minimum asset tax regimes to backstop their broad-based general income tax regime.<sup>198</sup> These

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<sup>192</sup> See Bret Wells, “Territorial” Tax Reform: Homeless Income is the Achilles Heel, 12 HOUS. BUS. & TAX L.J. 1, 39 (2012).

<sup>193</sup> See *G20 Leaders Declaration*, G20 RSCH. GRP. (June 19, 2012), <http://www.g20.toronto.ca/2012/2012-0619-loscabos.pdf> [<http://perma.cc/6L5D-U6F2>].

<sup>194</sup> See *G8 Factsheet: Tax*, GOV.UK (June 7, 2013), <http://www.gov.uk/government/publications/g8-factsheet-tax/g8-factsheet-tax> [<http://perma.cc/Y93J-AQGG>].

<sup>195</sup> The OECD has established a website to organize the various reports, press releases, conference calls, and other activities related to its base erosion and profit shifting initiative. See *Inclusive Framework on Base Erosion and Profit Shifting*, OECD, <http://www.oecd.org/ctp/beps.htm> [<http://perma.cc/G9UV-ZGHZ>] (last visited Oct. 28, 2022). A discussion of the BEPS project is beyond the scope of this article, but for further study, see generally Yariv Brauner, *What the BEPS?*, 16 Fla. Tax Rev. 55 (2014).

<sup>196</sup> See *Inclusive Framework on Base Erosion and Profit Shifting*, OECD, <http://www.oecd.org/ctp/beps.htm> [<http://perma.cc/G9UV-ZGHZ>] (last visited Oct. 28, 2022).

<sup>197</sup> See Reuven Avi-Yonah, *Should the U.S. Dictate World Tax Policy? Reflections on PPL Corporation v. Commissioner*, 138 TAX NOTES INT’L 671 (Feb. 18, 2013).

<sup>198</sup> Argentina, Chile, and Peru have all enacted thin capitalization rules. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Arg.-Den, art. 30, Sept. 4, 1997, 96 TAX NOTES INT’L 234(Argentina); Phillip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal*, 130 TAX NOTES 1025, 1033 (Feb. 28, 2011) (Chile); William J. Gibbons, *Tax Effects of Basing International Business Abroad*, 69 HARV. L. REV. 1206, 1249 (1956) (Peru). Thus,

countries have viewed asset tax regimes as necessary anti-abuse measures to protect against base erosion from aggressive inbound tax planning.<sup>199</sup> Asset taxes generally range from 0.2 percent to 2 percent and indirectly represent a limit on thinly capitalized companies.<sup>200</sup> Some form of asset tax has existed at some point in the tax laws of Argentina, Bolivia, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Peru, and Venezuela.<sup>201</sup>

Prior to the Treasury Department's regulatory changes in 1983, a business asset tax enacted to complement a country's collection of its general income taxes would probably have been viewed as a creditable foreign tax under pre-1983 case law.<sup>202</sup> In fact, the Argentine government adopted its business asset tax only after it received assurance from the International Monetary Fund ("IMF") that the Argentine asset tax would be creditable in the United States.<sup>203</sup> The Argentine government was later surprised to find out that the IMF's assurances that the Argentine asset tax would be entitled to U.S. foreign tax credit relief were incorrect.<sup>204</sup> With the notable exception of the United States, a survey of existing worldwide tax treaties reveals a broad international consensus that asset tax regimes implemented as part of the overall general income taxes of a foreign country should be eligible for foreign tax credit relief under bilateral income tax treaties around the world.<sup>205</sup>

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perhaps the trend to use a limitation on interest expense deductions will be a growing trend in Latin America as well.

<sup>199</sup> See, e.g., Dictamen D.A.L. 55/99 [Opinion by the Tax Legal Advisory Department of Argentina] (June 25, 1999). The theory for an asset tax is that a business asset should generate at least a minimum level amount of income (a return on asset) over a reasonable period of time. If this is not the case and the business is continued, then the assumption must be that there is unreported income. See Bret Wells, *Tax-Effective Methods to Finance Latin American Operations*, 28 INT'L TAX J. 21, 22-23 (2002) [hereinafter Wells, *Latin American Operations*].

<sup>200</sup> See John McLees, *The Business Asset Tax*, 93 TAX NOTES TODAY 175-24 (Sept. 10, 1993).

<sup>201</sup> See, e.g., Wells, *Latin American Operations*, *supra* note 199, at 22-23.

<sup>202</sup> See Rev. Rul. 67-329, 1967-2 C.B. 257; see also Rev. Rul. 73-117, 1973-1 C.B. 344; see also Rev. Rul. 78-62, 1978-1 C.B. 226.

<sup>203</sup> See Stephen Hodge, *Argentine Tax on Minimum Presumed Income, U.S. Foreign Tax Credit Out of Sync*, 22 TAX NOTES INT'L 2424 (May 14, 2001).

<sup>204</sup> See *id.*

<sup>205</sup> This is recognized explicitly in many treaties. Convenio Entre El Reino De España Y La República Argentina Para Evitar La Doble Imposición Y Prevenir La Evasión Fiscal En Materia De Impuestos Sobre La Renta Y Sobre El Patrimonio [The Argentina-Spain Tax Agreement], Arg.-Spain, art. 2(3)(b) and art. 23(1), Mar. 11, 2013, 69 TNI 1128, Doc. 2013-6458; Agreement between the United Mexican States and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital (with protocol), Mex.-Chile, art. 2(3)(b)(ii) and art. 23(1)(1), Apr. 17, 1998, 2484 U.N.T.S. 350; Convention Between the Republic of Venezuela and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Switz.-Venez., art. 2(3)(b)(ii) and art. 23, Dec. 23, 1997, 2235 U.N.T.S. 39782; Convention Between the Kingdom of Norway and the Republic of Venezuela for the

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Avoidance of Double Taxation and the Prevention of Fiscal Avoidance and Evasion with Respect to Taxes on Income and on Capital, Nor.-Venez., art. 2(3)(a)(ii) and art. 24(2)(a), Oct. 29, 1997, 98 TNI 23–25; Doc 98-4933; Convention between the United Mexican States and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Mexico-Denmark Tax Treaty, Mex.-Den., art. 2(3)(a)(ii) and art. 24(2), Jun. 11, 1997, 97 TNI 217-19, Doc 97-30474; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Avoidance with Respect to Taxes on Income Between the Republic of Indonesia and the Republic of Venezuela, Indon.-Venez., art. 2(3)(a) and art. 23(2), Feb. 27, 1997, 2000 WTD 16-35; Doc. 1999-39606; Agreement Between the Republic of Finland and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Fin.-Mex., art. 2(3)(a)(ii) and art. 22(2)(a), Feb. 12, 1997, 2124 U.N.T.S. No. 37029, at 295; Convention Between the Republic of Venezuela and the United States of Mexico for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mex.-Venez., art. 2(3) and art. 22(3), Feb. 6, 1997, 97 TNI 172-22, Doc 97-24843 (stating asset taxes of both countries are considered income taxes); Convention Between the Government of the Republic of Venezuela and the Government of the Republic of Trinidad and Tobago for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Avoidance with Respect to Taxes on Income and for the Encouragement of International Trade and Investment (with protocol), Trin. & Tobago-Venez., art. 2(3)(b) and art. 23(1), July 31, 1996, 2407 U.N.T.S. No. 43447; Convention Between the Czech Republic and the Republic of Venezuela for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Czech-Venez., art. 2(3)(b)(ii) and art. 23(2), April 26, 1996, 96 TNI 227-29, Doc. 96-30053; Convention between the United Mexican States and the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, Mex.-It., art. 2(3)(a) and art. 22(2), July 8, 1991, 97 TNI 109-27, Doc 97-16427; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (with exchange of notes), U.K.-Venez., art. 2(1)(b)(ii) and art. 22(1)(a), Mar. 11, 1996, 1972 U.N.T.S. 33711; Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Argentina for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, Arg.-U.K., art. 2(3)(b)(ii) and art. 23(4), Jan. 3, 1996, 2067 U.N.T.S. 197; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Mex.-Nor., art. 2(3)(a)(ii) and art. 24(8), Mar. 23, 1995, 1947 U.N.T.S. 166; Convention Between the Government of the Kingdom of Denmark and the Government of the Republic of Argentina for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, Arg.-Den., art. 2(3)(b)(ii) and art. 24(2), Dec. 12, 1995, 96 TNI 234-34, Doc 96-31248; Convention Between Canada and the Argentine Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital, Arg.-Can., art. 2(3)(b)(ii) and art. 23(1)(a), Dec. 30, 1994, 2027 U.N.T.S. 407; Convention Between Finland and the Argentine Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital, Arg.-Fin., art. 2(3)(b) and art. 23(1)(a)(ii), Dec. 13, 1994, 96 TNI 30-25; Doc 96-2267; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), S. Kor.-Mex., art. 2(3)(a)(ii) and art. 23(4), Oct. 6, 1994, 1873 U.N.T.S. 139; Agreement between the Kingdom of the Netherlands and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), Neth.-Mex., art. 2(1)(b) and art. 22(2), Sept. 27, 1993, 2217 U.N.T.S. 105; Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital (with protocol), Mex.-Ger., art. 2(3)(a) and art. 23(2)(b), Feb. 23, 1993, 1764 U.N.T.S. 204; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), Mex.-Swed., art. 2(1)(a)(ii) and art. 22(3), Sept. 21, 1992, 1719 U.N.T.S. 407; Convention for the Avoidance of Double Taxation and the Prevention of Fraud and Fiscal Evasion with Respect to Taxes on Income and Capital (with protocol), Spain-Mex., art. 23(1)(a)(i), July 24, 1992, 1832 U.N.T.S. 179;

Even though out-of-step with international norms, the I.R.S. has ruled that the “separate levy rule” requires an asset tax to be separately tested and, at present, is adjudged to not be an income tax in the U.S. sense.<sup>206</sup> Now that the final regulations allow space for reasonable base protection measures to prevent profit shifting, the question is whether these asset tax regimes might now be viewed as being “consistent with any principle underlying the disallowances required under the Internal Revenue Code.”<sup>207</sup> In 2017, the United States adopted an alternative minimum tax with respect to base erosion payments through the enactment of Section 59A.<sup>208</sup> Are the policy goals of Section 59A sufficiently similar to the goals of alternative minimum asset tax regimes employed in Latin America? Even if these regimes could satisfy the base protection safe harbor of the cost recovery test, these regimes still pose concerns under the gross receipts and realization tests. As of the writing of this treatise, Rev. Rul. 91-45 remains outstanding with the consequence that asset tax regimes are not eligible for U.S. foreign tax credit relief under existing published guidance even though such regimes are a base protection measure designed to protect the foreign jurisdiction’s income tax base.<sup>209</sup> Given the broad international consensus that foreign tax credit relief should be available for alternative minimum assets taxes, the fundamental question is: what is the U.S. tax policy justification for this divergence from this international consensus?

Perhaps the most significant discontinuity with the regulations is the fact that the I.R.S. has ignored the cost recovery requirement in several rounds of guidance on innovative foreign formulary tax levies that were adopted as part of a foreign country’s income tax laws. In this regard, Mexico enacted a tax in 2008 called the impuesto empresarial a tasa única [single business tax rate] (“IETU”) and repealed the IETU as of January 1, 2014.<sup>210</sup> The main goal of this tax was to fight tax evasion with Mexico’s underground

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Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Mex.-Fr., art. 22(1)(a), Nov. 7, 1991, 1719 U.N.T.S. 330; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Can.-Mex., art. 22(1), Apr. 8, 1991, 1883 U.N.T.S. 350.

<sup>206</sup> See Rev. Rul. 91-45, 1991-2 C.B. 336. Admittedly, Rev. Rul. 91-45 would allow Section 901 relief to apply if the Mexican asset tax payments were refunded and regular income tax payments were later made, but this requires the foreign country to carefully craft its asset tax laws; other Latin American countries with similar asset taxes have not done so, and it is difficult to articulate why they should. See generally I.R.C. § 901 (West 2022).

<sup>207</sup> Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) (2022).

<sup>208</sup> See generally I.R.C. § 59A (West 2022).

<sup>209</sup> See Rev. Rul. 91-45, 1991-2 C.B. 336.

