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US FTC & GLOBAL MINIMUM TAX

LEA GLOBAL EUROPEAN REGIONAL CONFERENCE

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US Foreign Tax System

General Background

- To mitigate potential multiple layers of tax, US persons are generally entitled to a foreign tax credit ("FTC") under section 901 for "any income, war profits and excess profits tax paid or accrued… to any foreign country or to any possession of the United States".
- Section 901 allows a credit for foreign income, war profits, and excess profits taxes.
- Section 903 allows a credit for taxes paid in lieu of a generally imposed foreign income, war profits, or excess profits tax (collectively, foreign income taxes).

FTC Background

US Definition of Tax

1. Compulsory Payment
2. Not a fine or penalty
3. Not for specific economic benefit.

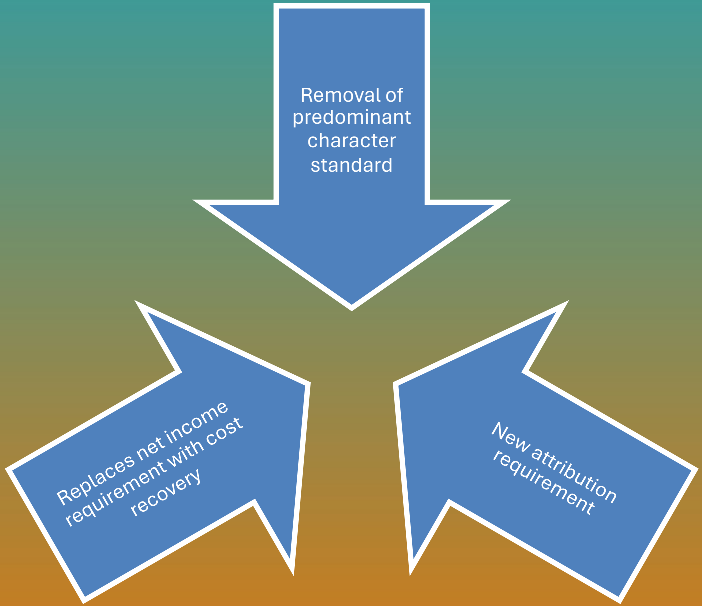
US Foreign Tax System

General Background

- The 2022 FTC final regulations revised the rules for determining whether a foreign levy is a creditable foreign income tax under both sections 901 and 903, including introducing new attribution requirements.
- The intent was to limit the allowance of an FTC for "novel extraterritorial taxes" (such as digital services taxes) that could undermine the purpose of the FTCs.
- However, concerns were raised that certain foreign taxes might fail to satisfy the revised creditability requirements.

New FTC Regulations

Creditable Tax Changes



Updated US Foreign Tax System

Cost Recovery Requirement

- Under this requirement, a foreign tax can be considered creditable if the tax base is computed by reducing gross receipts to allow for the recovery of significant costs and expenses (including capital expenditures) that are reasonably attributable to those gross receipts.

- In other words, the foreign tax must consider the costs and expenses associated with generating the income subject to taxation.

Updated US Foreign Tax System

Attribution Requirement

- The attribution requirement pertains to the allocation and apportionment of foreign taxes.
- Specifically, it addresses the reattribution of assets for purposes of determining how foreign taxes are allocated among different income categories.
- The attribution rules help ensure that foreign taxes are appropriately attributed to the relevant income streams, considering factors such as ownership and control.
- An element of the net gain requirement to allow a credit for a foreign tax only if the country imposing the tax has sufficient nexus to the taxpayer's activities or investment of capital that generates the income included in the tax base.

Model GloBe Rules for Pillar II

General Operation

- The Model GloBe Rules for Pillar II operate so that taxes are imposed in the following order of priority after a local jurisdiction's ordinary income tax: (1) the Qualified Domestic Minimum Top-up Tax (QDMTT), (2) CFC tax regimes and certain other cross-border taxes, (3) the Income Inclusion Rule (IIR), and (4) the Undertaxed Profits Rule (UTPR).

QDMTT is a Minimum tax included in the domestic law of a jurisdiction that allows the source jurisdiction to retain the primary right to tax profits to ensure a 15-percent minimum effective tax rate (ETR).

CFC taxes are not considered for purposes of determining the applicability and amount of a QDMTT in achieving the 15-percent minimum ETR.

The IIR is applied where the effective tax rate for a jurisdiction is below the 15-percent minimum ETR after considering the QDMTT and CFC tax regimes.

If the QDMTT, CFC Tax Regime, and IIR are unable to achieve the 15-percent minimum ETR on profits in a jurisdiction, the UTPR allows jurisdictions other than the jurisdiction of the UPE to impose a tax on the income up to the 15-percent minimum ETR.

