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Report No. 1476
May 31, 2023

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Re: Report No. 1476 - Report on Foreign Tax Credit Considerations Related to the OECD Global Anti-Base Erosion Model Rules (Pillar Two)

Dear Ms. Batchelder and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1476 of the Tax Section of the New York State Bar Association, which discusses foreign tax credit considerations related to the OECD Global Anti-Base Erosion Model Rules (Pillar Two).

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Philip Wagman
Chair

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Report No. 1476

New York State Bar Association Tax Section

REPORT ON FOREIGN TAX CREDIT CONSIDERATIONS RELATED TO THE OECD GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO)

May 31, 2023

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Report on Foreign Tax Credit Considerations Related to the OECD Global Anti-Base Erosion Model Rules (Pillar Two)[1]

I. INTRODUCTION

This report (the "**Report**") comments on certain foreign tax credit considerations related to taxes imposed under Pillar 2.[2]

Over the course of the last decade, members of the G20 and the Organization for Economic Cooperation and Development (the "**OECD**") agreed to work together to address base erosion and profit shifting with respect to international business income ("**BEPS**"), eventually creating the OECD/G20 Inclusive Framework (the "**Inclusive Framework**"). On October 8, 2021, the Inclusive Framework reached a general agreement on a new two-pillar plan to reform international tax rules addressing tax challenges from the digitalization of the global economy.[3] Inclusive Framework members approved the model rules (the "**Model Rules**")[4] on the second of two "pillars" ("**Pillar 2**")[5] on December 16, 2021. In March of 2022, the OECD published a commentary to the Model Rules (the "**Commentary**")[6] and examples illustrating the application

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1 This principal authors of this Report are Adam Kool, Ansgar A. Simon and Joseph Tootle, with substantial contributions from Maria Smith. This report reflects substantial comments from Kim Blanchard, Andrew Braiterman, Michael Caballero, Peter Connors, Jiyeon Lee-Lim, Stephen Massed, Richard Nugent, Deborah L. Paul, Yaron Reich, Gary Scanlon, Michael Schler, Stephen Shay, Andrew Solomon, Philip Wagman, Andrew Walker and Gordon Warnke. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or the House of Delegates of the New York State Bar Association.

2 The Tax Section has commented on Pillar 2 issues in NY State Bar Ass'n Tax Section Report No. 1465, Report on the OECD Global Anti-Base Erosion Model Rules (Pillar Two) (July 21, 2022) (the "**Prior Pillar 2 Report**").

3 On October 14, 2020, the OECD published a report on the status of the development of the Pillar 2 rules. See OECD (2020), Tax Challenges Arising from the Digitalisation of the Economy – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/abb4c3d1-en.

4 OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf.

5 References to Pillar 2 in this Report generally include both the legislation required to be implemented pursuant to the EU Directive, as well as local adoption of legislation based on the Model Rules, Commentary, Examples and Administrative Guidance in other jurisdictions. *See, e.g.*, the U.K.'s recent draft legislation contained in Finance (No. 2) Bill, Part 3, https://publications.parliament.uk/pa/bills/cbill/58-03/0310/220310.pdf. Additionally, this Report does not address whether and to what extent bilateral tax treaties may conflict with Pillar 2 principles.

6 OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf.

of the Model Rules (the "**Examples**").[7] On December 15, 2022, the Council of the European Union adopted a Directive requiring each European Union Member State to implement the Model Rules into law (the "**EU Directive**").[8] The Inclusive Framework released Administrative Guidance for Pillar 2 on February 2, 2023 (the "**Administrative Guidance**").[9]

The Model Rules, Commentary, Examples and Administrative Guidance set forth a complex and, in some cases, novel set of international global minimum tax rules. These rules are being, or are expected to be, enacted in substantially similar form by OECD members worldwide, pursuant to the EU Directive or otherwise.

Section 901 of the Internal Revenue Code of 1986, as amended (the "**Code**" or "**IRC**")[10] generally entitles domestic corporations, U.S. citizens and resident aliens to credit their foreign income tax liability against their U.S. federal income tax liability on income from foreign sources. While the basic premises of the U.S. foreign tax credit regime have remained relatively stable since their enactment, foreign tax regimes have undergone significant changes in recent years, including under Pillar 2. In certain regards, the taxes imposed under Pillar 2 do not fit neatly within the bounds of the existing Section 901 rules or related rules limiting or allocating creditable foreign income taxes. In other regards, there are fundamental inconsistencies between Pillar 2 and the existing Section 901 rules, as both Pillar 2 and the broader U.S. international taxation regime can effectively compete to tax the residual foreign-sourced income of the same enterprise.

The Department of the Treasury ("**Treasury**," including as applicable the Internal Revenue Service, or "**IRS**") has recognized that the implementation of Pillar 2 may require changes to the foreign tax credit system.[11] This Report discusses considerations raised by Pillar 2 taxes under the existing Section 901, Section 904 and Section 960 rules, raises policy considerations related to granting a credit for such taxes, and recommends related guidance.

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[7] OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two) Examples*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-examples.pdf.

[8] Directive 2022/2523, of the Council of the European Union of 14 December 2022 on Ensuring a Global Minimum Level of Taxation for Multinational Enterprise Groups and Large-Scale Domestic Groups in the Union, 2022 O.J. (L 328), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022L2523.

[9] OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), OECD/G20 Inclusive Framework on BEPS*, OECD, Paris. https://www.oecd.org/tax/beps/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf.

[10] References to "**Sections**" are to the Internal Revenue Code of 1986, as amended, and references to "**Articles**" are to the Model Rules, unless otherwise indicated.

[11] *See* Federal Register Vol. 85, No. 219, November 12, 2020 at 72089.

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

We recommend that Treasury consider the following in light of our discussion below.[12]

1. Clarify existing regulations to confirm that the Top-up Tax imposed under the QDMTT and, in some cases, the IIR generally meets the requirements for a creditable foreign income tax under Section 901.

2. Expand the soak-up tax limitation to add a rule that a foreign tax is not an "amount of foreign income tax paid" with respect to any U.S. person whose U.S. tax liability is taken into account in measuring the amount of such foreign tax. If a U.S. parent corporation incurs U.S. tax liability under the GILTI or subpart F rules on income inclusions in respect of a foreign subsidiary-CE in the U.S. parent's MNE Group, and such U.S. tax liability is taken into account in computing a foreign tax that is imposed in respect of such foreign subsidiary-CE's income under an IIR, the effect of the recommended rule would be to prevent the U.S. parent from claiming a foreign tax credit for such tax imposed under the IIR.

3. Confirm that the UTPR is never a creditable foreign income tax, either in a preamble to future regulations or through revisions to existing regulations demonstrating Treasury's views.