<sup>210</sup> See Randall Jackson, *From the Archives: When is a Foreign Tax Creditable in the U.S.?*, 2014 TAX NOTES INT’L 1, 1–2, <http://www.taxnotes.com/tax-notes-today-international/compliance/archives-when-foreign-tax-creditable-us/2014/12/29/gysx?highlight=%22randall%20jackson%22%20from%20the%20archives>.

economy by requiring companies that do a large amount of business in cash to pay a two percent tax (increased to three percent as of January 1, 2010) on the deposit of currency above MXN 25,000.<sup>211</sup> The IETU's explicit goal was to stop tax evasion, so the tax did not target compliant taxpayers.<sup>212</sup> The IETU was creditable against federal Mexican income tax. Because this tax did not allow deductions, tax scholars<sup>213</sup> and the tax practitioner community understood that this tax failed to meet the formalistic cost recovery requirement set forth in the regulations.<sup>214</sup>

Instead of issuing a ruling that set forth this result, the I.R.S. issued Notice 2008-3.<sup>215</sup> In this notice, the I.R.S. said that this tax needed “study” and that “the IRS will not challenge a taxpayer’s position that the IETU is an income tax that is eligible for a credit.”<sup>216</sup> The I.R.S. allowed interim creditability for the IETU without providing any coherent rationale for how this tax satisfied the cost recovery standards set forth in Treas. Reg. Section 1.901-2(b). The reality was, and is, that the I.R.S. simply did not want to apply its own overly formalistic cost recovery requirement.<sup>217</sup> However, to achieve this result the I.R.S. simply did not apply its own regulations.

In 2010, Puerto Rico imposed a formulary excise tax on multinational enterprises operating within its borders.<sup>218</sup> Instead of faithfully applying its existing 1983 final regulations and then applying the completely “in lieu of” standard of Section 903, the government stated in Notice 2011-29 that the provisions of this excise tax were “novel.”<sup>219</sup> Because this excise tax qualified as “novel,” the Service stated that “pending resolution of these issues, the IRS will not challenge a taxpayer’s position that the Excise Tax is a tax in lieu of an income tax.”<sup>220</sup> Thus, again, without any coherent explanation, the I.R.S. stated that it would not challenge the foreign tax credit eligibility of this formulary tax even though it did not (and in this author’s opinion could not)<sup>221</sup> articulate a coherent rationale for allowing credit relief within the framework

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<sup>211</sup> See *id.*

<sup>212</sup> See *id.*

<sup>213</sup> See David L. Cameron, *PPL Corp.: Where’s the Treaty Argument?*, 138 TAX NOTES 1117, 1121 (2013).

<sup>214</sup> See Randall Jackson, *supra* note 210, at 2.

<sup>215</sup> I.R.S. Notice 2008-3, 2008-1 C.B. 253.

<sup>216</sup> See I.R.S. Notice 2008-3, 2008-2 I.R.B. 253.

<sup>217</sup> See I.R.S. Notice 2008-3, 2008-2 I.R.B. 253.

<sup>218</sup> See I.R.S. Notice 2011-29, 2011-16 I.R.B. 663.

<sup>219</sup> See I.R.S. Notice 2011-29, 2011-16 I.R.B. 663.

<sup>220</sup> See I.R.S. Notice 2011-29, 2011-16 I.R.B. 663.

<sup>221</sup> Others have reached the same conclusion. See generally Martin A. Sullivan, *Puerto Rico Shows Tax Policy at its Best and Worst*, 77 TAX NOTES INT’L 467, 469 (2015); Martin A. Sullivan, *The Treasury’s Bailout of Puerto Rico*, 73 TAX NOTES INT’L 267 (2014).

of the regulations. As a consequence, the I.R.S. is developing a *de facto* administrative working law that is unmoored to its existing regulations.<sup>222</sup> This result is made all the more surprising as the government has issued regulations that make the noncompliance of this Puerto Rican tax even more clear.<sup>223</sup> As a concession to Puerto Rico, the Treasury Department did clarify in its final regulations that the effective date of its regulations would not apply to disallow the creditability of this Puerto Rico foreign tax levy on or before January 1, 2023.<sup>224</sup> Thus, a limited transition rule was provided for that levy. In June 2022, Puerto Rico amended its tax laws to replace its Excise Tax with an elective 10.5 percent income tax regime that would apply on the sale of goods and services into Puerto Rico.<sup>225</sup> Finally, in another notice, the Treasury Department indicated that it was aware that Puerto Rico had enacted legislation that would allow taxpayers to amend their existing tax decrees with the consequence that the taxpayers would no longer be subject to the elements of the Puerto Rico taxes that led the Treasury Department to conclude that those levies were noncreditable, but may subject the taxpayer to greater income taxation in Puerto Rico due to this voluntary renegotiation of the tax concession.<sup>226</sup> In this latter notice, the Treasury Department indicated that it would not contend that any portion of the resulting tax payment to Puerto Rico was a non-compulsory payment even if the ultimate amount paid to Puerto Rico under the modified tax decree was higher than the amount that would have been paid by that taxpayer under the previously negotiated tax decree as long as the modified tax decree was entered into before December 31, 2022, and the ultimate tax liability under the modified tax decree remained less than the general income tax liability that would have been imposed in Puerto Rico under its generally applicable income tax laws that would have applied if there had been no concessionary tax decree at all.<sup>227</sup>

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<sup>222</sup> See generally Treas. Reg. §1.901-2 (2022).

<sup>223</sup> See Treas. Reg. § 1.901-2(b)(5) (2022) (asserting that a foreign levy that does not have an appropriate jurisdictional nexus is non-creditable).

<sup>224</sup> See Treas. Reg. § 1.901-2(h) (2022).

<sup>225</sup> See Act 52-2022, 2011 P.R. I.R.C. 17.

<sup>226</sup> See I.R.S. Notice 2022-42, 2022-41 I.R.B. 276.

<sup>227</sup> See *id.* § 3. The government recognized that Reg. §1.901-2(e)(5)(iii)(A) provides that where a foreign tax law provides a taxpayer with options or elections in computing its liability for foreign income tax whereby a taxpayer's foreign income tax liability may be permanently decreased in the aggregate over time, the taxpayer's failure to use such options or elections results in a foreign payment in excess of the taxpayer's liability for foreign income tax. However, the Treasury Department then stated that given Puerto Rico's status as a U.S. territory and to aid in Puerto Rico's transition away from its prior tax decrees that imposed noncreditable levies the Treasury Department would not treat any additional tax liability as a non-compulsory payment. See *id.*



In 2008, the United Kingdom imposed a fixed £30,000 levy on U.K. non-domiciliary taxpayers.<sup>228</sup> In Rev. Rul. 2011-19, the Service allowed the foreign tax credit for this tax.<sup>229</sup> However, to reach this coherent outcome, the Service made the assertion that this levy was likely to reach net income even though it was a fixed amount and did not provide any deductions. As the press had reported at the time, this ruling cannot be reconciled with the regulatory net gain standard in Treas. Reg. Section 1.901-2(b).<sup>230</sup> Even worse, the Service has not even tried to articulate a coherent rationale for how to harmonize this allowance of foreign tax credit relief with the standards set forth in its regulatory regime. Rev. Rul. 2011-19 has not been withdrawn or superseded even though recent final regulations make its ambivalence even more inexplicable.<sup>231</sup>

Thus, taxpayers face difficult challenges in determining whether and to what extent Treas. Reg. Section 1.901-2(b) has in fact succeeded in changing the holistic approach that was characteristic of the existing case law. There have been public statements by Treasury officials indicating that they recognize that the conformity requirement imposed by the 2022 final regulations can provide overly harsh outcomes, but no further official guidance has been issued.<sup>232</sup> Nevertheless, given the government's prior practice of not applying its own overly formalistic standards in particularly harsh situations, it is foreseeable that the government may issue additional administrative guidance that would simply not apply the regulations to particular fact patterns, and there already have been calls for the government to do so. But even so, this practice, if continued, would also raise the question of whether the regulations should be reformed.

##### 5. *PPL's* Impact on the Application of the Biddle Doctrine

Significant disagreement exists in terms of the ongoing precedential impact of the Supreme Court's decision in *PPL Corporation v. Commissioner*.<sup>233</sup> As discussed earlier, the *Bank of*

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<sup>228</sup> See I.R.S. Notice 2011-19, 2011-36 I.R.B. 199.

<sup>229</sup> See I.R.S. Notice 2011-19, 2011-36 I.R.B. 199.

<sup>230</sup> See Lee A. Sheppard, *Does the U.K. Diverted Profits Tax Qualify for the FTC?*, 2015 TAX NOTES 1, 6, <http://www.taxnotes.com/tax-notes-today-federal/credits/news-analysis-does-uk-diverted-profits-tax-qualify-foreign-tax-credit/2015/01/12/fp67?highlight=Lee%20A.%20Sheppard%20%22does%20the%20U.K.%22>.

<sup>231</sup> See Treas. Reg. § 1.901-2(a)(4)(i)(A) (2022) (stating that a foreign tax whose base is gross receipts or gross income for which no reduction is allowed for costs and expenses under foreign tax law does not satisfy the cost recovery requirement, even if in practice there are few costs and expenses attributable to all or particular types of gross receipts included in the foreign tax base).

<sup>232</sup> See T.D. 9959, 87 Fed. Reg. 276, 283 (Jan. 4, 2022).

<sup>233</sup> See *PPL Corp. v. Comm'r*, 569 U.S. 329 (2013).

*America* standard had interpreted the *Biddle* doctrine to mean that U.S. principles are applied to determine whether a foreign tax was assessed on some amount of net gain.<sup>234</sup> Familiar hallmarks of the U.S. tax system, such as realization, cost recovery, and gross receipts, were helpful guideposts to determine whether the foreign levy reached net income in substance, but the ultimate question remained whether or not a foreign levy was assessed on net income in the normal circumstances in which it applied.<sup>235</sup> The 1983 final regulations purported to graft onto the *Bank of America* standard the additional requirement that a foreign tax must also be formally designed with the hallmarks of a U.S. income tax as an independent prerequisite before one could be eligible for foreign tax credit relief.<sup>236</sup>

The Supreme Court's decision in *PPL* occurred after the 1983 formalistic requirements were added to the Section 901 regulations, so it was decided after the Treasury Department had endorsed the *Bank of America* standard but then had grafted onto the *Bank of America* standard additional formalistic design hallmarks that must also be separately satisfied. Thus, consideration of the continued relevance of the *PPL* case is important for at least three reasons: (i) the decision was a unanimous decision of the Supreme Court where the Supreme Court was asked to decide whether a foreign levy, in addition to satisfying the *Bank of America* standard, must also possess formalistic design hallmarks of U.S. tax laws as enumerated in the Treasury regulations, (ii) the Supreme Court rejected the government's effort to apply the prior 1983 final regulations to disallow a foreign tax credit for a foreign tax that did assess taxation on some amount of net gain even though that foreign tax did not meet the formal design hallmarks set forth in the prior final regulations, and (iii) the government has attempted, through its 2022 final regulations, to graft onto the *Bank of America* standard even greater formal conformity requirements after the *PPL* decision. Thus, the continuing relevance, if any, of the *PPL* decision has important implications for determining to what extent the final regulations are able to deny foreign tax credit relief in a situation where the foreign levy reaches some amount of net gain but fails to comply with the heightened formalistic design hallmarks of realization, gross receipts, cost recovery, and attribution requirements set forth in the final regulations.

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<sup>234</sup> See discussion *supra* Part I.B.2.

<sup>235</sup> See discussion *supra* Parts I.B.2, I.B.3.

<sup>236</sup> See discussion *supra* Part I.B.3.

The decision in *PPL* involved a so-called windfall profits tax adopted by the United Kingdom.<sup>237</sup> The U.K. windfall profits tax at issue in the *PPL* litigation provided for a one-time twenty-three percent formulary assessment tax on all privatized utility companies.<sup>238</sup> This tax was assessed on the difference between a company's profit-making value<sup>239</sup> and the price for which the company was privatized.<sup>240</sup>

Under the case law that pre-dated the 1983 regulatory changes, the above-described U.K. windfall profits tax would have been eligible for U.S. foreign tax credit relief under the *Bank of America* standard. Earlier iterations of U.K. excess profits tax regimes considered in the pre-1983 period had been found to be creditable,<sup>241</sup> and I.R.S. administrative practice stated that a wide range of analogous excess profits tax regimes met the eligibility standards set forth in the pre-1983 case law.<sup>242</sup> The I.R.S. had even ruled that a tax levy imposed on average profits spanning multiple years, much like the U.K. windfall profits tax that was the subject of the *PPL* litigation, was entitled to U.S. foreign tax credit relief,<sup>243</sup> but these cases and administrative pronouncements preceded the 1983 regulatory amendments to Treas. Reg. Section 1.901-2(b).<sup>244</sup> Thus, the *PPL*

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<sup>237</sup> See *PPL Corp.*, 569 U.S. at 331.

