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Tax Elements of the U.S. Response to Russia's Invasion of Ukraine

By David G. Noren[*]
McDermott Will & Emery LLP
Washington, D.C.

INTRODUCTION

In response to Russia's invasion of Ukraine and the many credible reports of atrocities committed there by the Russian military, the U.S. government has adopted and is considering a wide range of sanctions to express U.S. outrage at the Russian government's actions and to isolate that government politically and economically. While tax measures understandably have not been at the forefront of this response, both present law and potential legislation suggest that U.S. tax law will be called upon to play a role. The policy aims of these tax measures would be both to encourage companies to withdraw from the Russian market (subject to humanitarian exceptions) and to ensure that the U.S. fisc and U.S. taxpayers are not effectively funding the Russian government's actions.

Different companies have differing degrees of connection with the Russian market, and accordingly face different challenges in cooperating with and promoting U.S. policy with respect to Russia while also giving due weight to other contractual, legal, ethical, and humanitarian considerations vis-à-vis their various stakeholders. This commentary considers certain issues that existing and proposed tax measures may present for a U.S.-based multinational group as it charts its course through these very unusual and difficult circumstances.

BACKGROUND: U.S. APPROACH TO SANCTIONED COUNTRIES

In General

The U.S. international tax rules include two primary penalties for taxpayers operating in identified sanctioned countries: a denial of foreign tax credits under §901(j)[1] for taxes paid to the relevant foreign governments, and a rule treating a controlled foreign corporation's (CFC's) income derived from a §901(j) sanctioned country as per se subpart F income under §952(a)(5).

The statutory criteria for sanctioning a country under these rules include nonrecognition of the foreign government by the U.S. government, the severing or nonconduct of diplomatic relations with the foreign government on the part of the U.S. government, or a finding by the U.S. Secretary of State that the foreign country repeatedly provides support for acts of international terrorism.[2] As of the time of this writing, the only §901(j) countries are Iran, North Korea, Sudan, and Syria.[3]

Foreign Tax Credits

The denial of foreign tax credits under §901(j) begins six months after the relevant foreign country meets one of the §901(j) criteria.[4] Any foreign taxes that are denied as foreign tax credits under the provision are instead deductible under §164.[5] Such taxes also do not give rise to a §78 gross-up.[6] Income derived from each §901(j) country is assigned to its own separate basket for foreign tax credit limitation pur-

[*] David G. Noren is a partner at McDermott Will & Emery LLP in Washington, DC. This article may be cited as David G. Noren, *Tax Elements of the U.S. Response to Russia's Invasion of Ukraine*, 51 Tax Mgmt. Int'l J. No. 5 (May 6, 2022).

[1] All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder.

[2] *See* §901(j)(2)(A).

[3] *See* Rev. Rul. 2005-3, *as modified by* Rev. Rul. 2016-8 (to remove Cuba from the list).

[4] *See* §901(j)(2)(B).

[5] *See* §901(j)(3).

[6] *See id.*

poses, and thus cannot be used to create limitation space to claim credits for taxes paid to other countries.[7] The President has the authority to waive the application of §901(j) if the President determines that such a waiver is in the national interest and would expand trade and investment opportunities for U.S. companies in the relevant country.[8]

It is possible that §901(j) could be invoked against Russia, presumably on the basis of a finding by the Secretary of State that Russia has repeatedly provided support for acts of international terrorism. That category, however, is a bit of an imperfect fit for Russia's recent conduct (which if anything appears to be *worse* than "merely" providing support for acts of international terrorism), and any designation under present law §901(j) would entail a six-month delay before the sanctions take effect, as described above. The interaction of §901(j) with the current bilateral income tax treaty between the United States and Russia also would need to be considered.[9] Without new legislation, and without terminating the treaty, it is possible that the treaty-based guarantee of double taxation relief by way of a foreign tax credit might dilute the operation of §901(j) (at least in the case of direct credits, if not indirect credits).[10]

Subpart F

Under §952(a)(5), subpart F income includes all income of a CFC derived from any country during any period in which §901(j) applies to such country.[11] Thus, this income is taxed on a current basis in the United States at the full corporate income tax rate of 21%, rather than the lower global intangible low-taxed income (GILTI) rate, with no ability to offset the resulting U.S. tax with foreign tax credits (under §901(j)).

This subpart F income is reduced by deductions (including taxes) properly allocable to such income.[12] Any losses attributable to this category of income would not be available to offset GILTI tested income generated in other countries.