Qualified Domestic Minimum Top Up Tax

QDMTT

- A QDMTT is a minimum tax included in the domestic law of a jurisdiction, allowing the source jurisdiction to maintain its primary authority over profit taxation to ensure an ETR of at least 15 percent.
- The QDMTT raises the domestic tax burden to an ETR of at least 15 percent on the domestic excess earnings by calculating the excess (and undertaxed) profits of constituent entities situated in a jurisdiction.
- To qualify as a QDMTT, such regime must exclude taxes paid or accrued by domestic constituent entities with respect to the income of foreign constituent entities that are subject to the controlled foreign corporation ("CFC") regime pertaining to its jurisdiction.
- Unlike the IIR, because the taxes of an entity's owner outside of the entity's jurisdiction are not considered in computing a QDMTT under the Pillar Two Rules, the Notice indicates that QDMTTs are generally creditable provided they are foreign income taxes. Furthermore, a QDMTT that is a foreign income tax may be considered under the subpart F and GILTI high-tax exceptions

Income Inclusion Rule

IIR

- The IIR operates similarly to the CFC rules in the US.
- When the ETR for a jurisdiction is less than 15 percent after accounting for the QDMTT and CFC tax regimes, the IIR is applied to the ultimate parent entity or intermediary parent entity in proportion to its ownership interests in any constituent entities that have excess profit taxed at an ETR lower than 15 percent.

Income Inclusion Rule

US Implications

- A top-up tax is a final top-up tax if, in computing the top-up tax, the foreign tax law considers:
  - the amount of tax imposed on the direct or indirect owners of the entity subject to the top-up tax by other countries (including the United States) with respect to the income subject to the top-up tax; or
  - in the case of an entity subject to the top-up tax on income attributable to its branch in the foreign country imposing the top-up tax, the amount of tax imposed on the entity by its country of residence with respect to such income.
- In computing an IIR under the Pillar Two Rules, the taxes imposed under a CFC regime (e.g., GILTI or subpart F) on a direct or indirect owner of an MNE Group member are considered in determining such MNE Group member's ETR if the direct or indirect owner is also a member of the MNE Group. As a result, the GILTI or subpart F taxes of an MNE Group member owed with respect to a lower-tier MNE Group member will reduce (or eliminate) the likelihood that an IIR top-up tax will be imposed with respect to such lower-tier MNE Group member.

Income Inclusion Rule

US Treatment of IRR

- Notice 2023-80 implies an IIR top-up tax may be considered a foreign income tax, a person may not take an FTC for such a tax if, in computing the IIR under the foreign tax law, any amount of U.S. tax liability of such person is considered. This rule applies without regard to whether the person has any amount of U.S. tax liability that is considered in such computation.

- If a particular IIR tax qualifies as a foreign income tax but is disallowed as a credit under the Push-Down Disallowance Rule, the Notice also proposes to cause a U.S. shareholder to recognize a §78 gross-up for that disallowed IIR tax (if owed by its CFC) and to deny a U.S. person a deduction under §275(a)(4) for that IIR tax

Undertaxed Profits Rule

UTPR

- Acts as a backstop to these provisions. If the QDMTT and IIR fail to attain a minimum 15 percent ETR on profits within a given jurisdiction, the UTPR permits jurisdictions that are beyond the ultimate parent entity’s jurisdiction to levy taxes to meet the minimum ETR threshold.

Foreign Tax Credit Test

Application

- The Notice announces that the proposed regulations will provide that each of an IIR, UTPR and QDMTT imposed by a foreign country is a separate levy within the meaning of section 1.901-2(d) of the Treasury regulations from any other levy imposed by that country.
- Accordingly, the IIR, UTPR and QDMTT will be tested separately from other taxes imposed by a particular country to determine whether it is a creditable foreign income tax, 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).
- With this rule, an IIR, UTPR or QDMTT in a particular jurisdiction may qualify as a creditable foreign income tax even if other taxes (including the generally applicable net income tax) in such jurisdiction do not.

Foreign Tax Credit Test

Application

- Taxpayers will be required to analyze the creditability of each country's IIR (and QDMTT) regime based on either the 2021 final foreign tax credit regulations or, if the taxpayer relies on the relief provided under Notices 2023-55 and 2023-80, under the prior foreign tax credit regulations.

- Treasury and the IRS have stated that they will not provide definitive guidance on whether any Pillar Two tax is a foreign income tax because:

(1) the IRS has a no-rule policy for whether a tax is a foreign income tax under Treas. Reg. §1.901-2, and

(2) countries can deviate from the Pillar Two Model Rules when implementing any of the Pillar Two taxes.