4. Make technical adjustments to Treasury regulations issued under Section 861 and 904 to account for Top-up Taxes to the extent such taxes are determined to be creditable.

5. Provide clarification of the "technical taxpayer" rules in the regulations under Section 901, regarding the allocation of QDMTT among taxpayers within a jurisdiction where multiple CEs are tax resident.

6. Adopt rules providing for the allocation of Top-up Taxes under Section 960 among the U.S. shareholders of a CFC, and give consideration to adopting one of the alternative approaches described below in those rules.

III. BACKGROUND ON QDMTT, IIR AND UTPR[13]

Under Pillar 2, multinational groups with annual revenue of EUR 750 million or more ("**MNE Groups**") generally are subject to a jurisdictional minimum tax at a rate of 15% (the "**Minimum Rate**"). The Model Rules apply this minimum tax regime under a hierarchical system of "top-up taxes" ("**Top-up Taxes**" or "**GloBE Taxes**"). Top-Up Taxes are imposed on MNE

[12] Capitalized terms used in Part II are defined below in Parts III and IV.

[13] See the Prior Pillar 2 Report for additional discussion of the Model Rules, Examples and Commentary.

Groups with respect to income of one or more constituent entities (each, a "**CE**")[14] in a jurisdiction whose effective tax rate ("**ETR**") is lower than the Minimum Rate. The members of such MNE Group and the MNE Group's revenue threshold are determined largely by reference to consolidated financial statements and accounting principles (rather than income tax principles), subject to certain modifications.[15]

To calculate a CE's ETR, the CE's net income or loss (determined under financial accounting principles) must be determined and adjusted for certain intragroup transactions, flow-through income or loss and various elections (the "**GloBE Income**" or "**GloBE Loss**", and the excess of such GloBE Income over GloBE Loss, if any, the "**Net GloBE Income**"),[16] and the CE's current tax expense accrued (again determined under financial accounting principles) for the fiscal year, subject to certain adjustments and allocations (such tax expense, as adjusted, the "**Adjusted Covered Taxes**"),[17] must be determined.

In computing a CE's Adjusted Covered Taxes, the Model Rules provide specific treatment for taxes imposed under a Controlled Foreign Company Tax Regime (a "**CFC Tax Regime**"), which is defined in the Model Rules as "a set of tax rules (other than an IIR [a type of Pillar 2 tax, defined below]) under which a direct or indirect shareholder of a foreign entity (the controlled foreign company or CFC) is subject to current taxation on its share of part or all of the income earned by the CFC, irrespective of whether that income is distributed currently to the shareholder."[18] Tax imposed under a CFC Tax Regime is to be allocated from the CE-shareholder subject to such tax to the subsidiary-CE which earns the income—i.e., CFC Tax Regime taxes are "pushed-down" to the CE that is the CFC to increase its Adjusted Covered Taxes, and therefore to

[14] A CE means: (i) any legal person (other than a natural person) or an arrangement that prepares separate financial accounts, such as partnerships or trusts, and (ii) any "Permanent Establishment" of a "Main Entity" (the entity that such Permanent Establishment includes its net income or loss in its financial statements). Arts. 1.3.1 and 10.1.1 (definitions of "Entity," "Main Entity" and "Permanent Establishment").

[15] Such consolidated financial statements generally must be prepared in accordance with IFRS or local generally accepted financial accounting principles of Australia, Brazil, Canada, Member States of the European Union, Member States of the European Economic Area, Hong Kong (China), Japan, Mexico, New Zealand, The People's Republic of China, the Republic of India, the Republic of Korea, Russia, Singapore, Switzerland, the United Kingdom and the United States ("**Acceptable Financial Accounting Standard**"), in which the assets, liabilities, income, expenses and cash flows of the preparing entity and the entities in which it has a controlling interest are presented as those of a single economic unit, subject to certain exceptions ("Consolidated Financial Statements"). Art. 10.1.1 (definition of "Consolidated Financial Statements"). If an MNE Group meets the revenue threshold of EUR 750 million in at least two of the four fiscal years preceding the fiscal year for which it is tested, an MNE Group is within the scope of the Model Rules, with proportional adjustments for fiscal years of periods other than 12 months. Art. 1.1.1 - 2.

[16] Art. 3.

[17] Art. 4. Adjusted Covered Taxes result from certain adjustments to the "Covered Taxes" of a CE.

[18] Art. 10.1.1. In this Report, a "**CFC**" refers to any entity income of which is subject to inclusion pursuant to a jurisdiction's CFC Tax Regime, including an entity that is a "controlled foreign corporation" as defined in Section 957(a) of the Code.

decrease any Top-up Taxes imposed in respect of the CFC's jurisdiction.[19] The Model Rules, however, do not provide a detailed mechanism for allocating such taxes. Further, the Model Rules do not account for CFC taxes that are computed based on a blend of income, losses or creditable taxes of multiple CFCs (within the MNE Group or not) held by a CE-owner (a "**Blended CFC Tax Regime**"). The Administrative Guidance provides clarity on the treatment of the U.S. Global Intangible Low-Taxed Income ("**GILTI**") regime, confirming that GILTI qualifies as a Blended CFC Tax Regime. The Administrative Guidance also provides for a simplified allocation of such CFC taxes under a Blended CFC Tax Regime applicable for a limited period of time.[20]

The Administrative Guidance provides for the amount of GILTI (reduced by the GILTI deduction), multiplied by 21%, less any foreign tax credit allowed in the GILTI basket (the "**Allocable Blended CFC Tax**"), to be allocated from a CE-owner to certain CE-CFCs located in low-tax jurisdictions.[21] The Allocable Blended CFC Tax will be apportioned among CE-CFCs in accordance with a mechanical formula, taking into account a ratio of the shareholder's share of the tested income (without reduction for foreign income taxes) of the CE-CFC and the difference between the GILTI effective tax rate of 10.5% (or 13.125% for taxable years beginning after 2025) and a jurisdictional ETR as determined under the Model Rules, without regard to any Covered Taxes under a CFC Tax Regime.[22]

Each CE's GloBE Income or Loss and Adjusted Covered Taxes (including any GILTI and other CFC taxes that are "pushed-down" to the CE) are aggregated on a jurisdictional basis, and the ETR with respect to each jurisdiction is equal to the sum of Adjusted Covered Taxes divided by the Net GloBE Income of the jurisdiction.[23] If the ETR in a jurisdiction is less than the Minimum Rate, the difference is the "**Top-up Tax Percentage**" at which the GloBE Taxes are applied (such CEs in jurisdictions with an ETR less than the Minimum Rate, "**Low-Taxed CEs**").[24]

The Top-up Tax Percentage is not applied to GloBE Income; rather, it is applied to the amount of Net GloBE Income that exceeds the specified return on certain tangible assets and payroll expenditures (the "**Substance-Based Income Exclusion**" or "**SBIE**", and such excess, the "**Excess Profit**").[25] The Top-up Tax is equal to the Top-up Tax Percentage multiplied by the Excess Profit, which is then reduced by any applicable qualified domestic minimum top-up taxes

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[19] Art. 4.3.2(c).

