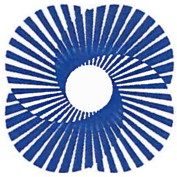


U.S. Chamber of Commerce

1615 H Street, NW
Washington, DC 20062-2000
uschamber.com

December 12, 2022

The Honorable Lily L. Batchelder
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Room 3120
Washington, DC 20220

Re: Guidance Related to the Foreign Tax Credit – The New Arm's Length Requirement

Dear Assistant Secretary Batchelder:

On behalf of the U.S. Chamber of Commerce ("Chamber") and its Brazil–U.S. Business Council ("Council"), we are writing to renew one of our utmost concerns with the 2022 final foreign tax credit regulations and highlight the growing they risk they pose to the commercial viability of U.S. foreign direct investment in Brazil, a major U.S. trading partner. As set forth below, we respectfully request the immediate withdrawal, suspension, or modification of the new arm's length requirement in Treasury regulations section 1.901-2(b)(5)(ii). This new requirement is unjustifiably overbroad and punitive in its effects, and its retention could cause lasting damage to U.S. commercial and economic interests in the region.

Background

On January 4, 2022, the Department of the Treasury ("Treasury") and Internal Revenue Service ("IRS") published final regulations relating to the foreign tax credit that addressed, inter alia, the definition of a foreign income tax and a tax in lieu of an income tax under sections 901 and 903 of the Internal Revenue Code.[1] The final regulations added a new jurisdictional nexus requirement—the "attribution requirement"—to the longstanding framework for determining whether a foreign tax qualifies as a "foreign income tax" for purposes of section 901.[2] The new rule generally requires that, for a foreign tax to be a foreign income tax, the foreign country imposing the tax must have sufficient nexus to the taxpayer's activities or investment of capital or other assets that give rise to the income base on which the foreign tax is imposed. And in the case of a foreign tax imposed by a foreign country on its residents, the final regulations provide that in determining whether the foreign tax meets the attribution requirement, any allocation of

---

[1] Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income, T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022) (as corrected by 87 Fed. Reg. 45,018, 45,021 (July 27, 2022)). Unless otherwise indicated, all references to "section" herein are to sections of the Internal Revenue Code of 1986, as amended ("Code" or "I.R.C.").

[2] Treas. Reg. § 1.901-2(b)(5).

income, gain, deduction or loss between a resident taxpayer and a related or controlled entity under the foreign country's transfer pricing rules must follow arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion (the "arm's length requirement").[3] The final regulations generally apply to foreign taxes paid in taxable years beginning on or after December 28, 2021.[4]

Treasury's primary stated justification for imposing this new requirement was that "[r]ecently, many foreign jurisdictions have disregarded international taxing norms to claim additional tax revenue, resulting in the adoption of novel extraterritorial taxes that diverge in significant respects from U.S. tax rules and traditional norms of international taxing jurisdiction."[5] Citing Pillar One of the OECD/G20 Inclusive Framework on BEPS's two-pillar plan for international tax reform, the preamble to the final regulations explains that these novel extraterritorial taxes often target digital services, where countries seeking additional revenue have chosen to abandon international norms to assert taxing rights over digital service providers.[6] Absent the new arm's length requirement, Treasury reasoned, the U.S. tax on net income could be reduced by credits for a foreign levy whose taxable base was "improperly inflated" by unreasonably assigning income to a taxpayer.[7] As the Chamber and others have pointed out, however, imposing the new arm's length requirement was neither a necessary nor an appropriate way for Treasury to address its stated concern.[8] The following discussion amplifies our previous comments on this issue and highlights some of the punitive ramifications facing U.S.-based multinationals with operations in Brazil.

Comments

Brazil's corporate income tax has long been treated as a creditable foreign income tax under section 901 of the Code.[9] The Brazilian transfer pricing rules, however, which were first introduced in 1996, use a simplified formulary approach that relies on fixed margins (instead of arm's length principles) to determine acceptable pricing for certain related-party transactions. In our previous comments, therefore, we raised the concern that Brazil's transfer pricing rules may

---

[3] *See* Treas. Reg. § 1.901-2(b)(5)(ii).

[4] Treas. Reg. § 1.901-2(h). Last month, Treasury and the IRS published a Notice of Proposed Rulemaking containing proposed regulations relating to the foreign tax credit, including guidance regarding the application of the new attribution requirement to withholding taxes on certain royalty payments. Guidance Related to the Foreign Tax Credit, REG-112096-22, 87 Fed. Reg. 71,271 (Nov. 22, 2022). None of this proposed guidance, however, would do anything to address the unjustifiably harsh effects of the new arm's length requirement in the final regulations.

[5] T.D. 9959, 87 Fed. Reg. 276, 285 (Jan. 4, 2022).

[6] *Id.*

[7] *Id.* at 283. The preamble elaborates that Treasury and the IRS determined it was necessary and appropriate to adapt the regulations under section 901 to address this change in circumstances, especially in relation to the taxation of the digital economy—a sector that did not exist when the foreign tax credit provisions were first enacted. *Id.*

[8] Earlier this year, the Chamber joined 18 other stakeholder organizations in commenting on four highly problematic aspects of the 2022 final foreign tax credit regulations that warrant withdrawal and reconsideration by Treasury. Coalition Letter to Treasury on Final Foreign Tax Credit Regulations (Mar. 4, 2022), https://www.uschamber.com/taxes/coalition-letter-on-final-foreign-tax-credit-regulations.

