SULLIVAN & CROMWELL LLP

s&c memo

January 4, 2024

IRS Issues Initial Guidance on Application of FTC and DCL Rules to Pillar Two Taxes

SUMMARY

On December 11, 2023, the IRS issued Notice 2023-80 (the "Notice"), announcing that the IRS intends to issue proposed regulations providing guidance on the application of the foreign tax credits ("FTCs") and dual consolidated loss ("DCL") rules to taxes described in the "Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)" (the "Pillar Two Model Rules").[1] In particular, under the Notice:

- Taxes imposed under the IIR would generally not be eligible as FTCs, while QDMTT would generally qualify;
- Even if disallowed as FTCs, such taxes are generally not deductible for purposes of determining Subpart F income or GILTI;
- Similarly, IIR taxes are excluded from (added back into income for) the high-tax exceptions for Subpart F and GILTI purposes; and
- Limited relief from the potentially detrimental interaction of DCL rules and Pillar Two taxes would be available for DCLs incurred in or before 2023 (or a portion of 2024 for certain non-calendar year taxpayers).

The Notice also extends indefinitely the temporary FTC relief provided by Notice 2023-55 with respect to the application of certain provisions under the 2022 FTC final regulations[2] that narrowed the scope of creditable foreign income taxes and addresses the application of such relief to partnerships and their partners.

BACKGROUND ON PILLAR TWO TAXES

The Pillar Two Model Rules, released on December 20, 2021, aims to ensure that large multinational enterprises ("MNEs") with annual revenue of EUR 750 million or more pay a minimum level of tax of at least 15 percent on the income arising in each jurisdiction where they operate. In-scope MNEs calculate their effective tax rate ("ETR") for each jurisdiction where they operate and pay a top-up tax for the difference

between their ETR per jurisdiction and the 15-percent minimum rate. The top-up tax may be imposed and collected under the Qualified Domestic Minimum Top-up Tax ("QDMTT") regime,[3] the Income Inclusion Rule ("IIR")[4] or the Undertaxed Payments Rule ("UTPR").[5] Under the Pillar Two Model Rules, the jurisdiction in which the income arises has "priority" in collecting the top-up tax by imposing a QDMTT, which is computed without taking into account any taxes paid by direct or indirect shareholders on such jurisdiction's income under a controlled foreign corporation tax regime ("CFC taxes"). Any top-up tax not collected under a QDMTT may be collected under the IIR or UTPR, *after* taking into account CFC taxes. Certain jurisdictions have enacted legislation implementing QDMTT and IIR, effective for fiscal years beginning on or after December 31, 2023, and UTPR, effective for fiscal years beginning on or after December 31, 2024.

DISCUSSION

The Notice provides initial guidance on the application of the FTC and DCL rules to Pillar Two taxes, focusing particularly on the IIR and QDMTT. Except in respect of the "separate levy" rule and the relief for legacy DCLs discussed below, the Notice explicitly does not provide guidance on the UTPR and states that the IRS continues to analyze issues related to the UTPR for future guidance.

A. Application of FTC Rules to Pillar Two Taxes

1. Disallowance of FTCs and Deductions for Certain Top-Up Taxes

The Notice states that Treasury and the IRS intend to issue proposed regulations denying the creditability of any "top-up tax". The Notice goes on to define a "top-up tax" as any foreign income tax that is computed by taking into account the amount of tax imposed by other countries (including the United States) on the direct or indirect owners of the entity.[6] Thus, foreign income tax imposed under an IIR that takes into account a U.S. owner's tax on Subpart F income or GILTI will not be creditable. Furthermore, a credit will be denied even if a U.S. owner has no actual U.S. federal income tax liability so long as the foreign law would take such tax into account.[7] However, a minority U.S. owner of an entity on which an IIR top-up tax is imposed may be eligible to claim FTCs for its proportionate share of such IIR top-up tax if the minority owner's U.S. taxes are not taken into account for purposes of determining the entity's IIR tax. This would generally arise in situations where the minority U.S. owner is not a member of the same MNE group (*e.g.*, under IFRS, generally ownership of less than 50%).[8] Though not clear from the Notice, the general disallowance of credit for IIR top-up taxes may have been intended to address the circularity that may arise if U.S. taxes on Subpart F income and GILTI that reduce an IIR top-up tax would then reduce the same U.S. taxes on Subpart F income or GILTI. Additionally, if IIR top-up taxes were creditable, then the United States would effectively be ceding taxing authority to a foreign jurisdiction (since a credit would result in an increase in foreign tax liability, whereas denying the credit would increase U.S. tax liability and reduce foreign tax liability). Further, a top-up tax will be excluded from the amount of foreign income taxes taken into account under the Subpart F and GILTI high-tax exceptions and must be added back to the net Subpart F and tentative tested income items tested for such high-tax exceptions.[9]