[20] Art. 2.10.1 of the Administrative Guidance.

[21] Art. 2.10.3 of the Administrative Guidance.

[22] *Id.*

[23] Art. 5.1.1.

[24] *Id.*

[25] Art. 5.2.2; Art. 5.3.

imposed in such jurisdiction (the "**QDMTT**") and increased by any additional current top-up taxes.[26]

The Top-up Taxes generally are allocated among Low-Taxed CEs with GloBE Income in the relevant jurisdiction and imposed on members of the MNE Group under the income inclusion rule ("**IIR**") and a mechanic once referred to as the under-taxed profits rule ("**UTPR**").[27] The CEs in the MNE Group that will be required to pay such Top-up Taxes will depend on the structure of the MNE Group and the rules in place in such jurisdiction.

A. QDMTT

The QDMTT for a jurisdiction offsets the Top-up Taxes that would otherwise be imposed under the IIR and UTPR with respect to CEs in such jurisdiction in a relevant fiscal year.[28] A QDMTT generally is a minimum tax that, pursuant to domestic law in a jurisdiction, (i) determines the Excess Profits of the CEs located in such jurisdiction in a manner equivalent to the Model Rules, (ii) results in an increase to the domestic tax liability of CEs in such jurisdiction, with respect to those domestic Excess Profits, to the Minimum Rate and (iii) is consistently implemented and administered in conformity with the Model Rules.[29]

As discussed in subsequent sections, the IIR and UTPR can or will be applied to CEs in jurisdictions other than the Low-Taxed CE jurisdiction that creates the Top-up Tax. Because the QDMTT is applied to reduce Top-up Taxes prior to application of the IIR or UTPR, a jurisdiction that enacts a QDMTT is, in effect, claiming the revenues associated with its own Top-up Taxes on CEs in the relevant jurisdiction.

Like the IIR and UTPR, in jurisdictions that have enacted a QDMTT, the QDMTT is imposed with respect to all CEs located in that jurisdiction, combining the Globe Income, Globe Loss, SBIE and other items of all CEs (including permanent establishments) in such jurisdiction.

The accounting standards applicable for the QDMTT calculation may differ from the accounting standards applicable to the imposition of the IIR or UTPR. For the QDMTT calculation, rather than computing Excess Profits under the same requirements of the MNE Group's Consolidated Financial Statements (like under the IIR or UTPR), Excess Profits can be computed as determined under the Acceptable Financial Accounting Standard that is permitted by an Authorised Accounting Body or other generally acceptable accounting principles adjusted to prevent material competitive distortions (as specifically defined under the Model Rules), in either case, in the jurisdiction where the CE is located.[30] The various accounting standards used for

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26 Art. 5.2.3.

27 Art. 5.2.4. *See* Commentary at 7 (defining "IIR" as "Income Inclusion Rule").

28 Art. 5.2.3.

29 Art. 10.1.1 (definition of "Qualified Domestic Minimum Top-up Tax").

30 Art. 10.1.1 (definitions of "Qualified Domestic Minimum Top-up Tax" flush language, "Acceptable Financial Accounting Standard" and "Authorised Accounting Body").

computation of the Top-up Taxes and the QDMTT could result in a higher or lower QDMTT than the Top-up Taxes arising with respect to CEs in such jurisdiction. If a Top-up Tax liability remains after the application of a QDMTT, Top-up Taxes are imposed under the IIR or UTPR.[31]

B. IIR[32]

The allocation of Top-up Tax to CEs (the "**GloBE Taxpayers**") depends on the structure of the MNE Group. The Top-up Tax is allocated to a CE that is (i) the "ultimate parent" of the MNE Group (the "**UPE**"), (ii) an "intermediate parent entity" ("**IPE**") or (iii) a "partially-owned parent entity" ("**POPE,**" and together with the UPE and IPE, "**Parent Entities**") in accordance with their proportionate allocable share.[33]

If the UPE is located in an IIR-adopting jurisdiction, the UPE is allocated its allocable share of Top-up Taxes of each Low-Taxed CE.[34] Unless another CE in the MNE Group is a POPE, the UPE is the sole entity that would be subject to the IIR. However, certain structures may cause application of the UTPR if there is low-taxed income not brought into charge under the IIR, as discussed below.

The IIR is applied to the Parent Entities in a top-down manner, beginning with the MNE Group's top-most CE in a chain of CEs located in an IIR-adopting jurisdiction, and moving down such chain, depending on the MNE Group structure. If the GloBE Taxpayer is an IPE, its Top-up Tax liability equals the Top-up Tax that is not allocated to the UPE (e.g., if the UPE is not located in an IIR-adopting jurisdiction) or any higher-tier Parent Entity that (directly or indirectly) owns a controlling interest in such IPE.[35]

[31] Art. 5.2.3(d).

[32] In this report, we refer to the IIR. The Model Rules distinguish between "IIR" and "Qualified IIR", which are rules "equivalent" to the IIR, including any provision associated with the IIR Articles, that are included in the domestic law of a jurisdiction and that are implemented and administered in a way consistent with the Model Rules, the Commentary, and the jurisdiction does not provide any benefit related to the rules. Art. 10.1.1 (definition of "IIR" and "Qualified IIR").

[33] *See* Art. 10.1.1 (definitions of "Ultimate Parent Entity", "Intermediate Parent Entity" and "Partially-Owned Parent Entity".).

[34] Art. 2.1.1. As in the Prior Pillar 2 Report, this report may use the shorthand of "IIR liability" or an IIR being imposed instead of stating that Top-up Tax is allocated under the IIR to a CE, which is then liable therefor in the jurisdiction where it is located, and likewise for UTPR.

[35] Arts. 2.1.2 and 2.1.3. A CE holds a "controlling interest" in a subsidiary CE if the first, higher-tier CE holds an "ownership interest" in the subsidiary CE and the higher-tier CE is required to consolidate with the lower-tier CE or would be required to do so if it prepared consolidated financial statements. An "ownership interest" in a CE is any equity interest in that CE that carries rights to the profits, capital or reserves of that CE. Art. 10.1. (definitions of "Controlling Interest" and "Ownership Interest").