[9] *See, e.g.*, Rev. Rul. 74-58, 1974-1 C.B. 180.

prevent its corporate income tax from satisfying the new attribution requirement under the 2022 final foreign tax credit regulations—meaning that Brazil's previously creditable corporate income tax may no longer qualify as a creditable foreign income tax with respect to resident taxpayers. This anomalous result is based on a plain reading of the final regulations, notwithstanding the fact that Brazil's corporate income tax bears no resemblance to the novel digital services taxes that Treasury sought to address.

Such an abrupt and complete reversal in the treatment of Brazil's corporate income tax is extraordinarily harsh on affected U.S. companies and their supply chains, as well as on broader U.S. economic interests, and warrants Treasury's immediate attention. American-headquartered companies with longstanding operations in Brazil, which is the United States' 14th largest goods trading partner and the largest economy in the world for which no U.S. tax treaty benefits apply, are now materially disadvantaged relative to their foreign-headquartered competitors that do not face unmitigated double taxation of their Brazilian-source income. Consider the case of a U.S.-based technology company that established operations in Brazil over 100 years ago to serve Brazilian customers, which now faces tens of millions of dollars in unmitigated double taxation (i.e., tens of millions in *additional* taxes paid on the *same* underlying income). The commercial viability of such a company's Brazilian operations is now at serious risk from Chinese and other foreign competitors that do not bear the same burden of unmitigated double taxation.

Beyond the obvious U.S. commercial and economic interests at stake, there also are significant U.S. foreign policy implications to consider. The new arm's length requirement disproportionately impacts the largest and most important economy in South America, Brazil, as well as other Latin American countries with which the United States does not have an income tax treaty in effect. It therefore contravenes the Biden administration's stated geopolitical aim of expanding economic engagement in the region by disincentivizing U.S. direct investment there. Furthermore, Brazil is home to resources—for instance, deposits of many critical minerals—for which the United States and our allies are in many instances dependent on China. Brazil and the United States could benefit significantly from responsible development of those resources, which could reduce U.S. and global reliance on China as the dominant supplier thereof. Now is not the time to affirmatively cede additional economic and political influence to China by directly undercutting the ability of U.S.-based companies to compete in the region.

As part of its bid to join the Organisation for Economic Co-operation and Development ("OECD"), the Brazilian government recently committed to completely align its current transfer pricing legislation with international taxing norms by adopting the arm's length standard in full alignment with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Given Brazil's current legislative timeline, however, U.S.-based multinationals are still likely to suffer two or more years of unmitigated double taxation on their Brazilian-source income, which is commercially untenable.[10] In the meantime, the Chamber and the Council continue to engage directly with the Brazilian Ministry of Economics in support of these important changes to Brazil's transfer pricing rules.

---

[10] *See, e.g.*, Caio Albino et al., *Brazilian Adoption of the Arm's-Length Standard Could Be a 'GOOAALL!!!' for U.S. Companies and Other Multinationals*, 51 Tax Mgmt. Int'l J. (BNA) No. 9 (Sept. 2, 2022) (observing that the legislation would likely be approved in 2023 and the new transfer pricing rules implemented by 2024).

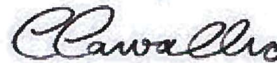
Recommendations

In view of the above, we respectfully renew our request for the immediate withdrawal or suspension of the new arm's length requirement in Treasury regulations section 1.901-2(b)(5)(ii).

If Treasury remains unwilling to withdraw or even suspend the new arm's length requirement pending the implementation of Brazil's current tax reforms, we would urge Treasury to issue guidance clarifying the rule's application in a manner consistent with the more measured approach in Treasury regulations section 1.901-2(e)(5) (governing noncompulsory amounts). Under this longstanding rule, amounts of foreign income tax paid generally are not creditable *to the extent* that they result from intercompany pricing that does not follow arm's length principles.[11] The balance of the foreign income tax paid (i.e., the amount of foreign income tax that would have been paid if arm's length principles were applied), however, remains creditable. Such an approach, firmly grounded in existing law, would mitigate the extraordinarily harsh results from the new arm's length requirement without jeopardizing Treasury's stated policy objective—preventing the reduction of U.S. tax on net income by credits for a foreign levy whose taxable base was improperly inflated by non-arm's length pricing.

The Chamber and the Council would welcome the opportunity to discuss these comments with you or your colleagues in further detail and provide whatever additional information or support you may need. The future of the new arm's length requirement is of tremendous concern to our members with operations in Brazil and we appreciate your timely attention to this matter.

Sincerely,



Watson M. McLeish
Senior Vice President, Tax Policy
U.S. Chamber of Commerce

Cassia Carvalho
Executive Director
Brazil–U.S. Business Council

Copies: The Honorable Ronald L. Wyden, Chairman, U.S. Senate Committee on Finance
The Honorable Michael D. Crapo, Ranking Member, U.S. Senate Committee on Finance
The Honorable Richard E. Neal, Chairman, U.S. House Committee on Ways and Means
The Honorable Kevin P. Brady, Ranking Member, U.S. House Committee on Ways and Means
Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation, United States Congress
William M. Paul, Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Peter H. Blessing, Associate Chief Counsel (International), Internal Revenue Service

[11] *See* Treas. Reg. § 1.901-2(e)(5)(vi)(A) (example 1); Rev. Rul. 92-75, 1992-2 C.B. 197.