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Treasury and IRS news

IRS proposed foreign tax credit regulations offer relief from cost recovery and source-based attribution rules, include other key changes

Treasury and the IRS published proposed regulations on 22 November 2022 ([REG-112096-22](#); Proposed Regulations) that address the definition of a foreign income tax and the allocation and apportionment of foreign taxes on disregarded payments. The Proposed Regulations would provide certain relief from the cost recovery requirement and the source-based attribution requirement on royalty income for purposes of determining the creditability of foreign taxes under Sections 901 and 903. The Proposed Regulations also would modify the disregarded payment rules for purposes of allocating and apportioning foreign taxes under Section 861.

The Proposed Regulations would modify the final foreign tax credit regulations published on 4 January 2022 ([TD 9959](#); 2022 Final Regulations), as amended by technical corrections published on 27 July 2022 ([87 FR 45018](#) & [87 FR 45021](#)).

More specifically, the Proposed Regulations would make two significant changes to the cost recovery requirement. First, a foreign tax law would only need to allow for recovery of "substantially all" of each item of significant cost or expense, regardless of what the principles underlying any disallowances are. This "substantially all" determination would apply based on the foreign tax law (not a particular taxpayer's individual facts).

For purposes of applying the "substantially all" test, the Proposed Regulations introduce two safe harbors. The first would treat the foreign tax as not failing the "substantially all" test if the underlying foreign tax law disallows no more than 25% of one or multiple items of significant cost and expense. The second safe harbor would treat the foreign tax as not failing the "substantially all" test if the underlying foreign tax law limits recovery of a single item of significant cost or expense or multiple items that relate to a single category of significant costs or expenses based on a "qualifying cap."

Under the second change, even if a disallowance fails to meet the "substantially all" test, the Proposed Regulations would not prevent a foreign tax from satisfying the cost recovery requirement if the disallowance is consistent with the principles-based exception.

The amended cost recovery rules under the Proposed Regulations are expected to provide more certainty as to whether the cost recovery requirement would be satisfied for specific foreign taxes.

Source-based attribution requirement

The Proposed Regulations would add a new prong to the source-based attribution rule for royalties. Under the new rule, a foreign royalty withholding tax would meet the source-based attribution requirement if (i) the income subject to the tax is generally characterized as royalty income under the foreign tax law, and (ii) the terms of the license agreement under which the payment is made characterize the payment as a royalty and limit the territory of the license to the jurisdiction imposing the tax (the single-country rule).

Even when the agreement does not limit the territory to the jurisdiction imposing the tax or provides for payments in addition to those for use of intangible property, a payment may still qualify for the rule if certain requirements are met.

The Proposed Regulations also would revise the rules on disregarded reallocation transactions under Reg. Section 1.861-20 by providing that disregarded payments received in exchange for property do not constitute reattribution assets for purposes of allocating and apportioning taxes upon a disregarded remittance.

The rules on the cost recovery and royalty attribution requirements would apply to foreign taxes paid in tax years ending on or after 18 November 2022, the date the Proposed Regulations were filed. Because the 2022 Final Regulations apply to foreign taxes paid in tax years beginning on or after 28 December 2021, the Proposed Regulations generally would apply to all tax years to which the 2022 Final Regulations would have otherwise applied, aside from short tax years that end before 18 November 2022. Taxpayers may choose to apply these rules, once finalized, for foreign taxes paid in earlier tax year(s) beginning on or after 28 December 2021 (this generally would only arise for short tax years), provided that taxpayers generally apply all the rules in Proposed Reg. Section 1.901-2 consistently.

Taxpayers may rely on all or part of the Proposed Regulations, before they are finalized, for tax years beginning on or after 28 December 2021 (for the cost recovery and royalty attribution rules), provided the rules are applied consistently and by any related parties (within the meaning of Section 267(b), but without regard to Sections 267(c)(3) and 707(b)(1)).

While the Proposed Regulations would broaden the scope of creditable foreign taxes through the relief provided under the cost recovery rules and the sourced-based attribution rules for royalty income, they do not address, or provide safe harbors, for other situations in which traditionally creditable foreign taxes may be non-creditable under the 2022 Final Regulations.

IRS moving forward on cryptoasset issues

As cryptoassets took center stage in the mainstream media this month, the IRS indicated it is continuing to move forward with getting a handle on issues and reporting, amid a dearth of guidance.

The IRS in October announced that it established a digital asset project office to address crypto issues. In November, the new head of the office said: "There was a recognition enterprise-wide that digital assets [are] big and that we should have a dedicated staff to address strategy, priorities, and then activities." The office will be staffed with seven full-time IRS employees, the official said. The official was quoted as saying the digital asset office will establish strategies and priorities over the coming 12 to 18 months.

The IRS reportedly is currently drafting questions on cryptocurrency and digital assets that will be added to corporate and partnership returns, including questions for individuals. The IRS began asking a crypto asset question on Form 1040 in 2019 but is now poised to begin collecting information from entities.