Treasury has regulatory authority to issue such regulations as may be necessary or appropriate to carry out the purposes of §952(a)(5), including authority to address the potential avoidance of the purposes of the rule through the use of intermediate entities, but this authority has not yet been exercised.[13] The subpart F *de minimis* and high-tax exceptions do not apply to §952(a)(5) subpart F income, although the current-year earnings and profits limitation remains applicable.[14]

WYDEN-PORTMAN PROPOSAL

In General

On April 7, 2022, Senator Ron Wyden (Senate Finance Committee Chairman and a Democrat from Oregon) and Senator Rob Portman (Senate Finance Committee Member and a Republican from Ohio) released a discussion draft of legislation that would adapt the tools of existing tax law to address Russia's actions in Ukraine (as well as the actions of Russia's partner in the invasion, Belarus) (the Wyden-Portman Proposal).[15] The Wyden-Portman Proposal would bring Russia and Belarus within the purview of §901(j) and §952(a)(5), but modifying the operation of both provisions as applied to Russia and Belarus. The proposal also includes an explicit treaty override.[16]

Foreign Tax Credits

With respect to foreign tax credits, the Wyden-Portman Proposal would apply §901(j) to Russia and Belarus, effective 30 days after enactment (thereby shortening what would be a six-month delay under present law if the Secretary of State were to make the relevant determination under present law). Unlike existing §901(j), the Wyden-Portman Proposal also would deny deductions for the relevant foreign taxes, and would apply the §78 gross-up to include the taxes

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[7] *See* §901(j)(1)(B).

[8] *See* §901(j)(5).

[9] Convention Between the United States of America and the Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital (signed June 17, 1992) (the U.S.-Russia Tax Treaty).

[10] *See* U.S.-Russia Tax Treaty, art. 22; *see also* Reuven Avi-Yonah, *US Should Leverage Tax Rules to Deter Business With Russia*, Law360 Tax Authority (Apr. 5, 2022) (recommending termination of the U.S.-Russia Tax Treaty in part for this reason). The U.S. Treasury Department already has suspended the exchange of information under article 25 of the U.S.-Russia Tax Treaty. *See* David Lawder, *U.S. Suspends Tax Information Exchange With Russian Authorities* , Reuters (Apr. 5, 2022).

[11] *See* §952(a)(5).

[12] *See* §952(a) (final sentence).

[13] *See* §952(d).

[14] *See* §954(b)(3), §954(b)(4), §952(c)(1)(A).

[15] *See* Sen. Fin. Comm. Press Release, *Wyden, Portman Release Bipartisan Bill to Disallow Foreign Tax Credits and Other Tax Benefits for Companies Operating in Russia*, Apr. 7, 2022 (including links to draft statutory language and a technical description).<https://www.finance.senate.gov/chairmans-news/wyden-portman-release-bipartisan-bill-to-disallow-foreign-tax-credits-and-other-tax-benefits-for-companies-operating-in-russia>

[16] The Wyden-Portman Proposal also includes special provisions denying various tax benefits to specifically sanctioned persons (tax treaty benefits, the §892 exemption for foreign governments, the portfolio interest exemption of §871(h) and §881(c), the trading safe harbor of §864(b), the shipping income exemption under §883, and Foreign Investment in Real Property Tax Act (FIRPTA) withholding exemptions under §897(l)).

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in the U.S. shareholder's income.[17] Thus, taxes paid to Russia and Belarus would be subject to somewhat harsher treatment than taxes paid to other §901(j) countries.

Subpart F

The Wyden-Portman Proposal would treat all income derived from Russia or Belarus as subpart F income under §952(a)(5). This subpart F treatment would not apply, however, if a taxpayer satisfies an ''exit safe harbor'' demonstrating that the relevant operations have been substantially shut down. Satisfying the safe harbor also would avoid separate basketing of income from the relevant country, although foreign tax credit and deduction disallowance would still apply.

[17] CFCs presumably would continue to deduct the foreign taxes against subpart F income, however, under §952(a), notwithstanding the proposal's application of §275 to these foreign taxes. Section 275 denies foreign tax deductions only where §901 credits are elected, and a CFC (tested as a hypothetical U.S. taxpayer under Reg. §1.952-2(b)(1)) presumably would not elect §901 and thus would be outside the scope of deduction disallowance under the proposal.

The safe harbor would be met if the company's gross revenues in Russia (or Belarus, as the case may be) drop, relative to 2021, by at least 85% in 2022 and 95% in 2023 and later years. Treasury is authorized to provide for an alternative safe harbor test in regulations. Treasury also is authorized to exclude from the calculation revenue from sales under a humanitarian license issued by the Office of Foreign Asset Control (OFAC).

Presumably the general economic isolation of Russia and Belarus as a result of the various non-tax sanctions that have been imposed will cause major reductions in revenue derived from these countries regardless of a particular company's decisions, but the proposal clearly aims to create an incentive to disinvest and unwind business operations in these countries, while continuing to accommodate humanitarian sales, such as for critical medicines and medical supplies. In a case in which a group is no longer earning positive net income from these markets, the main effect of satisfying the safe harbor would be to allow losses from these markets to offset GILTI tested income generated in other countries (subject of course to the proposed ''country by country'' GILTI proposals currently pending in Congress).

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