<sup>238</sup> *Id.* at 332.

<sup>239</sup> For this purpose, "profit-making value" was defined as its average annual profit per day over an initial period that was generally a four-year period, and then this amount was multiplied by nine—which was chosen as a baseline "price-to-earnings ratio." Though described as a tax on excess value, the tax actually had the economic effects of a tax on excess profits, since the calculation of "value in profits terms" was based on average net income over the four-year period, as opposed to an actual measure of value (which could have easily been established from market data); thus, from an economic point of view, the U.K. windfall profits tax was a tax on excess profits. See Brief for Rosanne Altshuler et al. as Amici Curiae Supporting Petitioners at 8–9, *PPL Corp. v. Comm'r*, 569 U.S. 329 (2013) (No. 12-43).

<sup>240</sup> See *Entergy Corp. v. Comm'r*, 683 F.3d 233, 234 (5th Cir. 2012).

<sup>241</sup> See *H.H. Robertson Co. v. Comm'r*, 176 F.2d 704, 708 (3d Cir. 1949); *Ethyl Corp. v. United States*, 75 F. Supp. 461 (Ct. Cl. 1948); *Columbian Carbon Co. v. Comm'r*, 25 B.T.A. 456, 462–63 (1932), *acq.*, 11-1 C.B. 2.

<sup>242</sup> Rulings concluded that a tax imposed at variable rates was creditable. See Rev. Rul. 68-318, 1968-1 C.B. 342 (stating that Italian tax on profits in excess of six percent of capital was creditable); Rev. Rul. 56-51, 1956-1 C.B. 320 (stating that Cuban tax on profits in excess of 1/10th of estimated real worth of capital was creditable); Rev. Rul. 74-435, 1974-2 C.B. 204 (stating that Swiss Cantonal tax imposed at variable rates on multi-year profits was creditable).

<sup>243</sup> See *Columbian Carbon Co.*, 25 B.T.A. at 473 (stating that the Service contested timing of accrual, but not creditability of U.K. tax based on average profits of three-year period preceding assessment year); see also Rev. Rul. 69-446, 1969-2 C.B. 150 (stating that Swiss National Defense Tax, which is imposed on average profits for the two years preceding the assessment year, is an income tax).

<sup>244</sup> See *Texasgulf, Inc. v. Comm'r*, 107 T.C. 51, 69 (1996), *aff'd* 172 F.3d 209 (2d Cir. 1999). Also, the government was categorical to the Tax Court, stating that the pre-1983 case law was of "little consequence" and that the 1983 final regulations superseded prior

case is interesting precisely because the taxpayer substantively satisfied the *Bank of America* standard for U.S. foreign tax credit relief under the historic pre-1983 case law criteria (a conclusion the I.R.S. National Office appears to have accepted before the litigation, or at least did not refute).<sup>245</sup> Even so, the U.K. windfall profits tax failed to comply with the formalistic design hallmarks that the Treasury Department's 1983 amendments to Treas. Reg. Section 1.901-2 had grafted onto the *Bank of America* standard. Thus, the facts set forth in the *PPL* case squarely put in issue whether the prior 1983 final regulations could require formalistic design hallmarks of a U.S. income tax to be met as a precondition for foreign tax credit relief even in situations where the foreign tax reached some amount of net gain (thus satisfying the *Bank of America* standard).

The Tax Court held that the taxpayer was entitled to foreign tax credit relief, finding as a factual matter that the U.K. windfall profits tax was designed to reach net income and did in fact tax net income in all cases.<sup>246</sup> On appeal, the Third Circuit reversed the Tax Court's decision.<sup>247</sup> In its appeal to the Third Circuit, the government asserted,<sup>248</sup> and the Third Circuit accepted,<sup>249</sup> that the U.K. windfall profits tax used a tax base greater than gross receipts and therefore failed the gross receipts test contained in

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case law. See Reply Brief for Respondent at 93–99, *PPL Corp. v. Comm'r*, 135 T.C. 304 (2010) (No. 25393-07).

<sup>245</sup> It is interesting to note at this point that the I.R.S. National Office appeared to have agreed that the pre-1983 case law was supportive of the taxpayer's position even before the *PPL* litigation; however, after analyzing that favorable case law, the I.R.S. National Office then argued that the government had authority to change the standards for creditability in its final 1983 Treasury regulations and stated as follows: "analysis of pre-regulation case law does not assist in the resolution of this case, since Taxpayer does not dispute that the U.K. Windfall Tax must satisfy the net gain test of the regulations to qualify as a creditable tax." I.R.S. Tech. Adv. Mem. 200719011 (May 11, 2007).

<sup>246</sup> The Tax Court stated as follows:

Parliament did, in fact, enact a tax that operated as an excess profits tax for the vast majority of the windfall tax companies. The design of the windfall tax formula made certain that the tax would, in fact, operate as an excess profits tax for the vast majority of the companies subject to it. [] Because both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized by the vast majority of the windfall tax companies, we find that it did, in fact, "reach net gain in the normal circumstances in which it [applied]," and, therefore, that its "predominant character" was "that of an income tax in the U.S. sense."

*PPL Corp. v. Comm'r*, 135 T.C. 304, 340–41 (2010), *rev'd*, 665 F.3d 60 (3d Cir. 2011), *rev'd*, 569 U.S. 329 (2013).

<sup>247</sup> See *PPL Corp. v. Comm'r*, 665 F.3d 60, 68 (3d Cir. 2011), *rev'd*, 569 U.S. 329 (2013).

<sup>248</sup> See Opening Brief for the Appellant at 23–33, *PPL Corp. v. Comm'r*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069). The government repeated this argument in its briefs before the Supreme Court. See Brief for the Respondent at 33–43, *PPL Corp. v. Comm'r*, 569 U.S. 329 (2013) (No. 12-43).

<sup>249</sup> *PPL Corp.*, 665 F.3d at 67–68.

the 1983 final regulations.<sup>250</sup> As an additional ground for reversal, the government asserted,<sup>251</sup> and the Third Circuit accepted,<sup>252</sup> that the U.K. windfall profits tax also failed to satisfy the realization test set forth in the 1983 final regulations. Because these formalistic criteria were not satisfied, the Third Circuit found that the U.K. windfall profits tax failed two of the mandatory tests contained in the 1983 final regulations and therefore was ineligible for U.S. foreign tax credit relief.<sup>253</sup>

The Third Circuit denied foreign tax credit relief to the taxpayer in *PPL*, but it never contested the Tax Court's factual determination<sup>254</sup> that the U.K. windfall profits tax actually achieved its intended operational purpose of taxing only net income.<sup>255</sup> Instead, the Third Circuit held that the 1983 final regulations had grafted onto the *Bank of America* standard additional formal design hallmarks that must independently be satisfied beyond simply satisfying the *Bank of America* standard, stating as follows:

Because the regulation repeats the phrase “predominant character” throughout its definitions, both the Tax Court and PPL on appeal suggest that it applies a “predominant character standard” independent of the three requirements. That is incorrect. We must

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<sup>250</sup> *Id.* at 65 (“In our view, PPL’s formulation of the substance of the U.K. windfall [profits] tax is a bridge too far. No matter how many of PPL’s proposed simplifications we may accept, we return to a fundamental problem: the tax base cannot be initial-period profit alone unless we rewrite the tax rate. Under the Treasury Department’s regulation, we cannot do that.”); Opening Brief for the Appellant, *supra* note 248, at 31–32 (“The windfall [profits] tax was then imposed on the *difference* between profit-making value and flotation value, and a tax on the value of property does not have the predominant character of an income tax in the U.S. sense. Thus, the tax base for the windfall [profits] tax was completely divorced from any traditional concept of gross receipts.”).

<sup>251</sup> The government asserted the following in its opening brief to the Third Circuit:

It is well-established that under U.S. tax law, a tax on value or appreciation is not a tax on realized income (and thus does not have the predominant character of an income tax in the U.S. sense). See *Cottage Sav. Ass’n*, 499 U.S. at 559; *Schmitt*, 208 F.2d at 821 (stating that it “is hornbook law of taxation” that a property owner “is not subject to income taxation upon the annual increase in value” of the property). Nor was the windfall tax a tax upon previously realized income. The fact that a company’s profit-making value was determined by reference to past profits does not convert the windfall tax into a tax on those past profits. Indeed, a tax on income-producing property does not become an income tax simply because the property’s value is calculated for tax purposes by reference to the amount of income the property generates.

Opening Brief for the Appellant, *supra* note 248, at 24–25. The government repeated these arguments before the Supreme Court. See Brief for the Respondent, *supra* note 248, at 34–36.

<sup>252</sup> See *PPL Corp.*, 665 F.3d at 67 n.3.

<sup>253</sup> See *id.*

<sup>254</sup> The Tax Court made specific findings of fact indicating that it found that the legislative intent for the U.K. windfall profits tax was to assess a tax on excess profits and the Third Circuit nowhere contests these findings. See *PPL Corp. v. Comm’r*, 135 T.C. 304, 339–40 (2010), *rev’d*, 665 F.3d 60 (3d Cir. 2011), *rev’d*, 569 U.S. 329 (2013).

<sup>255</sup> *PPL Corp. v. Comm’r*, 569 U.S. 329, 337 (2013) (noting that the Third Circuit explicitly discussed its concerns regarding the gross receipts and realization requirements).

assess whether a foreign tax satisfies each of the regulation's three requirements "judged on the basis of its predominant character." Treas. Reg. § 1.901-2(b)(1), (b)(2), (b)(3), (b)(4). We may not, however, simply ask whether the "predominant character" of a foreign tax is that of a U.S. income tax without addressing the requirements. The Court of Claims did essentially that in a pair of cases that predated the Treasury regulation governing our case. See *Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct.Cl.1982) (*per curiam*); *Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 519 (Ct.Cl.1972).<sup>256</sup>

In one sense, the *PPL* case represents an odd case for disallowing foreign tax credit relief because the Tax Court made a finding of fact that the U.K. windfall profits tax operated as a tax levied on net income<sup>257</sup> and resulted in a levy of some amount of net profits in all cases.<sup>258</sup> Yet, the Third Circuit held that the U.K. windfall profits tax was non-creditable for U.S. foreign tax credit purposes because the formal design of the U.K. windfall profits tax did not use notions of gross receipts or realization that complied with U.S. standards with the consequence that the U.K. windfall profits tax (as drafted) failed to comply with the strict formalistic design standards that Treas. Reg. Section 1.901-2(b) had grafted onto the *Bank of America* standard.<sup>259</sup>

The Fifth Circuit in *Entergy Corp. v. Commissioner* held that this same U.K. windfall profits tax was entitled to U.S. foreign tax credit relief, thus creating a split in the circuits.<sup>260</sup> In its evaluation of the Third Circuit's plain textual reading of the 1983 final regulations, the Fifth Circuit in *Entergy* stated that the Third Circuit's denial of foreign tax credit relief exalted "form-over-substance."<sup>261</sup> The Supreme Court granted certiorari

<sup>256</sup> See *PPL Corp.*, 665 F.3d at 64 n.1.

<sup>257</sup> The Third Circuit is silent on this point, but the Fifth Circuit makes the statement categorically as follows: "the tax *only* reached—and only *could* reach—utilities that realized a profit in the relevant period, calculating profit in the ordinary sense (*e.g.* by subtracting operating expenses associated with generating the utilities' income). This satisfies the net income requirement." See *Entergy Corp. v. Comm'r*, 683 F.3d 233, 236 (5th Cir. 2012).

<sup>258</sup> See *PPL Corp.*, 135 T.C. at 335, 339–40.

<sup>259</sup> See *PPL Corp.*, 665 F.3d at 67 n.3.

<sup>260</sup> See generally *Entergy Corp.*, 683 F.3d 233. *Entergy Corp. v. Comm'r*, 683 F.3d 233, 234, 239 (5th Cir. 2012).

