Observations on Notice 2023-80: The Treasury Department and IRS' Preliminary Guidance on the Interaction of Foreign Tax Credit and Dual Consolidated Loss Rules With Pillar Two Taxes and the Extension of Notice 2023-55 Relief Period

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Skadden

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

One Manhattan West
New York, NY 10001
212.735.3000

On December 11, 2023, the Department of the Treasury (the Treasury Department) and the Internal Revenue Service (IRS) released much-anticipated guidance in Notice 2023-80 (Notice) announcing their intention to issue proposed regulations to address the application of the foreign tax credit (FTC) and dual consolidated loss (DCL) rules to certain top-up taxes described in the Organization for Economic Cooperation and Development's (OECD's) "Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)" (GloBE Model Rules). The Notice also extended the temporary relief from the 2022 FTC final regulations that was offered in Notice 2023-55.

While much of the guidance described in the Notice is consistent with expectations, a few provisions discussed below are noteworthy.[1]

Treatment of IIRs Under FTC Rules

Rules Relating to a 'Final Top-Up Tax'

Section 2 of the Notice provides, in part, that a "final top-up tax" consistent with the Income Inclusion Rule (IIR) under the GloBE Model Rules is not creditable under Section 901 if a taxpayer's U.S. federal income tax liability is taken into account in computing the top-up tax under the relevant foreign tax law — *e.g.*, pursuant to a Controlled Foreign Corporation (CFC) Tax Regime under the GloBE Model Rules. [2]

Even if not creditable under Section 901, a U.S. shareholder is nevertheless required under Section 78 to include the amount of a final top-up tax in gross income to the extent the final top-up tax is deemed paid under Sections 960(a), (b) and (d) (without regard to the 80% "haircut" in section 960(d)) — *i.e.*, if a taxpayer elects to claim FTCs for foreign income taxes in a taxable year. In such a case, a final top-up tax would also not be deductible under Section 275(a)(4).

The Notice acknowledges that: "The GloBE Model Rules operate so that taxes are imposed on Net GloBE Income in the following order of priority: (1) Covered Taxes (other than [CFC Tax Regimes] and certain cross-border taxes); (2) QDMTT; (3) CFC Tax Regimes and certain other cross-border taxes; (4) IIR; and (5) UTPR."

The rules in Section 2 of the Notice regarding the treatment of final top-up taxes are presumably designed to prevent a circularity that could ultimately disrupt the priority structure established under the GloBE Model Rules.

- For example, if an IIR were fully creditable under Section 901, the IIR would reduce on a dollar-for-dollar basis the tax imposed under the CFC Tax Regime, thereby displacing the CFC Tax Regime within the priority structure of the GloBE Model Rules.
- Similarly, if the amount of an IIR were not included in gross income under Section 78, the amount of the IIR would effectively be deductible in determining the tax base to which the CFC Tax Regime applies (*e.g.*, GILTI or subpart F). This in turn reduces tax

[1] Unless otherwise indicated herein, references to "Section" are to the Internal Revenue Code of 1986, as amended, and references to "Treasury Regulation" are to the Treasury Department regulations promulgated thereunder.

[2] A final top-up tax is also not taken into account in determining whether the high-tax exception to foreign base company income in Treasury Regulation Section 1.954-1(d) or the high-tax exclusion from tested income in Treasury Regulation Section 1.951A-2(c)(7) applies.

imposed under the CFC Tax Regime iteratively, which again means that the IIR is displacing the CFC Tax Regime, albeit in part, within the priority structure of the GloBE Model Rules.

It is not clear, however, that the Notice fully accomplishes its purpose of ensuring that the priority structure under the GloBE Model Rules is respected. For example, the Section 78 mechanism in the Notice does not appear to apply to a tested loss CFC (including a CFC that is a tested loss CFC as a result of paying an IIR) because a U.S. shareholder would not have a tested income inclusion with respect to such CFC, and thus the IIR paid by the CFC would not be treated as deemed paid under Section 960(d) (which is the necessary condition for Section 78 to apply). Similarly, the payment of an IIR would ordinarily reduce the earnings and profits (E&P) of a CFC, which could limit the subpart F inclusion with respect to such CFC as a result of Section 952(c).

Moreover, the circularity that the Notice attempts to address (which leads to the IIR potentially displacing the CFC Tax Regime, at least in part) could also be present where a U.S. shareholder that is the owner of the relevant CFCs has an inclusion percentage, within the meaning of Section 960(d)(2), of less than 100%.