An exception to the IIR's general top-down approach applies in situations in which a POPE owns an ownership interest in a Low-Taxed CE.[36] In that case, Top-up Taxes are first imposed on the POPE.[37] Within the POPE exception lies another top-down rule, whereby if one POPE that directly or indirectly wholly-owns another POPE, the higher-tier POPE bears the Top-up Tax.[38]

If a UPE (together with other CEs located in its jurisdiction) is a Low-Taxed CE in the MNE Group, it does not apply the IIR to itself.[39] Likewise, an IPE or a POPE (together with CEs located in its jurisdiction) that is a Low-Taxed CE in the MNE Group and is not subject to the IIR with respect to a higher-tier Parent Entity, does not apply the IIR to itself.[40]

The Top-up Tax is attributable to Parent Entities in proportion to their allocable share. A Parent Entity's allocable share of Top-up Tax of a Low-Taxed CE is equal to the Top-up Tax multiplied by the Parent Entity's "**Inclusion Ratio**" for such Low-Taxed CE.[41] The Inclusion Ratio is the ratio of GloBE Income of the Low-Taxed CE, reduced by amounts of such GloBE Income attributable to ownership interests held by other direct or indirect owners, to the unreduced GloBE Income of the Low-Taxed CE.[42] The Inclusion Ratio is again based on accounting standards of the MNE Group.[43]

The Model Rules contain an offsetting mechanism to implement the IIR. If several Parent Entities are liable for the Top-up Tax under the IIR, an exclusion rule and an offset mechanism (the "**Offset Mechanism**") apply to account for the Top-up Taxes borne by Parent Entities lower in the ownership chain.[44] The exclusion rule applies where a higher-tier Parent Entity owns a controlling interest in a lower-tier Parent Entity or, if a POPE, the POPE wholly-owns another POPE. Consistent with the top-down approach, the Top-up Taxes are not allocated to the lower-tier Parent Entity under the IIR.[45] The Offset Mechanism applies where a higher-tier Parent Entity does not own a controlling interest in a lower-tier Parent Entity or, if a POPE, the POPE is not

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36 Art. 2.1.4. In general, a POPE is a CE that is not a UPE and is more than 20% owned directly or indirectly by shareholders that are not CEs. Art. 10.1.1.

37 *Id.*

38 Art. 2.1.5.

39 Art. 2.1.6.

40 *Id.*

41 Art. 2.2.1.

42 Art. 2.2.2.

43 Art. 2.2.3.

44 Art. 2.1.3 (exclusion for lower-tier IPEs if there is a higher-tier IPE or a UPE that is required to apply a Qualified IIR); Art. 2.1.5 (exclusion of lower-tier POPE wholly-owned by a higher-tier POPE); Art. 2.3.

45 Art. 2.1.3 (exclusion for lower-tier IPEs if there is a higher-tier IPE or a UPE that is required to apply a Qualified IIR); Art. 2.1.5 (exclusion of lower-tier POPE wholly-owned by a higher-tier POPE).

wholly-owned by another POPE. The Parent Entity's allocable share of the Top-up Tax is, in effect, credited to the extent that its ownership interest in a Low-Taxed CE is held indirectly through an IPE or POPE.[46]

C. UTPR

The allocation of Top-up Tax under the UTPR only applies if such Top-up Taxes are not allocated to a Parent Entity under the IIR. Such remaining Top-up Taxes are allocated to all CEs in UTPR-adopting jurisdictions, rather than just Parent Entities.[47] Unlike the IIR, which is allocated under a top-down approach, the UTPR is allocated among all CEs in the MNE Group (regardless of nexus) according to a formulary apportionment.

The UTPR's backstop mechanism applies if no applicable Parent Entity is in a jurisdiction that imposes the IIR. The UTPR may also apply where a Parent Entity located in a jurisdiction that imposes an IIR owns less than 100% of a Low-Taxed CE. Moreover, the UTPR may apply if the UPE is located in an IIR jurisdiction, and other Low-Taxed CEs are located in the same jurisdiction (including potentially the UPE itself) because the IIR in the UPE's jurisdiction does not apply to the Top-up Tax in respect of its own jurisdiction.

The amount of the UTPR applicable to an MNE Group equals the aggregate Top-up Tax of each Low-Taxed CE, reduced by the amounts charged to a Parent Entity under the IIR.[48] The UTPR is allocated on a jurisdictional basis, based on a proration of the average of employees and tangible assets in a jurisdiction.[49]

The amount of UTPR that is allocated to a CE generally is imposed through a disallowance of deductions (or equivalent adjustment under domestic law) in an amount resulting in those CEs having an additional cash tax expense equal to the amount of such UTPR.[50] If the CE does not have sufficient deductions available for any Fiscal Year to generate an additional cash tax expense equaling the amount of such UTPR, the excess of the Top-up Tax over the increase in the CE's cash tax expense is carried forward to future Fiscal Years (rather than being re-allocated to other CEs in jurisdictions adopting the UTPR).[51] The Model Rules also suggest that instead of denying deductions to effectively charge the CE for its UTPR amount, a CE alternatively could be required

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[46] Art. 2.3.2.

[47] Arts. 2.4 – 2.6.

[48] Art. 2.5.

[49] Art. 2.6.1.

[50] Art. 2.4.1.

[51] Art. 2.4.2.

to make an equivalent adjustment under domestic law. The Commentary suggests this would be an additional tax imposed on the CE or an additional amount of deemed income.[52]

D. Structural Conflict Between Pillar 2 and the U.S. International Tax Regime

There are aspects of the QDMTT, IIR and UTPR that resemble income taxes imposed in the United States, including under its international tax regime, in a broad sense. These taxes generally relate to income measured as and when realized, on a periodic basis, by governmental bodies with taxing authority. To the extent similar, these aspects favor treating such taxes as creditable under Section 901. Indeed, as analyzed in detail in Part IV.B and IV.C below, we believe the QDMTT and IIR should be creditable under Section 901 in appropriate circumstances, and the treatment of such taxes under the Section 901 rules is analyzed in detail. However, there are differences in the structure of Pillar 2 and the U.S. international tax regime, also analyzed in detail in Part IV below, that raise fundamental policy questions of creditability.

The U.S. international tax regime generally attempts to tax the foreign source income of U.S. persons at U.S. income tax rates, while avoiding double taxation by giving credit for foreign taxes paid on that income. In so doing, the U.S. international tax regime aims to impose a residual U.S. income tax on foreign source income that is under-taxed by foreign jurisdictions in which such income arises, as measured against U.S. income tax rates. The United States limits this residual tax to under-taxed foreign source income that is earned directly or indirectly by the U.S. person.