<sup>261</sup> *Id.* at 237. The Fifth Circuit explained its disagreement with the Third Circuit's analysis as follows:

In fact, as the record indicates, each utility could only be subject to the Windfall Tax after making a profit exceeding approximately an 11% annual return on its initial flotation value, and the Windfall Tax liability increased linearly with additional profits past that point. Moreover, the Third Circuit opinion seems to overlook that a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts, as, again, the record here indicates. London Electricity's profit for purpose of the Windfall Tax was calculated by computing gross receipts less operating expenses. The Windfall Tax was designed to reach

in *PPL Corp. v. Commissioner* to resolve the circuit split.<sup>262</sup>

The Supreme Court *unanimously* held that the U.K. windfall profits tax was entitled to U.S. foreign tax credit relief, thus reversing the Third Circuit’s decision and affirming the Tax Court’s original decision.<sup>263</sup> Instead of discussing how the 1983 final regulations had attempted to impose additional formalistic design hallmarks on top of the *Bank of America* standard, the Supreme Court attempted to harmonize the prior 1983 final regulations with the pre-1983 case law, stating that Treas. Reg. Section 1.901-2(b) “codifies longstanding doctrine dating back to *Biddle*.”<sup>264</sup> The Court omitted any serious discussion of the government’s assertion that its formal regulatory requirements sought to bring “structure and clarity” not found in the earlier case law.<sup>265</sup>

The Third Circuit held that it could not simply apply the *Bank of America* standard in isolation because the Treasury regulations grafted onto that standard imposed additional formal design requirements that must be met in form.<sup>266</sup> The government, in its brief before the Supreme Court, argued that its regulations imposed additional formal design prerequisites that must be met in addition to the prior case law standards and that its regulations should be afforded deference, citing the Supreme Court decision in *Mayo Foundation for Medical Education & Research v. United States*.<sup>267</sup> The Supreme Court applied *Biddle* for the purpose of

a subset of this leftover amount by beginning with an amount predicated on actual gross receipts minus flotation value.

*Id.* at 238 (internal emphasis omitted). In affirming the Tax Court’s allowance of foreign tax credit relief to the taxpayer in *Entergy*, the Fifth Circuit reformulated the U.K. windfall profits tax into an economically equivalent formulation that (as reformulated) did meet the formal design features of the 1983 final regulations. *See id.* at 238–39.

<sup>262</sup> *PPL Corp. v. Comm’r*, 569 U.S. 329, 334 (2013).

<sup>263</sup> *See id.* at 343.

<sup>264</sup> *See id.* at 334–35.

<sup>265</sup> *See* Brief for the Respondent, *supra* note 248, at 33.

<sup>266</sup> *PPL Corp. v. Comm’r*, 665 F.3d 60, 64 n.1 (3d Cir. 2011), *rev’d*, 569 U.S. 329 (2013).

<sup>267</sup> *Compare PPL Corp.*, 569 U.S. at 340–341 (where the Court discusses portions of the government brief dealing with pre-1983 case law), *with* Brief for the Respondent, *supra* note 248, at 33–43 (where the government asserts that the formalistic test set forth in the 1983 Treasury regulations is entitled to deference under *Mayo Foundation for Medical Education & Research v. United States*, 562 U.S. 44, 47 (2011)). The government’s argument was more robust in its brief before the Third Circuit and the Fifth Circuit as the following excerpt from its briefs in those proceedings so indicates:

[T]he Tax Court was required to accord the regulation *Chevron* deference. *See Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011). Moreover, “[b]ecause §901’s exemption from taxation is ‘a privilege extended by legislative grace,’” the regulation had to be “strictly construed.” *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209, 214 (2d Cir. 1999) (quoting *Inland Steel Co. v. United States*, 677 F.2d 72, 79 (Ct. CL. 1982)). Instead, the Tax Court paid only lip service to the regulation. Although it discussed the regulation in summarizing the relevant legal principles (PPL Op. 24-26), the court went on to

determining whether the U.K. windfall profits tax was assessed on net income and found that its formal design, which did not comply with the formal design hallmarks set forth in the prior 1983 final regulations, was not a fatal defect.<sup>268</sup> The Supreme Court's nuanced handling of the government's regulatory deference argument is interesting. Here is what the Court stated:

The Commissioner argues that . . . U.S. courts must take the foreign tax rate as written and accept whatever tax base the foreign tax purports to adopt. Brief for Respondent 28. As a result, the Commissioner claims that the analysis begins and ends with the Labour government's choice to characterize its tax base as the difference between "profit-making value" and flotation value. Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that "tax law deals in economic realities, not legal abstractions." *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 315, 76 S.Ct. 395, 100 L.Ed. 347 (1956). Given the artificiality of the U.K.'s method of calculating purported "value," we follow substance over form and recognize that the windfall tax is nothing more than a tax on actual profits above a threshold.<sup>269</sup>

Thus, the Supreme Court simply dismissed the government's regulatory deference argument as unwarranted because any reading of Treasury regulations to require a form over substance analysis<sup>270</sup> could not be squared with the black-letter principle that "tax law[s] deal[] in economic realities, not legal abstractions."<sup>271</sup> The Supreme Court eschewed any effort by the Treasury regulations to impose formalistic design requirements. In doing so, the Court opined that substance over form principles must be applied to effectuate the statutory purpose of Section 901 and that its application of those principles compelled the Supreme Court to conclude "that the windfall [profits] tax is [best viewed as] nothing more than a tax on actual profits above a threshold."<sup>272</sup>

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apply its own test for determining the predominant character of the windfall tax. Thus, the court considered at length the historical background and purpose of the windfall tax and its effect on the companies subject to the tax. It made no effort whatsoever to explain whether the windfall tax met any of the three regulatory subtests, all of which had to be met for the tax to be creditable.

Compare Opening Brief for the Appellant at 23–24, *Entergy Corp. v. Comm'r*, 683 F.3d 233 (5th Cir. 2012) (No. 10-60988), with Opening Brief for the Appellant, *supra* note 248, at 21–22.

<sup>268</sup> See *PPL Corp.*, 569 U.S. at 343–44 ("The tax is based on net income, and the fact that the Labour government chose to characterize it as a tax on the difference between two values is not dispositive under Treasury Regulation § 1.901–2. Therefore, the tax is creditable under § 901.").

<sup>269</sup> *Id.* at 340–41.

<sup>270</sup> See *PPL Corp. v. Comm'r*, 135 T.C. 304, 330 (2010), *rev'd*, 665 F.3d 60 (3d Cir. 2011), *rev'd*, 569 U.S. 329 (2013) ("Respondent argues that the 1983 regulations alone control the creditability of the windfall [profits] tax because those regulations subsume or supersede prior caselaw and 'neither require nor permit inquiry into the purpose underlying the enactment of a foreign tax or the history of a foreign taxing statute.'").

<sup>271</sup> *PPL Corp.*, 569 U.S. at 340.

<sup>272</sup> See *id.* at 340–41.



The Supreme Court decision can be read as a full-throated endorsement of solely applying the *Bank of America* standard notwithstanding that the Treasury Department—through its prior interpretive regulations—had attempted to circumscribe the *Bank of America* standard by adding formal design hallmarks of a U.S. income tax as an additional substantive prerequisite. The Supreme Court looked at the formal design hallmarks as simply helpful indicia, but even so, the ultimately dispositive question remained simply whether the U.K. levy was assessed on some amount of net income. Thus, instead of giving dispositive significance to the added regulatory formalistic design hallmarks set forth in the Treasury Department final regulations articulated, the Supreme Court placed a heavy judicial gloss over the prior 1983 final regulations to harmonize them with “longstanding doctrine dating back to *Biddle*”<sup>273</sup> when in fact, the 1983 final regulations attempted to impose formality to the foreign tax credit eligibility analysis not found in the prior case law.

After its defeat in *PPL*, the government has doubled down on its regulatory efforts. In the preamble to its 2022 final regulations, the Treasury Department attempted to distinguish and narrowly construe the continuing import of the *PPL* decision in the following manner:

The Supreme Court in *PPL* was applying the predominant character test in the existing regulations and was not interpreting the statute. Because the final regulations modify the standard for determining whether a foreign levy is an income tax in the U.S. sense, the final regulations do not conflict with the *PPL* decision. Thus, the Treasury Department and the IRS disagree with the comments’ contentions that the 2020 FTC proposed regulations have inappropriately shifted the inquiry away from the substance, or the substantive economic effect, of the foreign tax.<sup>274</sup>

At best, this characterization of the *PPL* decision is controversial. The Supreme Court decision rejected an invitation to apply Treasury regulations in a manner that would deny foreign tax credit relief to a U.K. levy that in substance was a net income tax but had failed to comply with the formal design features set forth in the Treasury regulations. The *PPL* decision utilized a substance-based inquiry that harkens back to the *Bank of America* standard. The 2022 amendments add further formalism and rigidity, which is in the same genre as the form over substance prerequisites that the Supreme Court categorized as “unwarranted” in the 1983

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<sup>273</sup> See *id.* at 330, 334 (stating that the regulations codify “longstanding doctrine dating back to *Biddle*” and then use “substance over form” principles to resolve the case).

<sup>274</sup> T.D. 9959, 87 Fed. Reg. 276, 294 (Jan. 4, 2022).

regulations.<sup>275</sup> The Supreme Court's decision is clear, and it is a unanimous decision that applied a substance over form approach to the foreign tax credit eligibility determination.

Thus, one is left with an important interpretive issue in terms of applying Section 901. This interpretive issue has to do with what one makes of the methodology utilized by the Supreme Court to decide the manner of applying Section 901 versus the methodology utilized in the Treasury regulations for applying Section 901. The Treasury Department recognizes this divergence, but it rationalizes the two methodologies by stating that *PPL* is best viewed as a historic case that interpreted prior regulations and thus has limited applicability going forward. In addition, after distinguishing *PPL* in this manner, the Treasury Department has added even greater formality into its regulations.<sup>276</sup>

In contrast, the *Bank of America* standard utilizes a substance over form analysis that looks to how foreign law operates in practice. In addition, the Supreme Court's actual holding and reasoning in *PPL* sought to position that decision within the historic rationale of Section 901 to reach a result that the government itself understood (and argued in its briefs) was inconsistent with its very own final regulations.<sup>277</sup> Thus, the holding of the *PPL* case was one that rejected a regulatory effort to circumscribe the prior judicial case law. Viewed in that light, the government's 2022 amendments seek to repudiate judicial case law in an even harsher manner. The issue can be succinctly stated as follows: would a court really deny a foreign tax credit for a foreign levy that in substance is assessed on net income but does not meet the formal design requirements set forth in the final regulations? If that result occurs, then that outcome would create the type of double international taxation that the Supreme Court has stated is antithetical to the policy goal that the statute was intended to effectuate.<sup>278</sup>

A final comment about *PPL* is in order, and it relates to the Supreme Court's own interpretation of the *Biddle* doctrine in the course of its *PPL* opinion. In a two-sentence statement in *PPL*, the Supreme Court offered its own further formulation of the *Biddle* doctrine in this statement:

Instead of the foreign government's characterization of the tax, the crucial inquiry is the tax's economic effect. See *Biddle, supra*, at 579, 58 S. Ct. 379, 82 L. Ed. 431 (inquiry is "whether [a tax] is the substantial equivalent of payment of the tax as those terms are used in our own statute"). In other words, foreign tax creditability depends

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<sup>275</sup> *PPL Corp.*, 569 U.S. at 340–41.

<sup>276</sup> See Foreign Tax Credit Guidance, *supra* note 274.

<sup>277</sup> *PPL Corp.*, 569 U.S. at 343.

<sup>278</sup> See *supra* note 66 and accompanying text.

on whether the tax, if enacted in the U.S., would be an income, war profits, or excess profits tax.<sup>279</sup>

This formulation (or reformulation, as the case may be) of the *Biddle* doctrine has several important touchstones. Again, the Treasury Department has stated that its regulations are an effort to apply the *Biddle* doctrine, so this recent Supreme Court rearticulation of the *Biddle* doctrine has profound significance in terms of determining whether the Treasury regulations are a faithful articulation of the *Biddle* doctrine. The Supreme Court said that *Biddle* requires one to determine the economic effect of a tax. This harkens back to the idea that one should look to empirical evidence to determine the actual operation of the foreign levy in practice. This translation of the *Biddle* doctrine (namely, looking to the economic effect of the foreign levy) is diametrically opposite to one that looks solely to the formal design of a foreign levy. Also, the above second sentence applies the *Biddle* doctrine by asking a hypothetical question: would the foreign levy be considered an income tax *if enacted in the United States*? The U.S. principles are used to determine the economic substance of the foreign levy in the first sentence, and U.S. principles are considered to determine whether the United States could have enacted the foreign levy under its own income tax laws under the second sentence.