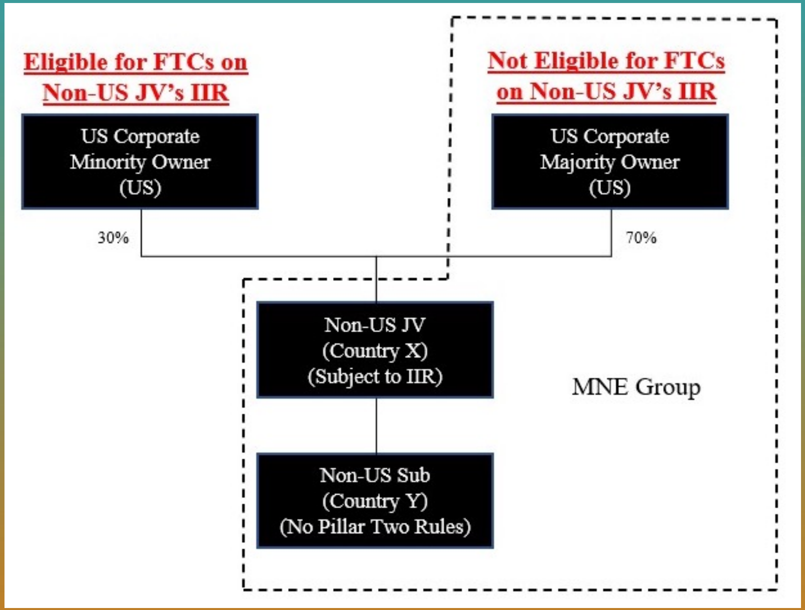
Treatment of IRR

Example

- As a result, if a U.S. person is a member of the same MNE Group as the entities on, and with respect to which, the IIR is imposed, such U.S. person should not be eligible to take an FTC for the IIR top-up tax because, for example, any U.S. federal income taxes imposed on such U.S. person under the GILTI or subpart F rules would have been considered in computing the IIR.

- A minority owner of an entity on which an IIR top-up tax is imposed may be eligible to take an FTC for its proportionate share of such IIR top-up tax because the minority owner should not be a member of the same MNE Group as such entity and its taxes (including GILTI and subpart F taxes) should not be included in the computation of the IIR. Consider the diagram below.

- The Notice provides that an IIR top-up tax will be excluded from the amount of foreign income taxes considered 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.



Treatment of IRR

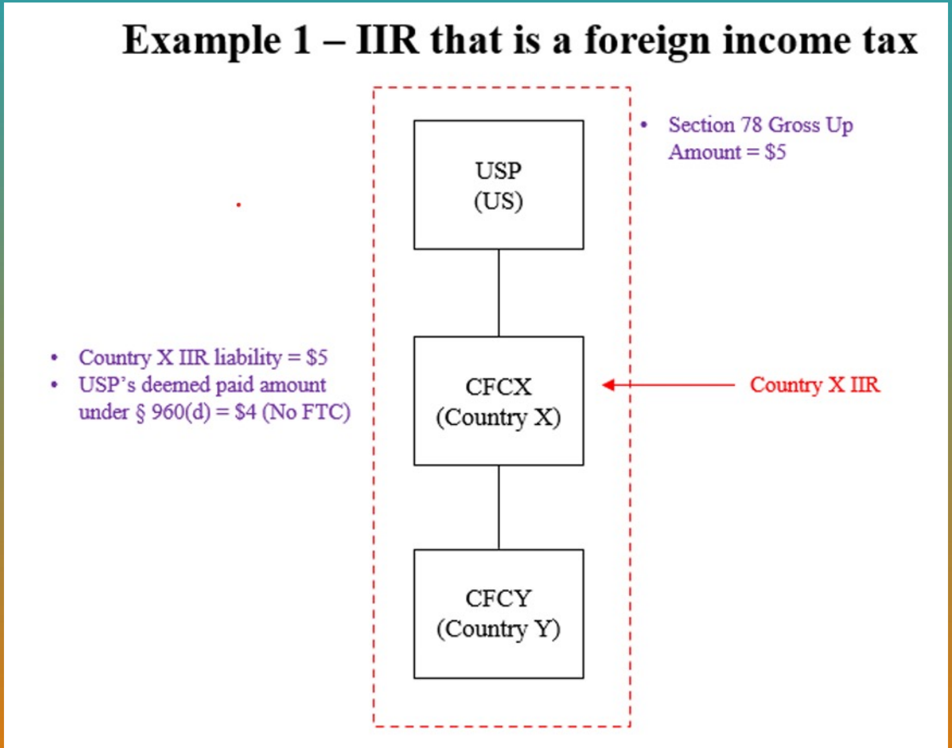
Foreign Tax

- In Example 1, Country X imposes an IIR that subjects CFCX to tax on the income of CFCY.