While Pillar 2 also attempts to impose a residual Top-up Tax on under-taxed income, the calculation of the under-taxed income is not limited to income earned, or taxes paid, directly or indirectly by the GloBE Taxpayer. Rather, income earned and taxes paid by other members of the MNE Group that are resident in different jurisdictions than the GloBE Taxpayer, including its parent and sibling entities, can be included in calculating the base for the Top-Up Tax imposed on the GloBE Taxpayer. Where a MNE Group subject to Pillar 2 includes one or more U.S. corporations, the U.S. international tax regime and Pillar 2 can compete to tax the residual, and the decision whether to afford a U.S. tax credit for an IIR or UTPR can become a decision of whether to surrender the United States' jurisdiction to tax the residual entirely.[53]

This is illustrated in the most straightforward manner by the application of the push-down for CFC Tax Regime taxes in a U.S.-parented MNE Group.[54]

> Example 1. USP owns 100% of the stock of CFC1, which in turn owns 100% of the stock of CFC2. Assume that CFC1 is organized

[52] Commentary to Art. 2, ¶46-47, pp. 32.

[53] The same is true, albeit with a comparatively smaller impact to the U.S. fisc, of deducting a Pillar 2 tax.

[54] In the examples illustrating a push-down in this Report, for simplicity it is assumed that it is clear how much of USP's U.S. federal income tax is pushed-down to a CFC. There may be circumstances in which calculating and allocating the taxes to be pushed down is a complex exercise; this issue may be addressed in a separate report to come. *See* Part IV.E.3 *infra*. In addition, for simplicity, all examples in this Report assume a functional currency for all entities of the U.S. dollar.

> in a jurisdiction that has adopted the Pillar 2 rules and imposes an IIR, while CFC2 is organized in a jurisdiction that has not. Further assume that (1) CFC2 has no SBIE and USP has no NDTIR and (2) CFC2 earns $100 of tested income and $100 of Net GloBE Income.
>
> USP is initially subject to GILTI tax of $10.5, assuming a 50% Section 250 deduction (i.e., $100 x 10.5%). CFC1 is subject to an IIR equal to $4.50 (i.e., $100 Net GloBE Income, subject to $10.5 of pushed-down Covered Taxes, topped-up to the 15% Minimum Rate).

The Pillar 2 jurisdiction effectively imposes a residual Top-up Tax after both CFC2's jurisdiction *and* the United States have had the opportunity to tax CFC2's income, notwithstanding the fact that the U.S. taxes have no direct or indirect economic effect on the CE in the Pillar 2 jurisdiction.

As the IIR is also a tax imposed in respect of CFC2's income, the GILTI tax imposed on USP arguably gives rise to double taxation. If Pillar 2 operated like a typical foreign CFC tax regime in imposing the IIR, then CFC1's IIR would be an obvious candidate for potential creditability under Section 901. However, crediting any such IIR against the USP's GILTI tax would in turn decrease the amount of such GILTI taxes pushed-down to CFC2, which would itself in turn increase the amount of CFC1's IIR, and so on. This iterative or "circular" calculation may stop only when such GILTI taxes have been fully offset due to such crediting.[55] In effect, by crediting the IIR, the United States would cede taxing jurisdiction for all or a portion of CFC2's under-taxed income.

If the United States had in place a regime recognized by other countries as constituting an IIR, then under the "top-down" hierarchical application of the IIR in Pillar 2, the U.S. parent of a MNE Group would be subject to the United States' IIR in respect of its Low-Taxed CE subsidiaries, and there generally would be no foreign IIR imposed on a subsidiary-CE for the U.S. parent to potentially credit.[56]

However, so long as the United States does not have in place a regime recognized as an IIR, the inconsistent and competing systems of Pillar 2 and the U.S. international tax regime raise this key question—to what extent should the U.S. international tax regime be administered or adjusted in a manner that yields residual taxing jurisdiction to a country imposing a Pillar 2 tax? We believe that established U.S. policies and principles underlying the foreign tax credit are promoted by not ceding the United States' right to tax the residual to the Pillar 2 country in cases like Example 1. By comparison, in other cases a Top-Up Tax may resemble a foreign tax that is

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[55] Any credit for a Pillar 2 tax may not fully offset the CFC Tax Regime tax where the use of credit is limited. For example, if the IIR in Example 1, determined before USP's GILTI tax is pushed-down (and therefore determined without crediting such IIR against USP's GILTI tax), exceeds USP's GILTI tax pushed-down to CFC2, but the amount of any such IIR (after applying the 20% GILTI haircut) is less than such GILTI tax, an insufficient amount of creditable IIR would be available to fully offset such GILTI tax.

[56] Even if the United States enacted an IIR, the difficulty described above in the text would still arise where a U.S. parent indirectly bears an IIR imposed on a subsidiary-POPE.

imposed based on a traditionally recognized economic connection between the country imposing the tax and the income being taxed, like taxes imposed under more traditional foreign CFC regimes. In such cases, the country imposing the tax can be viewed as not posing a direct challenge to the United States' residual taxing jurisdiction, and granting a credit for a Pillar 2 tax in such cases arguably would be consistent with established practice. Nevertheless, the structural friction highlighted above is a basic theme in applying the foreign tax credit rules to Pillar 2.

IV. DETAILED DISCUSSION OF PRINCIPAL CONSIDERATIONS AND RECOMMENDATIONS

A. Summary of Certain Foreign Tax Credit Requirements

1. Basic Principles

Section 901 generally permits domestic corporations, U.S. citizens and resident aliens to credit the amount of any income, war profits, and excess profits taxes paid or accrued to a foreign country or a possession of the United States (collectively, "**foreign income taxes**") against their U.S. federal income tax liability on income from foreign sources.[57] Section 901 also permits corporations to credit foreign income taxes that they are deemed to have paid under Section 960.

Longstanding judicial doctrine dating back to Biddle v. Comm'r, 302 U.S. 573, 578-79 (1938) provides that a foreign tax is a creditable foreign income tax under Section 901 if it would be an income, war profits or excess profits tax "in the U.S. sense."[58] That is, to be a creditable foreign income tax under Section 901, a foreign tax "must be the substantial equivalent of an income tax as that term is understood in the United States."[59] In 1983, Treasury largely codified then existing judicial and administrative criteria for determining when a foreign tax is an income tax in the U.S. sense under the "predominant character" test (the "**1983 regulations**").[60] The predominant character test, which persisted with little alteration until 2022, generally required that the foreign tax must (1) be likely to reach "net gain" in the normal circumstances in which it applies and (2) not be a "soak-up tax."[61]

To reach net gain under the predominant character test, the foreign tax generally must have been imposed on (1) income on or after the time it would have been realized for U.S. federal income tax purposes and (2) the basis of gross receipts, reduced by significant costs and expenses attributable to such gross receipts (or reduced by significant costs and expenses computed under a

[57] Section 903 extends the credit under Section 901 to taxes imposed "in lieu of" a foreign income tax (e.g., certain withholding taxes). *See infra* note 66. We believe that no Pillar 2 tax is an "in lieu of" tax.

[58] *See* PPL Corp. v. Comm'r, 133 S.Ct. 1897, 1901 (2013) (hereinafter "**PPL v. Comm'r**").