This rearticulation of the *Biddle* doctrine, as set forth in the above two sentences in the *PPL* decision, provides significantly more latitude in terms of adjudicating the creditability of foreign taxes than what the Treasury Department believes the Supreme Court meant in *Biddle*. The Supreme Court's rearticulation of the *Biddle* doctrine in its *PPL* decision is reconcilable with the *Bank of America* standard but expands upon it. Particularly, in terms of the second of the above two sentences, this understanding of the *Biddle* doctrine represents a negative harbinger with respect to the Treasury Department's argument that all significant costs must be allowed as a deduction in order for the foreign levy to be an income tax in the U.S. sense. Said differently, if the ultimate legal question is whether or not a foreign levy (if enacted in the United States) would be within the income tax authority of the Congress to enact, then existing case law provides strong support for the position that Congress need not afford cost recovery for all significant expenses for a U.S. tax to pass muster under the Sixteenth Amendment.

For example, an important case that addresses the necessity for cost recovery is *Indopco, Inc. v. Commissioner*.<sup>280</sup> In *Indopco*, the government contended that the allowance of cost recovery for

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<sup>279</sup> *PPL Corp.*, 569 U.S. at 335.

<sup>280</sup> *See generally* *Indopco, Inc. v. Comm'r*, 503 U.S. 79 (1992).

expenses was simply a matter of legislative grace and not an essential design feature of an income tax in the U.S. sense.<sup>281</sup> Here, the government urged the Supreme Court to not allow an immediate deduction for expenditures if those expenditures provided a future benefit, even when no separate and distinct asset was created that could allow for future cost recovery.<sup>282</sup> In contrast, the taxpayer in *Indopco* urged the Supreme Court not to require capitalization unless a separate and distinct asset was created because capitalization without cost recovery failed to clearly reflect the taxpayer's income.<sup>283</sup> In a strongly-worded and

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<sup>281</sup> See Brief for the Respondent at 30–31, *Indopco, Inc. v. Comm'r*, 503 U.S. 79 (1992) (No. 90-1278).

<sup>282</sup> It is important to note how many times the government states that there are “many” instances where significant expenses are not allowed for recovery under the U.S. income tax laws as of 1992:

If an expenditure produces a permanent or long-term benefit to the taxpayer that will help generate income in future years, it hardly would reflect the taxpayer's income to allow a current deduction for the expenditure merely because the benefit or advantage cannot readily be described as creating or enhancing an “asset.” . . . Indeed, the situation presented in this case provides a perfect example of the inadequacy of petitioner's “separate and distinct asset” test. Petitioner does not challenge the findings of the Tax Court (Pet. App. 30a) and the court of appeals (Pet. App. 12a) that the takeover transaction resulted in permanent benefits for petitioner. Application of the test urged by petitioner—under which outlays may be deducted in one year even though the benefits of the expense are reaped for many years in the future—would result in a distortion of petitioner's income. For this reason alone, petitioner's test should be rejected.

. . .

The courts have recognized *many* types of capital expenses that do not create or enhance any specific asset. 1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.1, at 20-68. Most relevant are the “changed corporate structure” cases discussed at pages 17-19, *supra*. In these cases, as then-Judge Blackmun noted in *General Bancshares*, 326 F.2d at 716, even when the reorganization expenses “have not resulted in the acquisition or increase of a corporate asset, [they are treated as capital charges and] are not, because of that fact, deductible as ordinary and necessary business expenses.” Similarly, in *Holeproof Hosiery Co. v. Commissioner*, 11 B.T.A. 547 (1928), which was cited in *General Bancshares*, the court observed that “[i]t can be argued, and not without merit, that no capital asset is acquired when attorneys' fees are paid in connection with an increase in capitalization, but it does not follow that the payments are ordinary and necessary expenses of the year when made.” 11 B.T.A. at 556. The mere fact that a corporation's structure is not a “separate and distinct asset” does not mean that expenses incurred to alter its structure for the permanent betterment of the corporation are not capital in nature. . . . There are *many other examples* of business expenditures that have long been recognized as capital in nature even though they do not create or enhance any specific asset. The cost of an educational program that qualifies the taxpayer to enter a new trade or business is a non-deductible capital expenditure.

*Id.* (emphasis added).

<sup>283</sup> Consistent with the government's argument in *PPL*, the taxpayer in *Indopco* argued that the Supreme Court must ensure that significant business expenditures must be recoverable over some period as indicated in the following statement from the taxpayer's brief:

Moreover, by requiring the identification of a specific asset to which capitalized costs are to be assigned, the Lincoln Savings test serves the clear reflection of

staunchly pro-government opinion, the Supreme Court stated that an income tax in the U.S. sense means gross income and that the allowance of deductions is purely a matter of legislative grace.<sup>284</sup> The following extended excerpt from the *Indopco* case is relevant for understanding the nature of the U.S. income tax system as now understood and interpreted by the Supreme Court:

In exploring the relationship between deductions and capital expenditures, this Court has noted the “familiar rule” that “an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.” The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a “complete list of nondeductible expenditures,” § 263 serves as a general means of distinguishing capital expenditures from current expenses. For these reasons, deductions are strictly construed and allowed only “as there is a clear provision therefor.”<sup>285</sup>

The Supreme Court’s decision in *Indopco* makes abundantly clear that the Court would not entertain criticism of Congress’s refusal to allow cost recovery for a significant business expenditure as Congress has the unquestioned “power to condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax.”<sup>286</sup> Consequently, post-*Indopco*, the formalistic cost recovery requirement that requires that all<sup>287</sup> significant costs must be allowed as a deduction is at variance with what the government argued and the Supreme Court held in *Indopco*. In 1992, the government told the Supreme Court in *Indopco* that there are “many . . . examples” under U.S. tax law of business-related expenditures that do not create deductible expenses and never

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income principle that underlies the statutory scheme—it permits such costs to be depreciated or amortized over the useful life of the asset and to be recovered upon its sale or other disposition. In contrast, the court of appeals’ future benefit approach does not give taxpayers any means of recovering their capitalized costs. Where there is a future benefit but no asset to which capitalized costs can be assigned, the taxpayer will not be allowed any depreciation or amortization deductions or any deductible loss prior to the sale or abandonment of its entire business. Thus, the future benefit approach, by thwarting any recovery of capitalized costs during the period in which the taxpayer is operating its business and earning the income generated by those costs, defeats a clear reflection of income.

Brief for Petitioner at 13, *Indopco, Inc. v. Comm’r*, 503 U.S. 79 (1992) (No. 90-1278).

<sup>284</sup> See *Indopco*, 503 U.S. at 1043.

<sup>285</sup> *Indopco*, 503 U.S. at 84 (citations omitted).

<sup>286</sup> See *Helvering v. Indep. Life Ins. Co.*, 292 U.S. 371, 381 (1934).

<sup>287</sup> See *supra* note 165 and accompanying text.

provide cost recovery.<sup>288</sup> Yet when judging a foreign country's tax levy, the net gain standard in the final regulations mandates that the foreign levy provide for recovery of *all significant* expenses in order for it to be considered an income tax "in the U.S. sense."<sup>289</sup> The insistence by Treas. Reg. Section 1.901-2(b) that all<sup>290</sup> significant costs must be recoverable in the foreign country's tax regime is diametrically opposed to what the government asserted in *Indopco* about our own income tax regime.

In addition, the Supreme Court decision in *Wayfair* is also relevant in terms of one's understanding of the *Biddle* doctrine as interpreted by the Supreme Court in *PPL*. In *Wayfair*, the Supreme Court stated that notions of physical nexus "must give way to the 'far-reaching systemic and structural changes in the economy' and 'many other societal dimensions'" of the Cyber-Age.<sup>291</sup> The Supreme Court then went on to state that "th[is] Court should not maintain a [physical presence] rule that ignores [these] substantial virtual connections to the State."<sup>292</sup> In *PPL*, the Supreme Court stated that the *Biddle* doctrine means that "foreign tax creditability depends on whether the tax, if enacted in the U.S., would be an income, war profits, or excess profits tax."<sup>293</sup> Because the Supreme Court's decision in *Wayfair* makes it clear that the Supreme Court would uphold any effort by Congress to assert jurisdictional nexus over remote participants that have continuous and sustained engagement with the U.S. marketplace, this rearticulation of the *Biddle* doctrine in the *PPL* decision calls into question the restrictive jurisdictional nexus standard set forth in the 2022 final regulations. The Treasury Department asserts that its restrictive jurisdictional nexus conformity requirement is based on an application of the *Biddle* doctrine,<sup>294</sup> but the Treasury Department's interpretation of the meaning of *Biddle* contradicts the Supreme Court's explanation of the *Biddle* doctrine in *PPL*. As a result, the Treasury Department's reliance on *Biddle* as the basis for its authority to issue the jurisdictional nexus conformity

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<sup>288</sup> See Brief for the Respondent, *supra* note 281, at 30–31 (emphasis added).

<sup>289</sup> This is the standard in the existing Treasury regulations that provide that in order for a foreign levy to qualify for credit relief then all but an insignificant amount of costs must be recovered. See Treas. Reg. § 1.901-2(b)(4)(i) (2022). Alternative cost recovery allowances must never be less than the amount of the significant cost to which they are a substitute unless the foreign levy applies only to small businesses. See Treas. Reg. § 1.901-2(b)(4)(i)(B) (2022). A per se list of significant costs is provided, but the test is ultimately a facts and circumstances test; disallowance regimes that are analogous to the United States, including base protection measures, do not cause a failure to comply with the cost recovery requirement. See Treas. Reg. § 1.901-2(b)(4)(i)(C)(1) (2022).

<sup>290</sup> See *supra* note 165 and accompanying text.

<sup>291</sup> *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2097 (2018).

<sup>292</sup> *Id.* at 2095.

<sup>293</sup> *PPL Corp. v. Comm'r.*, 569 U.S. 329, 335 (2013).

<sup>294</sup> See T.D. 9959, 87 Fed. Reg. 276, 283 (Jan. 4, 2022).

requirement in its 2022 final regulations is undercut by the Supreme Court's own rearticulation of the meaning of the *Biddle* doctrine in its *PPL* decision.

Thus, it is safe to say that the Treasury Department's understanding of the *Biddle* doctrine is diametrically opposite of the Supreme Court's own rearticulation of the *Biddle* doctrine in the *PPL* case.<sup>295</sup> This disagreement is more than an academic exercise. The Treasury Department relies on the *Biddle* doctrine as the basis for its authority to issue its conformity requirements in its 2022 final regulations and the family resemblance test in the 2022 proposed regulations. Yet the Supreme Court's handling of the *Biddle* doctrine, as rearticulated in *PPL*, countenances far more latitude in the foreign jurisdiction's design of its tax laws than is afforded by either of these regulatory pronouncements. The disagreement reaches a crescendo when the regulatory formal design prerequisites are not satisfied, but the foreign levy does assert taxation only over some amount of net gain in practice. In that situation, is the foreign levy eligible for foreign tax credit relief, or does the formal design defect cause the foreign levy to be ineligible for foreign tax credit relief? The Supreme Court stated in *PPL* that such an application of Treasury regulations was "unwarranted" and would be contrary to the longstanding "blackletter principle that tax law deals in economic realities, not legal abstractions" with the consequence that the substance of foreign law and not its form applies to determine the economic effect of a foreign law for purposes of determining credit eligibility under Section 901.<sup>296</sup> The level of disagreement between the Treasury Department and the judiciary in terms of how to apply the case law interpretation of the statutory provision of Section 901 has never been greater. Until one or the other backs down, the ultimate determination of the eligibility of a particular jurisdiction's foreign tax is likely to remain controversial.<sup>297</sup>

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<sup>295</sup> Compare T.D. 9959, 87 Fed. Reg. 276, 294 (Jan. 4, 2022), with *PPL*, 569 U.S. at 335.

<sup>296</sup> Compare T.D. 9959, 87 Fed. Reg. 276, 283 (Jan. 4, 2022), with *PPL*, 569 U.S. at 340–41.

