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US International Tax Alert

Notice 2023-80 lays out interaction of Pillar Two and foreign tax credits

Overview

On December 11, 2023, Treasury and the IRS issued Notice 2023-80 (the "Notice") announcing their intention to issue proposed regulations to address the application of the foreign tax credit (FTC) rules to certain top-up taxes, including income inclusion rules (IIRs), qualified domestic minimum top-up taxes (QDMTTs), and undertaxed profits rules (UTPRs) described in the Global Anti-Base Erosion Model Rules (Pillar Two) (the "GloBE Model Rules"), as well as guidance that taxpayers may rely on until proposed regulations are issued. This alert provides a high-level summary of the foreign tax credit rules set out in the Notice.

In addition, the Notice announces that proposed regulations will address the interaction of the GloBE Model Rules and the dual consolidated loss rules and extends and modifies the temporary relief granted by Notice 2023-55 for determining whether a foreign tax is creditable under sections 901 and 903. These sections of the Notice were addressed in our July 26, 2023 International Tax Alert.

Section 2 – GloBE Model Rules and the FTC

The Notice does not state whether IIRs, QDMTTs, and UTPRs are or are not creditable foreign taxes under section 901. The Notice does, however, provide guidance in Section 2 on the application of Internal Revenue Code rules related to foreign tax credits to IIRs, QDMTTs, and UTPRs that meet the creditability requirements under Treas. Reg. § 1.901-2. Taxpayers thus will need to analyze these taxes under the creditability rules in Treas. Reg. § 1.901-2 but may elect to apply the temporary relief granted by Notice 2023-55.

Final top-up taxes

If a top-up tax is determined to be creditable under section 901, the Notice would disallow a credit at the US taxpayer level under section 901 and section 59(l) if the tax is a "final top-up tax" and any amount of US federal income tax liability of *the taxpayer* would be taken into account in computing the tax (without regard to whether any such US tax liability is actually taken into account). The Notice, however, generally continues to treat a final top-up tax as a creditable tax at the CFC and partnership level because (as discussed below) the credit disallowance provision may not apply to all shareholders or partners.

A foreign income tax (a "tested tax") is a final top-up tax if it is computed taking into account taxes:

1. Imposed by other countries on the direct or indirect owners of the entity subject to the tested tax, or
2. Imposed by the parent entity's country of residence on income attributable to such entity's branch in another country.

Observation:

The credit disallowance rule may not apply to a domestic minimum top-up tax that is consistent with the GloBE Model Rules (*i.e.*, a QDMTT). However, many IIRs, UTPRs, and other top-up taxes that are inconsistent with the GloBE Model Rules are generally expected to be subject to the final top-up tax rule, provided that such taxes otherwise meet the creditability requirements under Treas. Reg. § 1.901-2.

A final top-up tax that is a creditable foreign tax for which a credit is disallowed at the US level would be treated as a creditable foreign tax at the CFC or partnership level. Accordingly, a United States shareholder of a CFC computes an amount of foreign taxes deemed paid under section 960 and must include the section 78 gross-up in income even though the deemed paid tax may not be claimed as a credit. The amount disallowed as a credit is not deductible under section 275 if the person chooses to take to any extent the benefits of section 901 (*i.e.*, the foreign tax credit).

Observation:

A direct or indirect owner's taxes generally would be taken into account in computing a final top-up tax only if it is a member of a multinational entity (MNE) group. An example in the Notice demonstrates that a foreign tax credit may be denied to a US shareholder that is a member of the CFC's MNE group, while the same inclusion may result in a creditable foreign tax for a minority shareholder or other person who is not a member of the MNE group.

Finally, a final top-up tax is not taken into account in applying the subpart F and GILTI high tax exceptions.

QDMTTs

A QDMTT may be computed with reference to the income of two or more persons in the same foreign country. In that case, the Notice provides specific rules for determining which persons have legal liability for the tax under Treas. Reg. § 1.901-2(f) (*i.e.*, the technical taxpayer rules). The rules in the Notice apply in place of Treas. Reg. § 1.901-2(f)(3) (*i.e.*, the combined income regime rules).

Allocations of a QDMTT between or among persons within a foreign country are made based on each person's "QDMTT Allocation Key," computed using the following formula:

(QDMTT Rate (15%) – Separate Pre-QDMTT ETR*) x Separate QDMTT Income
*Separate Pre-QDMTT ETR = Separate Pre-QDMTT Taxes/Separate QDMTT Income.

No QDMTT is allocated to a person with Separate QDMTT Income of zero or less than zero.

"Separate Pre-QDMTT Taxes" include positive (or negative) taxes of a person that are taken into account for purposes of computing the QDMTT. "Separate QDMTT Income" means the income (or loss) of the person that is taken into account under the foreign law for purposes of computing the QDMTT. These amounts are not reduced by negative amounts attributable to another person.

Observation:

While the QDMTT Allocation Key generally allocates a QDMTT to the entities with a low effective tax rate, no QDMTT is allocated to an entity with a GloBE loss.

Additional rules

The Notice makes clear that IIRs, QDMTTs, or UTPRs are intended to be treated as separate levies from any other levy imposed by a foreign country, even if the foreign country imposes an IIR, QDMTT, or UTPR by adjusting the tax base of another levy, *e.g.*, by denying certain deductions allowed for purposes of computing income tax liability.

The Notice also states that Treasury and the IRS intend to modify the "nonduplication requirement" in Treas. Reg. § 1.903-1(c)(1)(ii) to provide that a foreign tax can qualify as an in-lieu-of tax if it is imposed in substitution for a generally imposed net income tax and not in substitution for all generally imposed net income taxes imposed by a foreign country.

Observation:

If a foreign tax is imposed in substitution for a foreign country's generally imposed net income tax but in addition to a creditable QDMTT, it may still satisfy the nonduplication requirement.

Treasury and the IRS also are considering other changes to the section 903 regulations, including defining the term "generally imposed net income tax," to "ensure that foreign taxes continue to be creditable only where consistent with the scope and purposes of section 903."

Reliance

Taxpayers generally can rely on the foreign tax credit guidance in Section 2 of the Notice for taxable years ending after December 11, 2023, and on or before the date proposed regulations are published in the Federal Register, provided that they apply the guidance consistently for all years. Taxpayers can rely on

the proposed changes to the section 903 regulations for taxable years beginning on or after December 28, 2021.

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