[59] *See, e.g.*, Inland Steel Co. v. United States, 677 F.2d 72, 79 (Ct. Cl. 1982) and Bank of America Nat. Trust & Sav. Ass'n v. United States, 459 F.2d 513, 515 (Ct. Cl. 1972), cert. denied, 93 S.Ct. 271 (1972).

[60] T.D. 7918; Federal Register Vol. 48, No. 198, October 12, 1983 at 46272.

[61] *Id.* at 46273.

method likely to produce an amount that approximates, or is greater than, such costs and expenses).[62]

Strict conformity between foreign tax laws and U.S. tax laws was not required.[63] Because net gain was tested in the normal circumstances in which a foreign tax applies (that is, based on its practical application to taxpayers generally), statistical analyses of tax returns and accounts of industry participants could determine whether a foreign tax met the gross receipts or cost recovery tests above.[64] Thus, creditability could turn on complex and costly "empirical analysis", often performed by foreign tax experts.

Seeking to both (1) narrow the circumstances in which empirical analysis may be required to analyze the nature of a foreign tax and (2) clearly delineate when novel extraterritorial taxes, like those that would be imposed under the OECD's "Pillar One" regime (if and when adopted) and the UK's diverted profits tax regime, are creditable foreign income taxes, Treasury issued final regulations that significantly altered the definition of "foreign income taxes" in 2022.[65]

2. 2022 Final Regulations

The 2022 final regulations replaced the predominant character test with a revised, and significantly more strict, net gain test that requires a degree of legal conformity between foreign and U.S. income tax laws, rather than a degree of factual conformity in their effect. Under the final regulations, a foreign levy is a foreign income tax if it is a foreign tax that satisfies this revised net gain requirement.[66]

a. Separate Levy Requirement

Whether a foreign levy is a creditable foreign income tax is determined independently for each separate levy.[67] Each of the QDMTT, IIR and UTPR should typically be separate levies. First, each should typically be imposed on a different class of taxpayer in the relevant jurisdiction

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[62] *Id.*, 46277 - 79.

[63] *See, e.g.*, *id.* at 46278 ("A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied . . . Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code . . .").

[64] *See* Texasgulf, Inc. v. Comm'r, 172 F.3d 209 (2d Cir. 1999) and Exxon Corp. v. Comm'r, 113 T.C. 338 (1999).

[65] T.D. 9959. *See also* Federal Register Vol. 85, No. 219, November 12, 2020, 72083 - 91.

[66] Treas. Regs. §§ 1.901-2(a)(1)(i), -2(a)(3). A foreign tax imposed in lieu of an income tax may also be treated as a foreign income tax. *Id.; see* Treas. Reg. § 1.903-1. In general, a foreign tax qualifies as an "in lieu of" tax if either: (1) it is imposed by the taxing jurisdiction on part or all of the taxpayer's income in substitution for a generally-imposed net income tax that would otherwise have been imposed on that income; or (2) it is a withholding tax imposed on gross income of a nonresident which is sourced to the taxing jurisdiction and is not also subject to net income tax in that jurisdiction. *See* Treas. Reg. § 1.903-1(c). As indicated above, we believe Pillar 2 taxes are not in lieu of taxes.

[67] Treas. Reg. § 1.901-2(a)(1)(i).

compared to the relevant jurisdiction's corporate income tax, as each of the QDMTT, IIR and UTPR generally may apply only to CEs of MNE Groups with EUR 750 million or more.[68] Second, each of the QDMTT, IIR and UTPR are imposed on different bases. The QDMTT is imposed on income arising in the relevant CE's jurisdiction, unlike the IIR or UTPR. The IIR is imposed in respect of income arising in the jurisdictions of the relevant CE's subsidiaries, but only if the applicable CE has priority in the MNE Group's structure, unlike the QDMTT or UTPR. The UTPR is imposed based on neither of the forgoing bases.[69]

b. Compulsory Payment Requirement

A foreign levy is a tax only if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes, determined by principles of U.S. law and not by principles of law of the foreign country (the "**compulsory payment requirement**").[70] A foreign levy is not a tax to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit from the foreign country in exchange for paying the levy. All Pillar 2 taxes should satisfy the compulsory payment requirement and this requirement is not further analyzed in this Report.

c. Net Gain Requirement

In general, a foreign tax satisfies the "**net gain requirement**" only if the tax satisfies the realization, gross receipts, cost recovery, and attribution requirements, each as described below.[71] As described below in Parts IV.B through IV.C of this Report, Pillar 2 taxes do not fit do not fit neatly within the bounds of the net gain requirement, and its application to Pillar 2 taxes is analyzed in detail.

i. Realization

The "**realization requirement**" generally is satisfied if the foreign income tax (A) is imposed on or after the occurrence of events that result in the realization of income under the Code ("**IRC realization**"), (B) upon a pre-realization event that results in recapture of a tax deduction, credit or other allowance previously accorded to the taxpayer or (C) is imposed on another pre-

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68 *See* Treas. Reg. § 1.901-2(d)(1)(ii), generally providing that "where the base of a foreign levy is computed differently for different classes of persons subject to the levy, the levy is considered to impose separate levies with respect to each such class of persons . . . Where foreign tax law imposes a levy that is the sum of two or more separately computed amounts of tax, and each such amount is computed by reference to a different base, separate levies are considered to be imposed." *See also* Treas. Reg. § 1.901-2(d)(3)(vi) Example 6.

In addition to only being imposed on a CE in a MNE Group that meets the meets the EUR 750 million threshold, the IIR, UTPR and QDMTT also are each imposed on a base that is computed separately from the base for the relevant jurisdiction's regular corporate income tax.

69 Treatment of the UTPR as a separate levy is discussed further in Part IV.D.3 below.

70 Treas. Reg. § 1.901-2(a)(2)(i).

71 A foreign tax may satisfy the net gain requirement under the "surtax on net income" test in Treas. Reg. § 1.901-2(b)(6). As Pillar 2 taxes do not satisfy the surtax on net income test, it is not further analyzed in this Report.

realization event (provided that the foreign country does not later impose a second tax, without credit, on the same income) and, among other alternatives, the pre-realization event relates to a deemed distribution or inclusion (e.g., under a foreign CFC regime) of amounts (such as earnings and profits) that meet the realization requirements in the hands of the person that, under foreign tax law, is deemed to distribute such amounts ("**CFC realization**").[72]

If a foreign tax meets the realization requirement with respect to one or more specific types of nonrealization events (determined under the Code), and the gross receipts attributable to such nonrealization events are insignificant relative to the gross receipts that meet the realization requirement, as judged based on the application of the foreign tax to all taxpayers subject to it, then the foreign tax is nonetheless treated as meeting the realization requirement (the "**insignificant item exception**").[73]

ii. Gross Receipts

The "**gross receipts requirement**" generally is satisfied if the foreign income tax is imposed on the basis of (A) actual gross receipts, (B) deemed gross receipts in the event of certain insignificant nonrealization events or IRC realization events that do not produce gross receipts, (C) deemed gross receipts in the amount of certain tax deductions, credits or other allowances that are recaptured upon a pre-realization event and (D) gross receipts arising from other pre-realization timing difference events described above in the realization requirement.[74]

iii. Cost Recovery

The "**cost recovery requirement**" generally is satisfied if the base of the foreign tax is computed by reducing gross receipts described in the gross receipts requirement to permit recovery of significant costs and expenses that are attributable, under reasonable principles, to such gross receipts.[75]

Whether a cost or expense is significant for purposes of the cost recovery requirement is determined based on whether, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayers' total costs and expenses.[76] Foreign tax law is considered to permit recovery of significant costs and expenses even if recovery of all or a portion of certain costs or expenses is disallowed, if such disallowance

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72 Treas. Reg. § 1.901-2(b)(2).

