TAXES - The Tax Magazine (2006 to Present), THE KNIGHT WATCH—Happy Holidays from Treasury and Internal Revenue Service!, (Feb. 1, 2024)

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As 2023 was ending, the U.S. Department of Treasury and the Internal Revenue Service (IRS) released helpful guidance regarding foreign tax credits (FTCs). Notice 2023-80 extends relief provided in a prior notice and discusses the interaction of the U.S. FTC rules with the "Tax Challenges Arising from the Digitalisation of the Economy—Global Anti-Base Erosion Model Rules (Pillar Two)" (the GloBE Rules). [1]

FTC Guidance Background

On Jan. 4, 2022, Treasury published final FTC regulations that substantially changed whether a tax is creditable (the 2022 Final FTC Regulations). Under the prior FTC regulations, a foreign levy was creditable if the predominant character of the tax was an income tax in the U.S. sense. A foreign levy was treated as an income tax in the U.S. sense if it satisfied the net gain requirement and was not a soak-up tax. The net gain requirement was met if a foreign levy satisfied the realization requirement, the gross receipts requirement, and the cost recovery requirement. The realization requirement was met if the foreign tax was imposed on or after a realization event. The gross receipts requirement was satisfied if the foreign tax was imposed on gross receipts.

The 2022 Final FTC Regulations modified each element of the net gain requirement and added an attribution requirement. To be a creditable tax, a taxpayer must demonstrate that it satisfies attribution through activities, sourcing, or property situs. Sourcing attribution requires that gross income or receipts be included in the foreign tax base using sourcing rules that are reasonably similar to those that apply under the Internal Revenue Code. For example, the United States sources royalties to place of *use*, while other countries source to place of *payment*. [2] This mismatch in sourcing rules can transform a previously creditable tax to one that is not creditable. This fact pattern is referred to as the Brazilian royalty issue, as Brazil requires withholding on cross-border payments for royalties, regardless of where the intellectual property is used.

For residents of the foreign jurisdiction, the 2022 Final FTC Regulations also require the foreign country to allocate profit based on the arm's-length standard, without taking into account as a significant factor certain destination-based criteria.

Code Sec. 903 provides for a credit for taxes *in lieu* of income taxes, such as withholding taxes. An *in lieu* of tax must also satisfy the source-based attribution requirement, which requires sourcing rules for the tested tax to be identical to U.S. sourcing rules.

The Treasury Department and the IRS received significant stakeholder comments that took issue with the new attribution requirement (also known as the "jurisdictional nexus requirement" in the November 2020 proposed regulations). [3]

In response to the comments and complaints that taxes creditable before 2022 were suddenly not creditable (*e.g.*, withholding taxes on royalties paid from Brazil for licensing the global rights of a trademark) and other concerns, Treasury embarked on a series of changes to relax and clarify the 2022 Final FTC Regulations. First,

Treasury and the IRS relaxed the cost recovery requirement by requiring that substantially all of each item of significant cost or expense is attributable to gross receipts. [4] Second, Treasury and the IRS provided welcome limited relief for the attribution rules to address the Brazil royalty issue. [5] Under the single country rule, if the intellectual property is licensed to and used in a single country, the tax satisfies sourcing attribution.

The holidays came early this summer when Treasury and the IRS provided temporary relief from significant parts of the 2022 Final FTC Regulations by allowing taxpayers to apply the old regulations under Code Secs. 901 and 903 for foreign taxes paid in any taxable year beginning on or after Dec. 28, 2021, and ending on or before Dec. 31, 2023. [6] To rely on the relief, taxpayers must apply Notice 2023-55 to all foreign taxes paid within a relief year and for which they are eligible to claim a credit under Code Sec. 901 in the relief year. Also, all members of a consolidated group must apply Notice 2023-55 to qualify for relief. [7]

Notice 2023-55 prompted handwringing among fiscal year taxpayers—would they receive additional relief, or would the 2022 Final FTC Regulations spring into life in 2023? Treasury signaled it would extend the relief.

Notice 2023-80 **(the Notice)**

On Dec. 12, 2023, Treasury and the IRS released Notice 2023-80, which extends the temporary relief unless and until the date that a notice or other guidance withdrawing or modifying the temporary relief is issued. Unlike the annual notice modifying the effective date of the final Code Sec. 987 regulations, Treasury can focus on revising the 2022 Final FTC Regulations to address changes it would like to make in light of comments and Pillar Two. Also, calendar year and fiscal year taxpayers are now on equal footing.

One open question was whether and how the Notice 2023-55 applies to partnerships. In the case of a partnership that did not provide the temporary relief prior to Dec. 11, 2023, for a partnership 2022 year, a partner can apply the temporary relief to its share of the partnership's foreign taxes.

The Notice provides certainty for taxpayers that they can rely on relief beyond one year.

However, Treasury has not signaled if it will modify the attribution rules, especially sourcing attribution, and the addition of the arm's-length standard. In some instances, the U.S. sourcing rules are out of step with many jurisdictions. And the United States has yet to clarify its views on cloud computing, which may be inconsistent with other countries' sourcing rules.