The IRS also released the 2020 [Statistics of Income report](#) on 18 November 2022, showing that there was an almost 150% increase from 2019 to 2020, for taxpayers who checked "yes" on their returns in response to the question of whether they had cryptocurrency transactions. Over 2.3 million individual returns reported they had such transactions in 2020.

Section 367(d) regs coming early next year, official says

A senior IRS official said in November 2022 that proposed regulations under Section 367(d) will be released early next year, rather than by year-end. The regulations will limit a royalty inclusion for intellectual property that left the US and was subsequently repatriated.

Earlier this fall, a US government official said the proposed regulations "would provide high-level situations where you could turn off that royalty after [the IP] has been repatriated." The official indicated that the upcoming Section 367(d) proposed regulations are separate and apart from a project on the 2023 priority guidance plan that would address changes to Section 367(d) and Section 482 regarding aggregation and the definition of intangible property.

Congress returns to lame-duck session following mid-term elections

The congressional mid-term elections resulted in House Republicans gaining a slim majority in the 118th Congress when it convenes in January 2023. As we go to press, Democrats will control the Senate, though whether the ratio is 51-49 or 50-50 depends on the outcome of the 6 December Georgia runoff election, with divided government expected to dampen legislative activity for the next two years, although bipartisan legislation is possible.

Congress returned to Washington after the election for a lame-duck session, but the outlook for legislation remained unclear as the month of November closed. While there appears to be bipartisan support for addressing the *Tax Cuts and Jobs Act* Section 174 amortization requirement, Democrats are insistent that a Child Tax Credit expansion be part of any tax package, which could also address the Section 163(j) interest deductibility calculation, expensing, and the nonitemizer charitable deduction that was in effect for 2021.

There is no indication yet if the full Senate will take up the proposed US-Chile income tax treaty during the lame-duck session. The Senate Foreign Relations Committee approved the proposed accord on 29 March 2022.

No delay or transition period for final Section 1446(f) regs implementation date

An IRS official was quoted as saying in early November 2022 that taxpayers should not expect the government to implement a transition period or delay in the implementation date for the final Section 1446(f) regulations ([TD 9926](#)) that were released in October 2020.

Section 1446(f) imposes a new withholding tax on transfers by non-US persons of interests in partnerships that are engaged in a US trade or business. The IRS announced in [Notice 2021-51](#) that it would amend the regulations under Section 1446(a) and Section 1446(f) to defer the applicability date of certain provisions by one year to 1 January 2023. The affected provisions related to withholding address: (i) transfers of interests in publicly traded partnerships (PTPs); (ii) distributions made with respect to PTP interests; and (iii) non-publicly traded partnerships on distributions to transferees who failed to withhold properly.

Tax treaty news

Congressional Republicans urge Administration to not terminate US-Hungary treaty

In a 3 November 2022 [letter](#) to Treasury Secretary Janet Yellen and Secretary of State Antony Blinken, House Ways and Means Committee Ranking member Kevin Brady (R-TX), Senate Finance Committee Ranking Member Mike Crapo (R-ID), and Senate Foreign Relations Committee Ranking Member Jim Risch (R-ID) expressed concern about Treasury terminating the US-Hungary tax treaty.

“As we approach the end of the six-month advance-notice period to terminate the Treaty, we urge the Administration to reverse this decision and reengage with our treaty partner to ensure the United States upholds our treaty commitments.” The US-Hungary treaty is scheduled to terminate in January 2023, absent action by the US government.

Transfer pricing

IRS will consider applying economic substance doctrine and related penalties more frequently in transfer pricing audits

Holly Paz, Acting Commissioner of the IRS's Large Business and International (LB&I) Division, was quoted as saying that the IRS will more frequently consider whether the economic substance doctrine applies in transfer pricing audits. Paz spoke at the American Bar Association Section of Taxation during its Philadelphia Tax Conference on 15 November 2022.

The economic substance doctrine, which is codified in Section 7701(o), considers a transaction to have economic substance only if: (i) the transaction has a meaningful economic impact other than federal income tax effects; and (ii) the taxpayer has a substantial purpose for entering the transaction other than for federal income tax purposes. If a transfer pricing transaction fails to have economic substance, the IRS may assert a 20% penalty under Section 6662(b)(6) or a 40% penalty under Section 6662(i).

House Republicans seek retention of BEPS Pillar One documents and communications

US House Ways and Means Committee ranking member Kevin Brady (R-TX) and committee member Kevin Hern (R-OK) wrote to Treasury Secretary Janet Yellen requesting the retention of all documents and communications related to the OECD BEPS 2.0 Pillar One Agreement.

In a letter that was released on 31 October 2022, the Republican committee members wrote: “The lack of a sufficient response and information from the Administration to date is disappointing and unacceptable.” According to the lawmakers, Congress must know what companies “will be affected, what jurisdictions will be losing taxing rights, and what jurisdiction will be gaining taxing rights under the current proposals” so it can evaluate the impact of the proposal on the US fiscal position. The letter requested a response by 10 November 2022.