73 Treas. Reg. § 1.901-2(b)(2)(i).

74 Treas. Reg. § 1.901-2(b)(3).

75 Treas. Reg. § 1.901-2(b)(4)(i)(A). Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Code. Treas. Reg. § 1.901-2(b)(4)(i)(D).

76 Treas. Reg. § 1.901-2(b)(4)(i)(C)(1). Costs and expenses related to capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation are always treated as significant costs or expenses for purposes of the cost recovery requirement.

is consistent with any principle underlying the disallowances required under the Code, including the principles of limiting base erosion or profit shifting and public policy concerns.[77] A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered earlier or later than they are recovered under the Internal Revenue Code unless the time of recovery is deferred long enough to effectively deny such recovery.[78]

iv. Attribution

The "**attribution requirement**" (or jurisdictional nexus requirement) generally would be satisfied with respect to a foreign tax imposed on worldwide gross receipts of a resident of the foreign jurisdiction, provided that any allocations between the resident and its affiliates pursuant to transfer pricing rules must be determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.[79]

The attribution requirement generally would be satisfied with respect to a foreign tax imposed on nonresidents of the foreign jurisdiction if (A) the gross receipts and costs that are included in the base of the foreign tax are attributable, under reasonable principles, to the activities within the foreign country imposing the tax or (B) the amount of gross income arising from gross receipts (other than from the disposition of property) included in the base of the foreign tax on the basis of source is limited to gross income from sources within the foreign country imposing the tax, and the sourcing rules are reasonably similar to those under the Code.[80]

d. Soak-Up Tax Limitation

A foreign tax is not a "foreign income tax" to the extent it depends on the availability of a credit against income tax liability to another country.[81] A foreign tax depends on the availability of a credit only if and to the extent that the foreign tax would not be imposed but for the availability of such credit.

The soak-up tax limitation under the 1983 regulations is applied in two Revenue Rulings. First, in Rev. Rul. 87-39, a Uruguayan tax imposed on dividends and profits paid to non-Uruguayan shareholders was found to be a soak-up tax because it was imposed *only if* the shareholder's jurisdiction allowed the tax to be credited against the shareholder's income tax liability. Second, in Rev. Rul. 2003-8, a Costa Rican withholding tax on income paid to persons operating or residing outside of Costa Rica was found to be a soak-up tax because the Costa Rican

[77] *Id.*

[78] Treas. Reg. § 1.901-2(b)(4)(i)(C)(3).

[79] Treas. Reg. §§ 1.901-2(b)(5), -2(b)(5)(ii). *See also* T.D. 9959, 23 - 30.

[80] Treas. Reg. § 1.901-2(b)(5)(i)(A) and (B). The attribution requirement also is satisfied for a tax imposed on gains of a nonresident from sales of certain property that has a situs in the taxing jurisdiction. Treas. Reg. § 1.901-2(b)(5)(i)(C).

[81] Treas. Reg. § 1.901-2(e)(6)(i).

tax authority was entitled to grant a total or partial exemption if such person established that a credit for such withholding tax is not granted in its home jurisdiction (i.e., such tax was mandatorily imposed *only if* such a credit was afforded in the taxpayer's home country; if no such credit was provided by the home country, the taxpayer would potentially be exempt from the tax, although the Costa Rican authority could theoretically deny the exemption).

No authority has held that a tax that applies even if a direct or indirect shareholder is not afforded a credit is a soak-up tax; the *only if* criteria in the definition of a soak-up tax generally is a narrow test.[82]

B. QDMTT

In this section, we analyze the potential creditability of the QDMTT under the requirements described above, and we propose potential clarifications of regulations issued under Section 901 to confirm the creditability of QDMTT in appropriate circumstances.[83]

1. Realization

Like the other Pillar 2 taxes, a QDMTT is imposed on Excess Profits.[84] Excess Profits require GloBE Income. GloBE Income is Financial Accounting Net Income, subject to a series of complex adjustments described in more detail in Part IV.B.1.d below.[85]

Financial Accounting Net Income is the net income of a CE (before any consolidation adjustments related to intra-group transactions) in preparing the Consolidated Financial Statements of the Ultimate Parent Entity. Consolidated Financial Statements generally are the financial statements prepared by an entity in accordance with IFRS, or GAAP in certain jurisdictions, in which the assets, liabilities, income, expenses and cash flows of that entity and its controlled affiliates are presented as a single economic unit.[86] Therefore, income generally is realized for

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[82] *But see* Treas. Reg. § 1.901-2(e)(6)(ii)(B) Example 2.

[83] To the extent a jurisdiction adopts an IIR that applies domestically, such an IIR is analytically comparable to a QDMTT and the discussion in the Report regarding the creditability of a QDMTT would apply equally to such a domestically imposed IIR. In a similar vein, it is possible that a jurisdiction would attempt to adopt a QDMTT that applies solely to the extent a tax would otherwise be charged under an IIR or UTPR. Whether such a tax would actually qualify as a QDMTT under the Pillar 2 rules is uncertain since it does not appear to "reliably produce . . . an incremental liability for Top-up Tax that is equivalent to the Top-up Tax liability that would have arisen under the GloBE Rules." Art. 5.1.2 of the Administrative Guidance. However, to the extent that a QDMTT was contingent on the application of an IIR or UTPR, we would recommend treating the portion the QDMTT that is imposed in lieu of an IIR or a UTPR as the actual imposition of an IIR or UTPR, as applicable, for purposes of applying Section 901.

[84] Art. 10.1.1 (definition of "Qualified Domestic Minimum Top-up Tax").

[85] Art. 3.1.1. *See* Art. 3.1.2 (defining Financial Accounting Net Income as "the net income or loss determined for a CE (before any consolidation adjustments eliminating intra-group transactions) in preparing Consolidated Financial Statements of the UPE.").