It is unclear whether the U.S,' strict adherence to the arm's-length principle will force other countries to modify their rules to allow their taxes to be creditable. For example, Brazil recently modified its transfer pricing rules to align with the Organisation for Economic Co-operation and Development's (OECD) transfer pricing guidelines, which will allow its taxes to be creditable under the 2022 Final FTC Regulations. [8]

Ideally, Treasury and the IRS should repropose FTC regulations to work through comments and align on new rules that are easier for both taxpayers and the IRS to administer.

Pillar Two Interactions

The more interesting provisions of Notice 2023-80 relate to the creditability of top-up taxes under the GloBE Rules. The GloBE Rules provide interlocking rules that ensure that each jurisdiction (not entity) has an effective tax rate (ETR) of at least 15 percent, based on modified financial statement income. The primary rule is the qualified domestic minimum top-up tax (QDMTT), which gives the source country the first chance to tax the income. Second, the income inclusion rule (IIR) is a top-down rule that the parent jurisdiction applies downward, similar to a controlled foreign corporation (CFC) rule. Finally, the undertaxed profits rule (UTPR), formerly known as the undertaxed payments rule, applies bottom-up to ensure any jurisdiction that is not subject to a QDMTT or IIR is topped up to 15 percent.

A political compromise was reached regarding the order of the application of rules, including the U.S. CFC rules (subpart F and global intangible low-taxed income (GILTI) rules). Under the GloBE Rules, commentary, and

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administrative guidance, the order of taxing rights is as follows: (1) QDMTT/local income tax; (2) Subpart F and GILTI/CFC regimes; (3) IIR; (4) UTPR.

The GloBE Rules also contain a substance-based income exclusion (SBIE), which comprises tangible personal property and payroll (similar to GILTI with the treatment of tangible property). While the IIR and UTPR require the SBIE, a country can opt to eliminate the SBIE or make it less favorable. [9]

The QDMTT guidance provides flexibility for an adopting jurisdiction, such as the use of local financial statements instead of consolidated financial statements. As a result, a jurisdiction's QDMTT may apply, but due to base differences, an IIR may also apply to top off the jurisdiction to 15 percent. The QDMTT safe harbor will provide relief and treat a jurisdictional top-up tax as zero if the QDMTT applies.

Notice 2023-80 provides guidance regarding the creditability of an IIR and a QDMTT. The Notice defines a final top-up tax as a foreign income tax (tested tax) that, under foreign law, takes into account the following:

(a) the amount of tax imposed on the direct or indirect owners of the entity subject to the tested tax by other countries (including the United States) with respect to the income subject to the tested tax, or
(b) in the case of an entity subject to the tested tax on income attributable to its branch in the foreign country imposing the tested tax, the amount of tax imposed on the entity by its country of residence with respect to such income. [10]

A final top-up tax is not creditable if, under the foreign tax law, any amount of U.S. federal income tax liability of the person would be taken into account in computing the final top-up tax. Alternatively stated, a top-up tax that takes into account GILTI or subpart F is not creditable.

The top-up tax paid by a CFC or a partnership is treated as if it were a creditable tax at the partnership or CFC level, and then the disallowance is applied at the partner or U.S. shareholder level.

The impact of this rule is that the highly related U.S. shareholder of a CFC (*e.g.*, 80-percent owner) will not be able to credit the IIR paid at the CFC level because the final top-up tax will take into account taxes paid under subpart F and GILTI. Without a *per se* denial rule, the IIR and GILTI/subpart F would create a circularity issue. Generally, *per se* denials of the creditability of a foreign tax are statutory. When the final top-up tax rule is "regified," the description of the proposed rule and description of underlying authority will be important in the event a taxpayer challenges the final regulations.

In contrast, a minority shareholder that is unable to push down its GILTI and subpart F taxes under the GloBE rules may have a creditable IIR. The first two examples in Notice 2023-80 confirm this treatment.

In contrast, a QDMTT is not a final top-up tax because it does not take into account U.S. federal income tax liability of a person. It is the primary tax after the application of the income tax. However, a taxpayer will need to analyze the foreign tax under the applicable Code Sec. 901 regulations to determine whether the QDMTT is creditable. The OECD intends to undertake a peer review process to analyze and announce whether a domestic top-up tax is a QDMTT, and the result will be a list of approved jurisdictions and taxes. [11] Treasury and the IRS could refer to the OECD list to help taxpayers bypass additional analysis under the 2022 Final FTC Regulations.

The Code Sec. 78 gross-up and the deduction disallowance rule under Code Sec. 275(a)(4) apply if the final top-up tax is creditable.

Notice 2023-80 also provides that with respect to the IIR, QDMTT, and UTPR, each is treated as a separate levy and is computed separately from any other levy imposed by a foreign country.