<sup>297</sup> The Supreme Court has partially answered the question as to the result where an agency issues a regulation that is contrary to an existing case, stating that a "prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." See *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982 (2005). The Supreme Court subsequently extended its *Brand X* standard further by stating that prior case law can *remove any ambiguity* so that "there is no longer any different construction that is consistent with [existing case law] and available for adoption by the agency." See *United States v. Home Concrete & Supply LLC*, 566 U.S. 478, 487 (2012). The statutory language in Section 901 explicitly grants US foreign tax credit relief for any foreign tax that is in substance an income tax and does so without any statutory requirement that some

### C. Treaty Implications Arising From the 2022 Final Regulations

The jurisdictional nexus and sourcing conformity requirement creates the very real possibility that a foreign jurisdiction's taxes may fail the requirements of Section 901 and yet the United States already has a bilateral tax treaty with that jurisdiction. So, the next logical question is whether this newfound attribution requirement curtails eligibility for foreign tax credit relief vis-à-vis treaty partners of the United States. The final regulations answer this question by stating that a foreign levy that is treated as an income tax under an applicable U.S. income tax treaty qualifies as a "foreign income tax" if paid by a U.S. citizen or resident that elects the benefits under the treaty.<sup>298</sup> The final regulations then provide that because controlled foreign corporations ("CFCs") are not treated as U.S. residents under U.S. income tax treaties, those entities (as residents of a third country) do not qualify for benefits under U.S. treaties.<sup>299</sup> Thus, the final regulations clarify that taxes paid by a U.S. treaty partner to a third-country controlled foreign corporation are separate levies that must independently satisfy the attribution requirement of Section 901 or Section 903. However, if the foreign country has agreed under a treaty with another jurisdiction to apply a source rule consistent with the U.S. source rule, then that treaty provision's sourcing rule would be relevant to determine whether or not the foreign jurisdiction applied a sourcing rule that conforms to the U.S. rule as a result of the treaty provision.<sup>300</sup>

The broad assertion in the 2022 final regulations that a tax payment made to a controlled foreign corporation is ineligible for an indirect credit to the U.S. shareholder appears to be an overstatement. For example, the 2016 U.S. Model Tax Treaty

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formal design hallmarks must also exist. This statute could thus be read as unambiguous on its face as countenanced by *Brand X*, but if not, then the unanimous *PPL* decision arguably removed any ambiguity as contemplated by *Home Concrete*. Thus, after the *PPL* decision, there is arguably no ambiguity left as to the question of whether a foreign levy can be denied foreign tax credit relief based on form over-substance regulatory requirements. However, because the Court did not explicitly address the *Chevron* deference implications of its *PPL* decision as part of that decision, the issue of whether or not the Supreme Court's decision in *PPL* supplants the Treasury Department's authority to issue later regulations that interpret the statute differently remains unsettled. *See id.* at 493–94 (Scalia, J., concurring) (addressing this interpretive ambiguity when a Court settles a question but not explicitly addressing whether the statute had an ambiguity that satisfies the "Step 1" *Chevron* deference determination).

<sup>298</sup> Treas. Reg. § 1.901-2(a)(1)(iii) (2022).

<sup>299</sup> This is made clear in the preamble to the final regulations. *See* T.D. 9959, 87 Fed. Reg. 276, 292 (Jan. 4, 2022). However, the regulations provide that if the source rule is changed under a treaty to which the CFC is entitled to rely upon, then the modified source rule would potentially be tested to determine if the jurisdictional sourcing requirement is met. *See* Treas. Reg. § 1.901-1(a)(1)(ii) (2022).

<sup>300</sup> *See* Treas. Reg. § 1.901-2(a)(1)(iii) (2022).



explicitly provides for deemed paid credits for income taxes paid by a controlled foreign corporation.<sup>301</sup> Furthermore, the existing treaty with Finland contains the same provision as Art. 23(2) of the U.S. Model Treaty and then explicitly provides that a withholding tax at source is a covered tax under the treaty.<sup>302</sup> The question of whether this categorical denial of treaty benefits to foreign taxes paid by CFCs represents a regulatory effort to override treaties is made all the more relevant because those same Treasury regulations now explicitly recognize that an independent treaty-based foreign tax credit is available in some instances that are unsupported by the standards of Section 901. The scope of this treaty-based foreign tax credit is thus ambiguous now that Section 901 is no longer the controlling standard.

Regardless of the ultimate scope afforded to this newfound independent treaty-based foreign tax credit (whether available to only U.S. persons, or whether it extends to deemed paid credits for income taxes paid by controlled foreign corporations), its existence provides a “solution” that reopens an old Pandora’s box. In the early 1980s, a significant law review article argued that the Treasury Department had negotiated tax treaties that afforded foreign tax credit relief for foreign levies that failed to satisfy the Section 901 requirements.<sup>303</sup> The article then posited that this independent treaty-based foreign tax credit was unmoored to domestic law and thus raised serious normative policy concerns.<sup>304</sup> After that article, the Treasury Department set about a multi-decade effort to ensure that U.S. foreign tax credit relief was not afforded under a U.S. tax treaty in a manner that was not consistent with the contours of Section 901. In fact, the allowance of a foreign tax credit under a U.S. tax treaty defers to domestic statutory provisions as the authorizing mechanism. In relevant part, the italicized portion of the following excerpt from the U.S. Model Treaty makes this point clear:

*In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States*

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<sup>301</sup> See U.S. Model Income Tax Convention for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, art. 23(2), Feb. 17, 2016 [hereinafter U.S. Model Tax Treaty], <http://home.treasury.gov/policy-issues/tax-policy/treaties> [<http://perma.cc/CT6X-2MED>].

<sup>302</sup> See The Convention Between the Government of the United States of America and the Government of the Republic of Finland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Fin.-U.S., art. 2(1)(a)(iv), art. 23(1)(b), Sept. 21, 1989, T.I.A.S. No. 12101, <http://www.irs.gov/pub/irs-trty/finland.pdf> [<http://perma.cc/8PEJ-44NT>].

<sup>303</sup> See Pamela B. Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 TAX L. REV. 1, 2 (1982).

<sup>304</sup> See *id.* at 2–3 (1982).

shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens: . . .the income tax paid or accrued to \_\_\_\_\_ by or on behalf of such resident or citizen.<sup>305</sup>

The technical explanation reinforces this point, stating that the eligibility for a foreign tax credit is a creature solely of domestic statutory law, stating as follows:

[A]lthough the Convention provides for a foreign tax credit, *the terms of the credit are determined by the provisions*, at the time a credit is given, *of the U.S. statutory credit*. Therefore, the *U.S. credit* under the Convention *is subject to* the various limitations of U.S. law (see, e.g., *Code sections 901-908*). For example, the credit against U.S. tax generally is limited to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a) and (d)), and the dollar amount of the credit is determined in accordance with U.S. currency translation rules (see, e.g., Code section 986). Similarly, U.S. law applies to determine carryover periods for excess credits and other inter-year adjustments.<sup>306</sup>

Thus, the historic understanding since the early 1980s has been that a treaty jurisdiction's tax is eligible for credit relief only to the extent allowed under domestic law.<sup>307</sup> In U.S. treaty negotiations, the Treasury Department must itself satisfy that a covered tax was compliant with the contours of domestic law. Given this understanding, the holding period requirements of Section 901(k) or 901(l), the disallowance of otherwise eligible treaty-based credits by reason of Section 901(m), or the limitations applied to foreign tax credits under Section 904 overrode any usage of credits allowed under the treaty because the ability to claim or utilize a foreign tax credit is ultimately always dependent on domestic law. An independent treaty-based foreign tax credit was a non sequitur.

With the above historical context in mind, the 2022 final regulations significantly alter the understanding of foreign tax credit relief under U.S. treaties. The regulations now create a situation where a foreign tax credit exists, even though that foreign tax would fail to meet the eligibility requirements under Section 901. Thus, the Treasury Department has resurrected the notion that an independent treaty-based foreign tax credit exists apart from domestic law by reason of a bilateral tax treaty between the United States and the treaty jurisdiction. The allowance of a

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<sup>305</sup> U.S. Model Tax Treaty, *supra* note 301, art. 23(2) (emphasis added).

<sup>306</sup> See *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006*, U.S. DEP'T OF THE TREASURY 74 (Nov. 15, 2006) (emphasis added), <http://home.treasury.gov/system/files/131/Treaty-US-Model-TE-2006.pdf> [<http://perma.cc/ECR3-CE72>].

<sup>307</sup> See *Toulouse v. Comm'r*, 157 T.C. 1, 16 (2021).

treaty-based foreign tax credit that is unmoored to Section 901 represents a significant departure from prior practice. It opens a Pandora's box of questions as to whether and to what extent domestic law is overridden by a treaty-based credit when the treaty does not purport to restrict or deny the credit based in the same detail as domestic law. Would the later in time treaty represent the grant of an independent treaty-based foreign tax credit that is not constricted by the disallowance and eligibility rules of Section 901 or Section 904? This obsolete question posited by Professor Gann is a highly relevant question once again.<sup>308</sup>

The import of the 2022 final regulations, therefore, is that it applies one set of rules to foreign jurisdictions that have a tax treaty with the United States and a different set of rules to those jurisdictions that do not. Given that the United States has tax treaties with all developed nations and only a few developing nations, the impact of this bifurcated handling of U.S. domestic law is that developing nations will be held to a harsher and stricter standard than developed nations. Developing nations do not have the tax resources that the United States has at its disposal, so it is reasonable and unexceptional to believe that developing nations would adopt conventions and rules that attempt to provide greater administrability and that do not closely conform to how the U.S. has designed its income tax laws. Developing nations now face a Hobson's choice: agree to an income tax treaty with the United States, redesign tax laws<sup>309</sup> to closely conform to the design hallmarks of the U.S. income tax laws, or be denied credit relief on their foreign tax levies. It is unclear why the United States has an interest in disadvantaging its own multinational enterprises in terms of investing in developing nations, or why the United States should pressure developing nations to adopt principles that conform to a developed nation's tax laws. Thus, another remarkable divergence is highlighted here. In 1918, the United States, in a great act of statesmanship, afforded foreign tax credit

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<sup>308</sup> See Gann, *supra* note 303 at 2.

<sup>309</sup> The new conformity requirements raise concerns as to creditability in many developing nations worldwide and pose a concern that the largest Latin American economy, Brazil, would not have any taxes eligible for U.S. foreign tax credit relief. See Letter from Timothy McDonald, Chair, & Rick Minor, Vice President & Int'l Tax Couns., U.S. Council for Int'l Bus., to Lily Batchelder, Assistant Sec'y (Tax Policy), Jose E. Murillo, Deputy Assistant Sec'y for Int'l Tax Affairs, & Kevin Nichols, Int'l Tax Counsel, U.S. Dep't of the Treasury (Mar. 24, 2022), [http://uscib.org/uscib-content/uploads/2022/03/USCIB-FTC-Treas.03.24.2022.final\\_.pdf](http://uscib.org/uscib-content/uploads/2022/03/USCIB-FTC-Treas.03.24.2022.final_.pdf) [<http://perma.cc/SD83-2WVS>]. *But see* Stephanie Soong Johnston & Alexander F. Peter, *Brazil Drafting Law for OECD-Aligned Transfer Pricing Revamp*, 106 TAX NOTES INT'L 410 (2022) (stating that in response, Brazil has announced that it will reform its transfer pricing conventions to align with the OECD framework).

relief on a unilateral basis.<sup>310</sup> The import of the 2022 final regulations is to condition allowance of foreign tax credit relief either on the requirement that a developing nation enter into a U.S. tax treaty or redesign its tax laws to closely conform to the laws of the United States.

#### D. Developing Nations' Interest in International Taxation

The OECD Inclusive Framework seeks to both ring-fence the revenue claims of developing nations and assert some level of minimum taxation over multinational enterprises.<sup>311</sup> The big winners in this arrangement appear to be developed nations in the European Union, but other big winners appear to be multinational enterprises that now have the OECD arguing on their behalf against the claims of developing nations that otherwise would have asserted additional taxation over residual profits earned from digital sales into their market economies.<sup>312</sup> In a letter to the OECD, the United Nations Committee of Economic, Social, and Cultural Rights argued that the OECD did not provide an equal voice to developing nations and then argued as follows:

This [OECD-sanctioned] solution will bring about only minimal benefits to developing countries. According to OECD's own estimates, it will reallocate around USD 125 billion of profits to market jurisdictions. However, that amount represents only around USD 10 billion in tax revenue for the countries which as noted by the South Centre is "a minuscule amount, especially when the annual scale of corporate tax avoidance ranges from 100-307 billion."

...

We wish to express our concern that the Two Pillar solution, as it stands, would significantly undermine the revenue collection and taxing rights of low and middle-income countries. This in turn will affect the availability of resources to ensure the progressive realization of all economic, social and cultural rights, as well as of the right to development, as expeditiously and effectively as possible. This is more

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<sup>310</sup> Michael J. Graetz & Michael M. O'Hear, *The Original Intent of U.S. International Taxation*, 46 DUKE L.J. 1021, 1022 (1997).

<sup>311</sup> See *International Community Strikes a Ground-Breaking Tax Deal for the Digital Age*, OECD (Aug. 10, 2021), <http://www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm> [<http://perma.cc/4WKG-TCZQ>].