Other Observations

In addition to the complexity raised by the rules relating to a final top-up tax, the Notice also raises several important technical and policy questions:

- What authority are the Treasury Department and the IRS relying on to support a rule that a foreign income tax is not creditable under Section 901? The Notice clearly contemplates that a final top-up tax can be an "income tax." Indeed, it is treated as an "income tax" for purposes of the Section 78 mechanic described in the Notice itself. The Notice is unclear why such an "income tax" is therefore not creditable under Section 901.
- The Notice does not address whether a final top-up tax is a "foreign law inclusion regime" for purposes of allocating and apportioning foreign income taxes under Treasury Regulation Sections 1.861-20.
- Although the United States has not yet enacted legislation in line with the GloBE Model Rules, the Treasury Department and the IRS have, through the Notice, indicated their intention to adopt rules that aim to respect the priority structure of the GloBE Model Rules.

DCL Guidance

Section 3 of the Notice includes a special rule for DCLs incurred in (i) taxable years ending on or before December 31, 2023, or (ii) provided the taxpayer's U.S. tax year begins and ends on the same dates as the fiscal year of the Multinational Enterprise Group (MNE), taxable years beginning before January 1, 2024, and ending after December 31, 2023 (collectively, Legacy DCLs).

The Notice provides that foreign use would not be considered to occur with respect to a Legacy DCL "solely because all or a portion of the deductions or losses that comprise the [L]egacy DCL are taken into account in determining the Net GloBE Income for a particular jurisdiction." This means that the application of the GloBE Model Rules will not result in the recapture of Legacy DCLs subject to a domestic use election, or prevent a taxpayer from making a domestic use election with respect to a Legacy DCL incurred in the relevant period (*i.e.*, a DCL incurred in a taxable year ending December 31, 2023, for which a domestic use election will be filed with the taxpayer's 2023 return due in 2024).

This grandfathering rule, however, 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.

The Notice states that the treatment of DCLs going forward remains under consideration, and the "Treasury Department and the IRS specifically solicit comments on the interaction of the DCL rules with the GloBE Model Rules[.]" Affected taxpayers should strongly consider providing comments in response to this request.

Provisions Regarding Temporary Relief From 2022 Final FTC Regulations

The Notice indefinitely extends the temporary relief from the 2022 final FTC regulations previously provided in Notice 2023-55.

Lastly, the Notice modifies and clarifies the consistent application requirement in Notice 2023-55 for partnerships and their partners. The consistent application requirement in Notice 2023-55 requires that if a taxpayer applies the temporary relief, then the taxpayer must apply the temporary relief to (i) all foreign taxes paid by the taxpayer in the taxpayer's relief year and (ii) all foreign taxes that are paid by any other person in a taxable year that begins on or after December 28, 2021, and that ends with or within the taxpayer's relief year and for which the taxpayer would be eligible to claim an FTC.

The Notice provides that partnerships and their partners are each subject to the consistent application requirement. Therefore, a partnership that applies the temporary relief to a relief year must apply the temporary relief to all the partnership's foreign taxes. For a partnership's taxable year beginning after December 31, 2022, a partnership's application (or nonapplication) 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 an FTC, with a notable exception for a partner that does not control whether the partnership applies the temporary relief for the relief year. For purposes of this exception, whether a partner controls the partnership's application of the temporary relief will be determined based on the facts and circumstances, including the partnership agreement. For example, a partner may have such control by reason of being a general partner or owning, individually or together with related persons, a majority of the capital or profits interests in the partnership.

Contacts

Alec J. Jarvis
Partner / New York
212.735.2276
alec.jarvis@skadden.com

Eric B. Sensenbrenner
Partner / Washington, D.C.
202.371.7198
eric.sensenbrenner@skadden.com

Moshe Spinowitz
Partner / Boston
617.573.4837
moshe.spinowitz@skadden.com

Benjamin N. Lucas
Counsel / Washington, D.C.
202.371.7245
benjamin.lucas@skadden.com

Chen (Tracy) Grais
Associate / New York
212.735.2319
tracy.grais@skadden.com

Joshua G. Rabon
Associate / Washington, D.C.
202.371.7157
joshua.rabon@skadden.com

Jeff A. Romero
Associate / Houston
713.655.5177
jeff.romero@skadden.com