- Under its IIR, the foreign tax liability of the direct and indirect owners of the Country X taxpayers that relate to the income subject to the IIR is considered if those owners are part of the same MNE Group (as defined under Country X's tax law) as the Country X taxpayer.

- Assume that USP, CFCX, and CFCY are all members of the same MNE Group under Country X tax law. For 2024, further assume that CFCX is liable for $5 of the Country X IIR on CFCY's income, and USP is deemed to pay $4 of the Country X IIR under §960(d). The $4 of Country X IIR that USP is deemed to pay is not eligible for a foreign tax credit under the Push-Down Disallowance Rule because, under Country X tax law, USP's U.S. federal income tax liability may be considered in computing the Country X IIR.

- Country X IIR In addition, even though USP is denied a foreign tax credit, it must still recognize a §78 gross-up amount of $5.



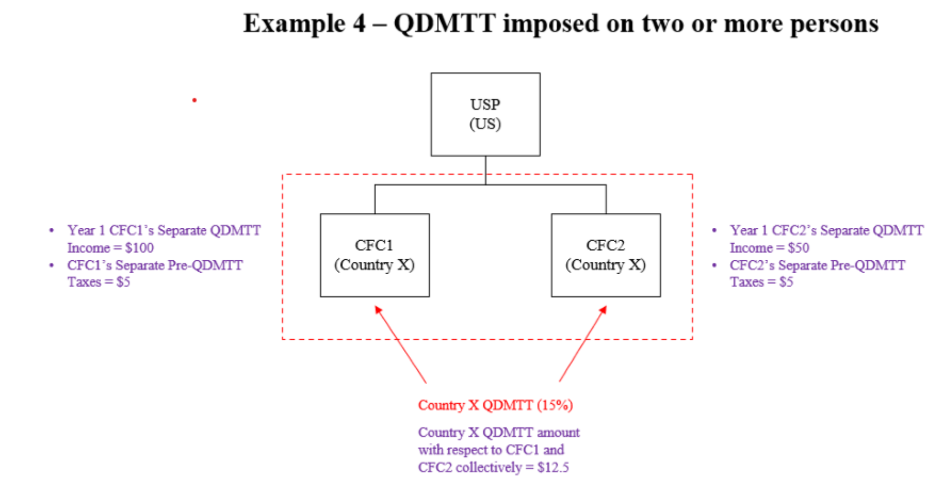
Treatment of QDMTT

Imposition on Multiple Taxpayers

- Country X's QDMTT is imposed on entities that are resident in, or have a taxable presence in, Country X and that are members of the same MNE Group. Entities subject to the Country X QDMTT are jointly and severally liable for the QDMTT. The Country X QDMTT is computed with reference to CFC1 and CFC2's income, and the $12.5 of QDMTT liability is allocated between CFC1 and CFC in proportion to each entity's QDMTT Allocation Key.

- The QDMTT Allocation is the product of (1) the QDMTT Rate less the Separate Pre-QDMTT ETR, and (2) the Separate QDMTT Income amount. Here, CFC1 has Separate QDMTT Income of $100 and Separate Pre-QDMTT Taxes of $5.

- CFC1's income was subject to QDMTT at an effective rate of 5% ($5 tax / $100 income). Accordingly, CFC1's Allocation Key is (15% - ($5 / $100)) x $100) which equals $10. Thus, $10 of the $12.5 of QDMTT is allocable to CFC 1. CFC2 has Separate QDMTT Income of $50 and Separate Pre-QDMTT Taxes of $5. CFC 2 was subject to QDMTT at an effective rate of 10% ($5 tax / $50 income). Thus, CFC2's Allocation Key is (15% - ($5 / $50)) x $50) which equals $2.5. Thus, $2.5 of the $12.5 of QDMTT is allocable to CFC 1.



Other Considerations

Other Pillar Two issues

- The Notice also proposes to update the separate levy rules in Treas. Reg. §1.901-2(d) so that each of a QDMTT, IIR tax, and UTPR tax is treated as a separate levy (See Notice §2.03). This change allows a country's regular foreign income tax and some of the country's Pillar Two taxes to qualify as foreign income taxes under §901, even if one of a country's Pillar Two taxes (such as a UTPR) does not qualify as a foreign income tax under §901.

- withholding taxes and other in lieu of taxes under §903 will continue to be creditable once a country adopts Pillar Two. Specifically, the Notice provides that an in lieu of tax (e.g., a withholding tax) can still be creditable under §903 even though the in lieu of tax is only imposed in lieu of a country's general income tax and not in lieu of a country's Pillar Two taxes (See Notice §2.05).

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