Paz's statement follows an April 2022 memorandum changing IRS policy to no longer require IRS executive approval before raising the economic substance doctrine in audits. When Section 7701(o) was first enacted, Paz said, executive approval was required because the IRS was unfamiliar with the doctrine. Under the new policy, revenue agents only need approval from their direct supervisor before asserting a penalty under the economic substance doctrine (which is similar to the process for other assessable penalties).

The memorandum also listed the circumstances under which applying the economic substance doctrine may be appropriate. Examples include: (i) a transaction being highly structured; (ii) a transaction including unnecessary steps; (iii) an artificial limitation on gain or loss; and (iv) a transaction generating a deduction that is not matched by an equivalent economic loss or expense.

Another IRS official in November was also quoted as saying that taxpayers should expect more penalties to be asserted in transfer pricing cases. The official said the agency is continuing to review cases more closely, including those with transfer pricing documentation, to determine if penalties are warranted. An official earlier said the IRS hopes the increased penalties will result in taxpayer's providing better transfer pricing documentation reports.

IRS 2022-2023 Priority Guidance Plan includes transfer pricing projects similar to last year

The [2022-2023 IRS Priority Guidance Plan](#) lists the projects to which the IRS and Treasury will allocate resources for plan year 1 July 2022, through 30 June 2023. This year's plan includes transfer pricing-related projects similar to those listed in the 2021-2022 guidance plan.

The IRS and Treasury again included the transfer pricing project which would clarify the effects of group membership on arm's-length pricing (specifically for financial transactions) under the Section 482 regulations. This year's guidance plan also again includes updating (i) Revenue Procedure 2015-40, which provides procedures for requesting and obtaining assistance from the US competent authority under US tax treaties; and (ii) Revenue Procedure 2015-41, which provides procedures for requesting and obtaining Advance Pricing Agreements.

Daniel Werfel nominated to lead IRS

President Joe Biden on 10 November 2022 announced that he was nominating former acting IRS commissioner Daniel Werfel to lead the IRS. The position requires US Senate confirmation.

Any modifications to Revenue Procedures 2015-40 and 2015-41 will give taxpayers more guidance on the criteria governing acceptance into the Advance Pricing and Mutual Agreement Program and how to structure requests for advance pricing agreements and US competent authority assistance.

Like the 2021-2022 plan, the guidance plan listed regulations under Sections 367 and 482 under the transfer pricing section. The project, which appears to combine two projects from the [2021-2022 Priority Guidance Plan](#), includes (i) regulations addressing the changes to Sections 367(d) and 482 "on aggregation, realistic alternatives, and the definition of intangible property"; and (ii) regulations under Section 482 clarifying certain aspects of the arm's-length standard, including periodic adjustments.

Unlike the 2021-2022 plan, this year's guidance plan does not include parts of the project on Section 482 regulations concerning "coordination of the best method rule with guidance on specified methods for different categories of transactions" or "discretion to determine the allocation of risk based on facts and circumstances of transactions and arrangements."

The guidance plan also includes, as it did last year, the inbound transfer of intangible property subject to Section 367(d). If a US person transfers any [intangible property](#) to a foreign corporation in an exchange under Sections 351 or 361, the outbound transfer is generally governed by Section 367(d).

OECD developments

OECD holds Tax Certainty Day addressing MAP developments, tax certainty under BEPS Pillars One and Two

The OECD on 22 November 2022 held its fourth annual [OECD Tax Certainty Day](#). During the event, the OECD released the [2021 statistics](#) on mutual agreement procedures (MAPs) and presented the [2021 MAP awards](#). There were also updates on other activities of the MAP Forum, the International Compliance Assurance Programme ([ICAP](#)) and the ongoing work on tax certainty under Pillars One and Two of the OECD/G20 project on addressing the tax challenges of the digitalization of the economy (the BEPS 2.0 project).

The OECD reported that MAP case inventory for new cases (post-2016) continues to rise. According to the organization, 2021 saw an increase of approximately 7% for all cases as compared with 2020. This consists of a 5% increase for new transfer pricing (TP) cases and a 10% increase for other new cases. There is a relatively even split between TP cases and other cases. In 2021, a high number of old cases (pre-2016) were closed; this resulted in a 25% decrease in the old cases in the MAP inventory. Taking old and new cases together, the overall MAP inventory stabilized for the first time in 2021.

Around 70% of total MAP cases are concentrated in the top 10 countries and around 40% in the top 5 countries (Germany, France, Italy, Spain, and India). In 2021, 77% of total MAP cases closed with resolution of the issue under dispute; no agreement was reached in only 2% of the MAP cases closed (including agreement to disagree).

The OECD also continues to be highly supportive and invested in ICAP, the voluntary risk assessment and assurance program, which has continued to grow following its initial pilots in 2018.

OECD updates guidance on implementation of CbC Reporting

The OECD in October 2022 updated its publication *Guidance on the Implementation of Country-by-Country Reporting*. The updates to the [Guidance](#) provide clarifications on the following topics: (i) use of positive and negative figures in Table 1; (ii) reporting permanent establishment information in Table 2; and (iii) treatment of certain short accounting periods or long accounting periods.

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