In addition, the Notice states that, under existing U.S. CFC rules, a U.S. shareholder of a CFC that elects to claim FTCs generally would be treated as receiving a deemed dividend from such CFC to the extent that such U.S. shareholder is deemed to pay such CFC's foreign income taxes (so-called "Section 78 gross-up"), without any offsetting deductions for such foreign income taxes paid, *regardless of whether such foreign income tax is creditable.*[10] Accordingly, a top-up tax paid by a CFC, such as an IIR top-up tax, that is not creditable may nonetheless be treated as deemed distributed to the CFC's U.S. owners and not be eligible for a deduction. In other words, an IIR top-up tax may be both non-creditable to the U.S. shareholder of a CFC and non-deductible for purposes of determining such shareholder's Subpart F income and GILTI.

In contrast, because a QDMTT is generally determined without taking into account any taxes imposed on the direct or indirect owners of the entity subject to the QDMTT, QDMTT would generally be eligible as FTCs under the Notice.

2. Treatment of Pillar Two Taxes as Separate Levies

Each foreign levy that is a "separate levy" must be analyzed separately to determine eligibility for FTCs, while the creditability of foreign levies considered together as a "single levy" are determined for the entirety of such single levy.[11] The Notice states that future proposed regulations will provide that each of an IIR, UTPR and QDMTT imposed by a foreign country is a separate levy from any other levy imposed by that country, regardless of whether the country imposes the IIR, UTPR or QDMTT by adjusting the base of any other levy (such as through an addition to income or denial of deductions).[12] Accordingly, the IIR, UTPR and QDMTT will each be tested separately from other taxes imposed by a particular country to determine whether it is a creditable foreign income tax, regardless of the manner in which such country enacts an IIR, UTPR or QDMTT under its foreign tax law.

3. Determining the Taxpayer of QDMTT That Is Computed by Reference to Multiple Persons

Generally, the person on whom foreign law imposes legal liability for tax is the person by whom foreign taxes are considered paid for FTC purposes, even if another person (*e.g.*, a withholding agent) remits such tax.[13] Future proposed regulations will also include rules for determining the person by whom a QDMTT is considered paid when a QDMTT is computed by reference to the income of two or more persons. For example, members of the same MNE group in the same jurisdiction may be assessed on a group basis for a QDMTT. In particular, future proposed regulations are expected to allocate legal liability for a QDMTT based on each person's "QDMTT Allocation Key" that takes into account the product of (i) the excess (if any) of the QDMTT rate over such person's separate pre-QDMTT ETR and (ii) such person's separate income taken into account in the QDMTT computation.[14]

4. Amendment of the Non-Duplication Rule for In Lieu of Taxes

In addition to foreign income taxes, foreign taxes "in lieu of" income taxes are also potentially eligible as FTCs. For example, many countries impose withholding taxes on a gross basis, particularly for cross-border

payments of interest or dividends or upon the disposition of property by nonresidents, that would qualify as such "in lieu of" taxes. Under current Treasury Regulations, for a foreign tax to qualify as an in lieu of tax, no portion of the income subject to the tested foreign tax may also be subject to the generally imposed net income tax or any other separate levy that is a net income tax imposed by the foreign country (the "non-duplication requirement").[15] The Notice provides that QDMTT or IIR top-up tax may be imposed without causing an in lieu of tax to no longer qualify as an in lieu of tax. Future proposed regulations will amend the non-duplication requirement to clarify that, in order to qualify as an in lieu of tax, a foreign tax need only be in substitution for a generally imposed net income tax and not in substitution for all net income taxes imposed by that country.[16]

5. Applicability Date and Reliance on the FTC-Pillar Two Guidance

With respect to the foregoing guidance on the application of FTC rules to Pillar Two taxes:

- The Notice anticipates that proposed regulations will provide that rules consistent with such guidance apply to taxable years ending after December 11, 2023;
- A taxpayer may rely on such guidance for taxable years that end after December 11, 2023 and on or before the date of publication of the proposed regulations, subject to being required to consistently apply such guidance; and
- A taxpayer may rely on the guidance regarding the amendment of the non-duplication rule discussed above for taxable years that begin on or after December 28, 2021 and end on or before December 11, 2023.