The Notice introduces some complexity with the creditability of a QDMTT. The GloBE Rules are applied on a per-jurisdiction basis. Notice 2023-80 proposes rules that would determine the split of QDMTT where two or more entities are resident in a jurisdiction. QDMTT is allocated in proportion based on the person's QDMTT Allocation Key. The QDMTT allocation is defined as the product of the (i) excess of the QDMTT Rate over the person's Separate Pre-QDMTT ETR, and the person's Separate QDMTT Income. The QDMTT Rate is defined as the minimum ETR under foreign law. Separate Pre-QDMTT Taxes are the taxes of the person used

in computing the QDMTT. Separate QDMTT Income is the income or loss of the person used in computing the QDMTT. The Separate QDMTT Income and Separate Pre-QDMTT Taxes are computed based on a relevant return filed in the jurisdiction or files maintained for purposes of reporting the QDMTT. Additionally, the QDMTT Allocation Key ignores the SBIE.

These provisions of Notice 2023-80 apply to taxable years ending after Dec. 11, 2023, and taxpayers can rely on this notice so long as the notice is consistently applied.

Notice 2023-80 does not opine on the creditability of taxes paid pursuant to the UTPR. Treasury will have more time to consider the interaction of the UTPR with Code Secs. 901 and 903, as the UTPR standstill ensures that U.S.-parented groups will not be subject to the UTPR until 2026. [12]

The Notice reflects what Treasury and the IRS forecasted—a QDMTT should be creditable and generally an IIR is not creditable, except for a minority shareholder who cannot push down taxes from GILTI or subpart F. Of course, the devil will be in the details. Foreign jurisdictions would prefer to have proposed regulations in hand as they design their QDMTTs and other domestic taxes, but they will need to be happy with the Notice outlining current Treasury and IRS thoughts.

Dual Consolidated Losses

A dual consolidated loss (DCL) is defined as a loss for a dual resident corporation or a net loss of a domestic corporation that is attributable to foreign separate units (*e.g.*, branches). The DCL rules are concerned that a dual resident or domestic corporation could use a loss more than once—in the United States and abroad. Generally, a DCL cannot be used to offset domestic income.

The Notice describes the differences between the GloBE Rules and the U.S. system. The GloBE rules use a jurisdictional blending approach, resulting in the aggregation of entities in a jurisdiction. The aggregation can trigger double-dipping concerns that are policed by the DCL rules. Also, unlike the U.S. consolidated return rules, the GloBE Rules do not allow taxpayers to disaggregate groups in a jurisdiction.

Treasury and the IRS are considering the interaction of the DCL rules with the GloBE Rules, including the extent to which aggregation should result in a foreign use of a DCL. Also, Treasury and the IRS will consider the application of DCL rules where the GloBE Rules should treat a nonresident entity as a dual-resident corporation or a hybrid entity. Treasury and the IRS are also studying similar issues in the context of the anti-hybrid rules and similar provisions. [13]

The Notice provides relief for legacy DCLs, which are those taken into account for tax years beginning before Jan. 1, 2024, and ending after Dec. 31, 2023. Legacy DCLs will not be treated as a foreign use solely because they are taken into account in determining net GloBE income for a jurisdiction. This relief is not extended where a DCL was incurred or increased with a view to reducing the top-up tax or the proposed rule in the Notice.

Conclusion

Treasury and the IRS will continue to consider comments regarding the 2022 Final FTC Regulations and the interaction of the GloBE Rules. Additional guidance may further soften the impact of the 2022 Final FTC Regulations, but it is unlikely Treasury and the IRS will completely abandon the 2022 Final FTC Regulations.

Footnotes

1 *www.oecd-ilibrary.org/docserver/782bac33-en.pdf?expires=1702953274&id=id&accname=guest&checksum=03410F6567AEA360E3A76B32E545BC32*.

2 Code Secs. 861(a)(4) and 862(a)(4).

3 *See Report on Proposed Regulations Providing Guidance Related to the Foreign Tax Credit, Report No. 1448*, New York State Bar Association Tax Section (Feb. 9, 2021) *www.regulations.gov/comment/*

IRS-2020-0040-0015. More than 30 stakeholders filed comments, and some stakeholders may still wish to air grievances regarding the attribution rules. For a discussion of Festivus and the airing of grievances, *see en.wikipedia.org/wiki/Festivus*.

4 REG-112096-22, 87 FR 71271.

5 Notice 2023-31, IRB 2023-16, 661.

6 Notice 2023-55, IRB 2023-32, 427.

7 Notice 2023-55, IRB 2023-32, 427 does not turn off the rules for disregarded payments between taxable units.

8 Normative Instruction (NI) 2,161/23 to govern Law 14,596/23, published on Jun. 15, 2023.

9 OECD (2023), Tax Challenges Arising from the Digitalisation of the Economy—Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), Jul. 2023, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, *www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosionrules-pillar-two-july-2023.pdf*.

10 Notice 2023-80, IRB 2023-52, 1583.

11 It is also possible that the OECD peer review process will address a larger issue, whether a tax implemented by a country is creditable under Pillar Two. To date, OECD administrative guidance addressed certain tax planning by multinational enterprises.

12 OECD (2023), Tax Challenges Arising from the Digitalisation of the Economy—Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), Jul. 2023, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, *www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosionrules-pillar-two-july-2023.pdf*.

13 Code Secs. 245A(e) and 267A.

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