<sup>312</sup> See Stephanie Soong Johnston, *Argentina Says Global Tax Deal is Bad for Developing Nations*, 2021 TAX NOTES TODAY INT'L 1, <http://www.taxnotes.com/tax-notes-international/politics-taxation/argentina-says-global-tax-deal-bad-developing-nations/2021/10/11/7bbmz> ("Let me be very straight: We policymakers from developing countries are sort of forced to choose between something bad and something worse," Martín Guzmán, Argentina's economy minister, said. "Worse is to get nothing, and bad is what we're getting."); see also Stephanie Soong Johnston, *OECD Pillar 2 Subject-to-Tax Rule Falls Short, Officials Say*, 2022 TAX NOTES TODAY INT'L 1, 2, <http://www.taxnotes.com/tax-notes-today-international/politics-taxation/oecd-pillar-2-subject-tax-rule-falls-short-officials-say/2022/01/27/7d4hh>.

worrisome during times of severe resource constraints caused by a cumulative negative impacts of the COVID-19 pandemic, previous fiscal adjustments due to high levels of indebtedness and additional need for public resources to respond to health and social protection requirements of the population.<sup>313</sup>

Other economic reports also indicate that the OECD Inclusive Framework largely benefits developed nations over developing nations.<sup>314</sup>

In contrast to the OECD approach, the commentary to the U.N. Model Treaty makes clear that the U.N. approach leaves the ultimate allocation of taxation as a matter of negotiation among the treaty jurisdictions, as indicated in the following statement:

[T]he new article [12B] simply represents an approach to allocating taxing rights between two jurisdictions — the market jurisdiction and residence jurisdiction — that both have a valid claim to tax the income. . . My clear view is it's not a new taxing right. It's as old as the hills [and] you see it at the state level in the U.S. The problem we have is that the residence state taxing rights are also legitimate, so you have to have an allocation of taxing rules by treaty to try to prevent double taxation.

. . .

Countries' common practice of relinquishing their market-based taxing rights through bilateral treaties does not imply that those rights do not exist. It's entirely legitimate in domestic law to tax based on presence in the market. You should try to be moderate, bearing in mind your situation. But then you have to negotiate at the international level about how much of that taxing right is preserved, and countries are more and more saying [they] want to preserve more of those taxing rights.<sup>315</sup>

As the ongoing debate ensues between developing and developed nations in terms of what allocation of taxation rights

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<sup>313</sup> See Letter from Attiya Waris et al., Comm. on Econ. Soc. & Cultural Rights, to Pascal Saint-Amans, Org. for Econ. Co-operation & Dev. (Mar. 30, 2022), <http://spcommreports.ohchr.org/TMResultsBase/DownloadPublicCommunicationFile?gId=27165> [<http://perma.cc/WAG8-C7DE>].

<sup>314</sup> See Julie McCarthy, *A Bad Deal for Development: Assessing the Impacts of the New Inclusive Framework Tax Deal on Low- and Middle-Income Countries* 3 (Brookings Global, Working Paper No. 174, 2022); Letter from Alex Cobham, Tax Just. Network, to Pascal Saint-Amans, Org. for Econ. Co-operation & Dev. (Feb. 18, 2022) (on file with author); see also *The Effect of the OECD's Pillar 1 Proposal on Developing Countries - An Impact Assessment*, OXFAM 1 (Feb. 17, 2022), [http://webassets.oxfamamerica.org/media/documents/Pillar\\_1\\_impact\\_assessment\\_v2\\_25JAN2022.pdf?\\_gl=1\\*g4fwu7\\*\\_ga\\*ODU3NTkxMzgwLjE2NzIyNjMyMTc.\\*\\_ga\\_R58YE7TD6XK\\*MTY3MjI2MzIxNi4xLjEuMTY3MjI2MzIwNC41Ny4wLjA](http://webassets.oxfamamerica.org/media/documents/Pillar_1_impact_assessment_v2_25JAN2022.pdf?_gl=1*g4fwu7*_ga*ODU3NTkxMzgwLjE2NzIyNjMyMTc.*_ga_R58YE7TD6XK*MTY3MjI2MzIxNi4xLjEuMTY3MjI2MzIwNC41Ny4wLjA). [<http://perma.cc/BCG9-5PD4>] (stating “[w]e already know that the OECD’s Pillar 2 grants almost all revenue to a handful of rich countries, while leaving less than 3% for the poorest countries” and then finding that Pillar 1 provides little more than a 3% digital service tax would, making it questionable whether developing nations should implement this more complicated arrangement).

<sup>315</sup> Michael Lennard, Chief of the Int'l Tax Cooperation and Trade in the Fin. for Dev. Office, U.N. Dep't of Econ. and Soc. Affairs, 2021 TNTI 164-3, Tax Doc. DOC 2021-33179 (Aug. 26, 2021).

should be afforded to market jurisdictions, the Treasury Department's 2022 final regulations have added to that jurisdictional debate in a manner that creates far-reaching consequences. For example, although Brazilian income taxes have historically been considered to be creditable under general U.S. tax principles,<sup>316</sup> the 2022 final regulations require that a jurisdiction's income tax utilize the U.S. notion of the arm's length standard.<sup>317</sup> For administrative convenience, Brazilian income tax laws have long utilized a variety of fixed margin presumptions for purposes of applying a minimum income tax or for applying presumptive tax regimes; now, those longstanding aspects of Brazilian tax law raise concerns that the entirety of the Brazilian income tax is non-creditable under the 2022 final regulations.<sup>318</sup> It is easy to understand why developing countries with less administrative resources would rely on simplifying assumptions in order to make their income tax laws administrable, versus how a developed nation with significant resources would administer its income tax laws.<sup>319</sup> The Treasury Department's expectation that all nations must apply the level of rigor that the United States utilizes in terms of applying the arm's length standard imposes a heightened standard on developing nations without any expressed Congressional endorsement for such treatment.

Congress has not endorsed the usage of Section 901 as a bargaining chip among nations. In fact, the regulatory effort to impose conformity standards in terms of jurisdictional nexus and

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<sup>316</sup> See, e.g., Rev. Rul. 74-58, 1974-1 C.B. 180.

<sup>317</sup> See Treas. Reg. § 1.901-2(b)(5)(ii) (2022). Brazil is the largest South American economy that does not have a tax treaty in force with the United States. Bob Michel & Tatiana Falcão, *Pillar 1 as a Ticket to a Fairer Taxation for Low- and Middle-Income Countries*, 106 TAX NOTES INT'L 655, 658 (2022). Commentators have recognized that Brazil has avoided entering into a bilateral tax treaty with the United States to preserve its sovereignty as a source state to tax profits realized in Brazil by nonresident aliens. See *id.* It is this type of market jurisdiction that the OECD's Pillar 1 proposal would seek to circumscribe. In contrast, the U.N. approach in its Model Treaty would afford significant deference toward it in terms of allowing it to continue to forge its path for exercising taxation over nonresident persons that earn digital income in its jurisdiction. See U.S. Model Tax Treaty, *supra* note 301, art. 23.

<sup>318</sup> See Letter from Leslie J. Schneider, Partner, Ivins, Phillips & Barker, to the Comm'r of Internal Revenue, Internal Revenue Serv. (June 3, 2022), <http://www.taxnotes.com/research/federal/other-documents/public-comments-on-regulations/ivins-phillips-seeks-reconsideration-of-ftc-arm's-length-requirement/7dlg9> [<http://perma.cc/2L4A-J3XV>].

<sup>319</sup> See Isabel Gottlieb, *India Urges Focus on Developing Country Needs in Global Tax Deal*, BLOOMBERG DAILY TAX REPORT (July 14, 2022, 1:25 PM), <http://news.bloombergtax.com/daily-tax-report-international/sitharaman-urges-focus-on-developing-country-needs-in-tax-deal> (arguing for the need for developing nations to have flexibility to adopt simplified transfer pricing formulas and treaty-based minimum tax regimes for administrative reasons); see also Reuven Avi-Yonah & Yoram Margalioth, *Taxation in Developing Countries: Some Recent Support and Challenges to the Conventional View*, 27 VA. TAX REV. 1, 9 (2007) (noting academic literature recommending greater reliance on withholding taxes).

the requirement of a foreign jurisdiction to utilize transfer pricing standards that closely conform to those of the United States involves the United States in the formal design of a foreign jurisdiction's tax laws at a granular level—which departs from the principal goal of mitigating against the evils of international double taxation. The effort to reorient Section 901 into a prescriptive provision designed to promote conformity calibrates that provision to achieve a goal that is different from the original goal of eliminating double income taxation of U.S. persons.

## II. SECTION 901 SHOULD HAVE BEEN AMENDED TO DENY FOREIGN TAX CREDIT RELIEF TO TOP-UP TAXES IMPOSED UNDER PILLAR TWO

The OECD's Pillar Two project is designed to ensure that large multinational enterprises pay a minimum level of tax regardless of where they are headquartered and regardless of the jurisdictions where they operate.<sup>320</sup> The OECD's Pillar Two project introduces the concept of Global Anti-Base Erosion rules (so-called "GloBE" rules) that implement a minimum tax through interlocking rules.<sup>321</sup> The first-in-line top-up tax is a qualified domestic minimum tax which is defined to be a minimum tax included in the domestic law of a jurisdiction and that: (a) determines the excess profits of the constituent entities located in the jurisdiction (domestic excess profits) in a manner that is equivalent to the GloBE Rules and (b) operates to increase domestic tax liability with respect to domestic excess profits to the minimum rate for the jurisdiction.<sup>322</sup> The next-in-line top-up tax is the income inclusion rule (IIR) which is a top-up tax applied by the owner of the constituent entity.<sup>323</sup> The IIR effectively operates by requiring a parent entity (in most cases, the ultimate parent entity) to bring into account its share of the income of each constituent entity located in a low-tax jurisdiction and taxes that income up to the minimum rate (after crediting any covered taxes on that income).<sup>324</sup> "The IIR imposes a top-up tax only on that

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<sup>320</sup> See OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: TAX CHALLENGES ARISING FROM DIGITALISATION – REPORT ON PILLAR TWO BLUEPRINT 14–15 (2020) [hereinafter REPORT ON PILLAR TWO BLUEPRINT], [http://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint\\_abb4c3d1-en](http://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint_abb4c3d1-en) [<http://perma.cc/YQ4P-S9JR>].

<sup>321</sup> *Id.* at 14–16.

<sup>322</sup> See OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO) art. 4.2.1 (2021) [hereinafter GLOBAL ANTI-BASE EROSION MODEL RULES], <http://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf> [<http://perma.cc/HC3V-RZMZ>]. The qualified domestic minimum tax is given priority over the IIR in Model Rule 5.2.3. See *id.* art. 5.2.3.

<sup>323</sup> See *id.* art. 2.2.

<sup>324</sup> See *id.* art. 2.1–2.3.

portion of the low tax income of a foreign [c]onstituent [e]ntity which is beneficially owned (directly or indirectly) by the member of the group that applies the IIR (the Parent [entity]).”<sup>325</sup> The last-in-line top-up tax is called the undertaxed payments rule (UTPR) which is a top-up tax that seeks to impose a top-up tax on a constituent entity and the tax is not a qualified domestic minimum tax or imposed by an entity other than the owner of the constituent entity.<sup>326</sup> The UTPR acts as a backstop that can be triggered into operation if and only if a sufficient IIR did not already assess the minimum tax.<sup>327</sup> Thus, the GloBE rules set forth a pecking order: the QDMT is in the front-of-the-line, the IIR is in the middle position, and the UTPR is the last-in-line top-up tax. However, the QDMT, the IIR, and UTPR apply only after covered taxes are taken into account, and those include the taxes paid by the constituent entity and taxes paid by the owners of a constituent entity under a CFC tax regime.<sup>328</sup>

Importantly, the OECD Model Rules explicitly exclude top-up taxes from the definition of a covered tax.<sup>329</sup> Thus, the OECD Model Rules make clear that the imposition of a top-up tax (a QDMT, a qualifying IIR, or a qualifying UTPR) is excluded from the definition of a covered tax and is thus ineligible for consideration with respect to whether a minimum tax has been paid in order to avoid a circularity problem.<sup>330</sup> Because these taxes, in effect, are denied foreign tax credit relief under the Model Rules, these top-up taxes operate more closely in design to an international alternative minimum tax<sup>331</sup> that would take second-chair status to the assertion of taxing jurisdictions that impose taxation under either a CFC tax regime or under the regular income taxes of a particular jurisdiction. However, as a concession to allow the source jurisdiction to assert taxation first on low-taxed income, any top-up tax assessed under a Qualified Domestic Minimum Top-Up Tax excludes any tax imposed under a CFC tax regime for purposes of computing the amount of the

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<sup>325</sup> REPORT ON PILLAR TWO BLUEPRINT, *supra* note 320, at 112.