B. Application of DCL Rules to Pillar Two Taxes

The IRS is studying the extent to which the DCL rules should apply with respect to the Pillar Two Model Rules, including the extent to which aggregation of income across jurisdictions should result in a "foreign use" of a DCL, and the extent to which the Pillar Two Model Rules should cause an entity that is not otherwise subject to an income tax of a foreign jurisdiction to be a dual resident corporation or a hybrid entity, or should prevent such an entity from being a transparent entity for purposes of the DCL rules.[17]

Notably, the Notice states that the IRS intends to issue proposed regulations that provide relief in respect of "legacy DCLs." Legacy DCLs are defined as DCLs incurred in (i) taxable years ending on or before December 31, 2023 or (ii) taxable years beginning before January 1, 2024 and ending after December 31, 2023 provided that such taxable year matches the fiscal year of the MNE group that could take into account DCLs as an expense. For such legacy DCLs, "foreign use" would not be considered to occur solely because all or a portion of the deductions or losses that comprise the legacy DCL are taken into account in determining net income under the Pillar Two Model Rules for a particular jurisdiction. However, the proposed rule would not apply to any DCL that was incurred or increased with a view to reducing the jurisdictional top-up tax or qualifying for the proposed rule described in the Notice.[18]

Taxpayers may rely on the guidance in the Notice regarding DCLs until proposed regulations are published.

C. Extension and Modification of Temporary Relief in Notice 2023-55

Notice 2023-55, issued on August 7, 2023, provided temporary relief from certain provisions of the 2022 FTC final regulations, which had significantly narrowed the scope of creditable foreign income taxes under Section 901 and Section 903. Relief was offered for foreign taxes paid in any taxable year beginning on or after December 28, 2021, and ending on or before December 31, 2023 (the "Relief Period").

Notice 2023-80 modifies the Relief Period to mean taxable years beginning on or after December 28, 2021, and ending before the date that a notice or other guidance withdrawing or modifying the temporary relief is issued (or any later date specified in such notice or other guidance), thereby extending the temporary relief provided by Notice 2023-55 indefinitely.[19]

Additionally, Notice 2023-80 clarifies, in the context of partnerships that file U.S. tax returns, that, with respect to foreign taxes paid or otherwise required to be reported by such partnership (including taxes paid by a CFC), the partnership (rather than its partners) would apply (or not apply) the temporary relief of Notice 2023-55. However, if, before December 11, 2023, a partnership did not apply the temporary relief for a partnership's relief year ending on or before December 31, 2022 (a "partnership 2022 tax year"), a partner may apply the temporary relief to its share of the partnership's foreign taxes for a partnership 2022 tax year.[20] Further, Notice 2023-80 provides that a partnership that applies the temporary relief to a relief year must apply the temporary relief to all the partnership's foreign taxes, and for a partnership's taxable year beginning after December 31, 2022, a partnership's application (or non-application) of the temporary relief for a relief year will cause a partner to be required to apply (or to be precluded from applying) the temporary relief for the relief year to all other foreign taxes for which the partner would be eligible to claim a credit, unless the partner does not control whether the partnership applies (or does not apply) the temporary relief for the relief year.[21] Moreover, a partnership (or a partner) may not apply the temporary relief in a relief year to claim a credit for any amount of foreign tax for which a deduction is allowed in the relief year or any other taxable year.[22]

* * *

Copyright © Sullivan & Cromwell LLP 2024

ENDNOTES

1 OECD, Tax Challenges Arising from the Digitilisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two) (December 20, 2021), *available at* https://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two_782bac33-en.

2 87 FR 276.

3 Jurisdictions can enact their own domestic minimum top-up tax based on Pillar Two mechanics to collect tax with respect to low-taxed income in their own jurisdictions.

4 Under IIR, any resulting top-up tax is generally imposed in the jurisdiction of the ultimate parent of the MNE.

5 UTPR serves as a backstop to IIR to the extent IIR is insufficient to achieve the 15-percent minimum rate.

6 Notice 2023-80, § 2.02(2). In the case of an entity that has income from a branch in a foreign country, foreign income tax assessed by that country on the branch's income that is computed by taking into account the amount of tax imposed on the entity by its country of residence would also be a "top-up tax". *Id.*

7 Notice 2023-80, § 2.02(3).

8 Notice 2023-80, § 2.02(6)(b).

9 Notice 2023-80, § 2.02(4).

10 Notice 2023-80, § 2.02(5).

11 Treasury Regulation Section 1.901-2(d).

12 Notice 2023-80, § 2.03.

13 Treasury Regulation Section 1.901-2(f).

14 Notice 2023-80, § 2.04.

15 Treasury Regulation Section 1.903-1(c)(1)(ii).

16 Notice 2023-80, § 2.05.

17 Notice 2023-80, § 3.02.

18 Notice 2023-80, § 3.03.

19 Notice 2023-80, § 5.04.

20 Notice 2023-80, § 5.02.

21 Notice 2023-80, § 5.03.

22 *Id.*

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.