<sup>326</sup> See GLOBAL ANTI-BASE EROSION MODEL RULES, *supra* note 322, at 2.4–2.6.

<sup>327</sup> See REPORT ON THE PILLAR TWO BLUEPRINT, *supra* note 320, at 15.

<sup>328</sup> See GLOBAL ANTI-BASE EROSION MODEL RULES, *supra* note 322, art. 4.2. A qualified domestic minimum tax applied by the jurisdiction of the constituent entity would appear to also be a covered tax because it is recorded on the financial statements of the constituent entity per Article 4.2.1(a) and is not excluded by Article 4.2.2. *Id.*

<sup>329</sup> See *id.* art. 4.2.2.

<sup>330</sup> *Id.*

<sup>331</sup> OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – COMMENTARY TO THE GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO) 8 (2022), <http://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf> [<http://perma.cc/V3ZD-9VSL>].



Qualified Domestic Minimum Top-Up Tax, thus affording it first priority status as to the right to tax low-taxed income of the particular QDMTT jurisdiction.<sup>332</sup>

Importantly, this nuance does not exist under Section 901 or its regulations. In this regard, a foreign income tax paid under a foreign law inclusion regime (like a qualifying IIR) would be considered attributable to the income to which the top-up tax relates,<sup>333</sup> and the residency-based tax would appear likely to satisfy the attribution requirement<sup>334</sup> and the other requirements of the Treasury regulations.<sup>335</sup> Moreover, a qualifying UTPR and QDMT asserted by the jurisdiction of a constituent entity and a qualifying IIR asserted by the residency jurisdiction of the constituent entity's owner are likely to be eligible for foreign tax credit relief under the existing regulations.<sup>336</sup> This outcome represents a normative mistake, at least with respect to a qualifying IIR and a qualifying UTPR.<sup>337</sup> If a foreign tax credit were allowed for IIR and UTPR top-up taxes, then the imposition of these top-up taxes would reduce the amount of actual tax imposed under GILTI, Subpart F, and the new U.S. corporate alternative corporate minimum tax with the consequence that the amount of tax paid on the particular country income would be further reduced below the minimum tax threshold. This, in turn, creates a circularity problem. The reduction of covered taxes due to the allowance of foreign tax credit relief for top-up taxes would create the need for a further top-up tax that would then again be triggered to apply, and so on. This circularity problem would ultimately lead to top-up taxes taking a first-priority status over the covered taxes that should be given first priority under the OECD framework (the CFC tax regimes of GILTI, Subpart F, and

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<sup>332</sup> See OECD, OECD/G20 Base Erosion and Profit Shifting Project: Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two) para. 118.30 (2023), <http://www.oecd.org/tax/beps/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf> [<http://perma.cc/E94M-GB34>].

<sup>333</sup> See Treas. Reg. §§ 1.861-20(d)(3)(iii), 1.861-20(g)(7), 1.901-2(b)(5)(ii) (2022).

<sup>334</sup> See Treas. Reg. § 1.901-2(b)(5)(ii) (2022).

<sup>335</sup> Because the tax is applied to excess profits determined using income tax principles, it is likely the other requirements of the net gain requirement will be satisfied. See Treas. Reg. § 1.901-2(b) (2022).

<sup>336</sup> See Treas. Reg. § 1.901-2(b) (2022).

<sup>337</sup> Conceptually, a qualified domestic minimum top-up tax imposed by a jurisdiction on the income earned in that jurisdiction is a tax that should be afforded foreign tax credit relief in the U.S. in order to recognize that jurisdiction's first right to assert taxation over the income arising from its own jurisdiction. The OECD has recognized this priority in its recent guidance. See OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – ADMINISTRATIVE GUIDANCE ON THE GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO) para. 118.30 (2023), <http://www.oecd.org/tax/beps/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf> [<http://perma.cc/E94M-GB34>].

the new alternative corporate alternative minimum tax). The OECD has already expressed the view that top-up taxes should not supplant a CFC tax regime, nor should they supplant a minimum tax imposed by the United States on its jurisdiction, but existing U.S. law does not provide for a mechanism to exclude these top-up taxes because no conforming amendment has been made to Section 901 to address this design challenge. This is a mistake in existing U.S. law. The U.S. foreign credit regime should deny foreign tax credit relief to all top-up taxes. This is made all the more urgent because it appears that several countries are moving forward with implementing Pillar Two.<sup>338</sup>

As a result, even though the Treasury Department signed on to the OECD Framework along with 137 other nations in October 2021, the fact remains that the 2022 amendments to the Treasury regulations,<sup>339</sup> the corporate alternative minimum tax legislation enacted in 2022,<sup>340</sup> and the 2022 Greenbook proposal identify the need to amend Section 901 to deny foreign tax credit relief for top-up taxes imposed under the auspices of the OECD Pillar Two project.<sup>341</sup> For the reasons already addressed in Part I.C., an amendment to Section 901 that denies foreign tax credit relief to IIR and UTPR top-up taxes is not a treaty override because the allowance of a credit under U.S. tax treaties is made subject to the conditions of domestic U.S. tax law. Thus, the treaties defer to domestic law to define the terms of what taxes are eligible for tax credit relief. Thus, Congress could and should unilaterally deny U.S. foreign tax credit relief for any qualifying IIR and qualifying UTPR in order to prevent the imposition of those top-up taxes from reducing otherwise applicable U.S. taxation over that income.

#### CONCLUSION

The United States missed the correct turn and took a wrong turn with respect to the U.S. foreign tax credit implications of the OECD inclusive framework and the novel taxes that are being considered by other nations.

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<sup>338</sup> See Amanda Athanasiou, *Yielding to Stakeholder Pressure, U.K. Delays Pillar 2 Implementation*, 106 TAX NOTES INT'L 1585 (2022) (announcing delay but expecting implementation beginning in 2024). It is also believed that Canada, France, Germany, Italy, and Japan will also proceed to implement Pillar Two as well. See Reuven S. Aviyonah & Bret Wells, *Pillar 2 and the Corporate AMT*, 107 TAX NOTES 693 (2022).

<sup>339</sup> See T.D. 9959, 87 Fed. Reg. 276, 288 (Jan. 4, 2022).

<sup>340</sup> See Inflation Reduction Act, Pub. L. No. 117-169, 136 Stat. 1818 (2022).

<sup>341</sup> See DEPT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS 6-8 (2022), <http://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf> [<http://perma.cc/4GS4-QJPY>]; see also DEPT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS 6-10 (2021), <http://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf> [<http://perma.cc/SJB3-YW9W>].

The wrong turn that was taken was to amend the Treasury regulations to impose a U.S. conformity and a jurisdictional nexus requirement. The Treasury Department, via the issuance of its 2022 final regulations, repudiated the text, purpose, and policy grounds that undergird the foreign tax credit since its adoption by restricting its scope in ways that eviscerate the intended goals of the foreign tax credit regime. These 2022 final regulations also represent a strong repudiation of the Supreme Court's own rearticulation of the *Biddle* doctrine in the *PPL* decision by attempting to formulate an interpretation of the *Biddle* doctrine that is inconsistent with the Supreme Court's interpretation of its own doctrine. The timing of these regulations is ironic. The world today has many similarities to the circa 1918-1921 era, albeit the drivers that create the similarities are different. The foreign tax credit was enacted to prioritize elimination of international taxation in the midst of the post-World War I chaos. In the circa 1918-1921 era, the United States, in statesmanlike fashion, took the unilateral step of mitigating against instances of international double income taxation during the period when no agreed international norms existed. The crushing war debts after World War I resulted in instances of international double income taxation when there was no consensus on norms. The United States afforded a foreign tax credit without any prerequisite agreement on international norms, and then in the next fifteen years, spearheaded an effort to forge international norms. The U.S. representative who was the architect of the foreign tax credit, T.S. Adams, spearheaded this effort to forge international taxation norms until his passing at which point Mitchell Carroll took over that role for the United States.<sup>342</sup> The COVID-19 pandemic, not World War I, has created enormous strains on fiscal resources in this era. The explosive growth of the internet has allowed multinational enterprises to maintain a significant virtual presence with customers in market jurisdictions. There is an unlevel playing field between traditional brick-and-mortar businesses subject to jurisdictional taxation and virtual businesses that escape income taxation in those local market economies.<sup>343</sup> Thus, for different reasons, the world is now again in a situation where internal norms of taxation are in the midst of reformulation. The OECD and over

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<sup>342</sup> See generally Carroll, *supra* note 59.

<sup>343</sup> The commentary to Article 12B of the U.N. Model Treaty makes this point in the following manner:

In this regard, modern methods for the delivery of services allow non-residents to render substantial services for customers in the other country with little or no presence in that country. This ability to derive income from a country with little or no physical presence there is considered by the Committee to justify source taxation of income from automated digital services.

See U.N. MODEL DOUBLE TAXATION CONVENTION, *supra* note 11, at 4.

135 participating countries and jurisdictions all agree that reformulation is needed. The OECD has announced an extremely accelerated timeframe for implementing a new international consensus. It took more than a decade for an international consensus to be forged in the post-World War I era, so the OECD's timeframe by that standard is ambitious.

Yet, although remarkable similarities exist in the two eras, the U.S. Treasury Department has forged a diametrically opposite policy approach in this era compared to the one that Congress chose in the circa 1918-1921 era. In 1918, Congress adopted a unilateral foreign tax credit before a consensus on international taxation norms was forged, and the United States worked for a consensus on international norms in the succeeding years. In contrast, in 2022, the Treasury Department has sought to deny foreign tax credit relief on destination-based taxes until a further international consensus on taxation of the digital economy is fully implemented. Congress in 1918 prioritized mitigation of international double taxation above the interests of the U.S. fisc and then worked to create a consensus on international taxation. In contrast, in 2022, the Treasury Department prioritized the interest of the U.S. fisc over the consequences of international double income taxation. Seen in light of its historical objectives and historical context, the 2022 final regulations eviscerate the text, purpose, and policy goals that guided the enactment of the foreign tax credit regime. It remains to be seen what a court will decide in terms of this reformulation, but in this author's mind, the Supreme Court's rearticulation of the *Biddle* doctrine in *PPL* provides a negative harbinger for the Treasury Department's attempt to further impose formalistic design hallmarks onto the *Bank of America* standard.

Although the path taken by the Treasury Department represents a "wrong turn," it is true to say that an adjustment was needed to Section 901 as part of the international agreement to implement the OECD Pillar Two recommendations. The "right turn" that should have been taken is that Section 901 should have been amended to deny foreign tax credit relief for top-up taxes, modeled after an income inclusion rule or an under-taxed payment rule. This is made all the more critical because Congress adopted a corporate alternative minimum tax that does not comply with the GloBE rules. By enacting a corporate alternative minimum tax that does not fit neatly with the GloBE rules, the newly enacted U.S. corporate minimum tax may represent a better outcome than if the United States had enacted a qualified IIR in compliance with the GloBE rules. But the enacted legislation contains a deficiency. What should have been done concurrently with the enactment of

this corporate alternative minimum tax (but was not done) was to make a companion amendment to Section 901 so that Section 901 would not afford foreign tax credit relief for any non-covered tax that is designated as a qualifying IIR or a qualifying UTPR under the GloBE rules. Failing to do so has put the residual U.S. tax jurisdiction at risk of being eroded through minimum taxes imposed by other nations in preference to the corporate alternative minimum tax imposed by the United States. The OECD framework envisions that top-up taxes modeled after the GloBE rules would not be afforded foreign tax credit relief among nations, so the United States' denial of foreign tax credit relief for top-up taxes would have been consistent with the OECD proposal for how these top-up taxes should be handled under the OECD inclusive framework. The U.S.' failure to make this conforming amendment to Section 901 represents a self-inflicted wound. Congress should correct this mistake by amending Section 901 to make it clear that top-up taxes under a qualifying IIR or a qualifying UTPR would not be afforded U.S. foreign tax credit relief. Doing so would ensure that the U.S. tax base is not eroded and that these taxes truly represent incremental "top-up" taxes that cause a multinational enterprise to be subject to the minimum tax rate. Thus, reform along these lines effectuates the policy goals sought by the OECD framework and also protects the U.S. tax base. It is now time for Congress to address this deficiency before it creates an inappropriate reduction of the U.S. tax base.