[86] Art. 10.1.1 (definitions of "Consolidated Financial Statements" and "Acceptable Financial Accounting Standard"). Consolidate Financial Statements may also be prepared on a basis other than IFRS and GAAP in such jurisdictions, if they are subject to adjustments to prevent any "Material Competitive Distortions". *Id.*

QDMTT purposes when it is realized for "book" purposes, including under IFRS or GAAP in certain circumstances.

a. IRC Realization

A QDMTT would satisfy the realization requirement if it is imposed on or after the occurrence of events that result in IRC realization of the relevant income. Unless the insignificant item exception applies, IRC realization would require strict legal conformity between the realization principles of the foreign law implementing the QDMTT and the Code.

Calculating income for tax and for book purposes differs in material respects. A purpose of calculating book income generally is to measure the economic income of the enterprise under a transparent and consistent methodology. Taxable income may also measure a taxpayer's economic income,[87] but its calculation deviates intentionally from book income in certain respects for purposes of administrative convenience, encouraging certain activities and collecting revenues.[88]

b. GloBE Income and IRC realization generally

Taxpayers using the accrual method of accounting, which should represent the vast majority of U.S. taxpayers affected by Pillar 2, generally realize gross income no later than the date that the "all events test" is met.[89] Under the 2017 law known as the Tax Cuts and Jobs Act (the "**TCJA**"), the all events test was revised to provide it is met no later than the date the relevant income is taken into account as revenue in the taxpayer's applicable financial statements ("**AFS**").[90] A taxpayer's AFS generally include a financial statement that is prepared in accordance with GAAP or IFRS and is (1) if prepared under GAAP, a 10-K or other annual shareholder statement filed with the SEC, (2) if prepared under IFRS, a statement filed with an equivalent foreign agency that has reporting standards "not less stringent" than the SEC's or (3) an audited financial statement used for credit purposes, reporting to the taxpayers' owners or beneficiaries or any "substantial nontax purpose."[91] A taxpayer's AFS may be prepared on a consolidated basis.[92]

Additional rules apply if the UPE does not prepare any such financial statements. *Id*. In effect, any such Consolidated Financial Statements generally would need to be prepared in a manner that would result in 75 million euros or less of aggregate variation for the relevant fiscal year, had such financial statements been prepared in accordance with IFRS. Art. 10.1.1 (definition of "Material Competitive Distortion").

87 *See, e.g.*, Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).

88 Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts ¶2.1, 5.2 (WG&L).

89 Treas. Reg. § 1.451-1(a).

90 *See* Section 451(b)(1), as amended by the "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution the budget for fiscal year 2018," P.L. 115-97. Treas. Reg. § 1.451-3.

91 Treas. Reg. § 1.451-3(a)(5).

92 *See* Treas. Reg. § 1.451-3(h).

Because Pillar 2 ordinarily applies only to taxpayers with Consolidated Financial Statements, and because Consolidated Financial Statements generally should overlap with a taxpayer's AFS, GloBE Income (and therefore any QDMTT imposed thereon) generally should meet the IRC realization requirement under the all events test, other than with respect to income items afforded deferral or other separate treatment under the Code, which require additional analysis.

c. Deferral or Separate Treatment Under the Code

Some of the key circumstances in which realization of income may be deferred or otherwise treated separately under the Code include the following:

First, income may be recognized for book purposes before there is an actual or deemed sale or exchange of property for tax purposes.[93] For example, a company owning a minority interest in a subsidiary over which it does not have significant influence may mark those interests to market for book purposes on a quarterly basis.

Second, even where there is an actual or deemed sale or exchange of property for tax purposes, the realization of taxable income or loss may be deferred (and income or loss may be accelerated for book purposes) where a nonrecognition provision applies to such a sale or exchange under the Code.

Third, realization of taxable income or loss may depend on the legal form of the relevant transaction and any related tax elections, while the legal form and any such elections generally are irrelevant for book purposes. For example, an equity acquisition for tax purposes generally does not result in a "step-up" or "step-down" in the target's basis in its assets for tax purposes, but a taxable asset acquisition for tax purposes generally does (including because an election under Section 336(e), 338(g) or 338(h)(10) is made, or because the target is treated as a disregarded entity or a partnership that has made a Section 754 election). For book purposes, any form of business combination generally results in such a step-up or step-down in the target's basis in its assets under purchase accounting.

Fourth, a taxpayer's basis in its assets may differ for book and tax purposes, including for the reasons described above.

Fifth, GloBE Income of a CE may not otherwise be treated as existing under the Code, or may be treated as earned by a separate CE under the Code. For example, where CE-owner owns subsidiary-CE, which is disregarded as separate from CE-owner under the Code, GloBE Income earned by subsidiary-CE will be treated as income of CE-owner under the Code. Payments made by subsidiary-CE to CE-owner may give rise to GloBE Income to CE-owner but would not give rise to income to CE-owner under the Code.

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93 *See* § 1001 and the Treasury regulations thereunder.

d. GloBE Income "Book to Tax" Adjustments

GloBE Income is Financial Accounting Net Income, adjusted to reflect general tax principles of realization common in Inclusive Framework jurisdictions.[94] While these adjustments may make realization of GloBE Income more likely to approximate IRC realization, they do not conform strictly to the Code. We have identified a number of examples of adjustments below, although others may be relevant as well.

First, adjustments are made to defer items of gain or loss realized for book purposes before there is an actual or deemed sale or exchange of such property. For example, mark-to-market gain or loss in interests in certain subsidiaries are subtracted from or added to Financial Accounting Net Income, as applicable, to determine GloBE Income.[95] This adjustment generally accords with IRC realization. On the other hand, gains or losses from the sale of certain Portfolio Shareholdings are subtracted from or added to Financial Accounting Net Income, as applicable, to determine GloBE Income.[96] While such adjustments reflect tax principles under participation or substantial shareholding exemptions implemented in certain Inclusive Framework jurisdictions, such gains or losses generally are treated as realized under the Code.

Second, adjustments are made to defer items of gain or loss from actual or deemed sales or exchanges of property, where such sales or exchanges may qualify for deferral of tax under general tax reorganization principles.[97] For example, gain or loss resulting from a disposition by a CE that qualifies as a "GloBE Reorganisation" is subtracted from or added to Financial Accounting Net Income, as applicable, to determine GloBE Income.[98] A GloBE Reorganisation generally includes a transfer of assets and liabilities, including in a merger, where (a) the consideration is, in whole or in significant part, equity interests issued by the acquiring CE (or a connected person), (b) the disposing CE's gain or loss on those assets is not subject to tax, in whole or in part, and (c) the acquiring CE takes a carryover basis in the assets (adjusted for certain tax gain or loss realized by the disposing CE).[99] Conceptually, a GloBE Reorganisation may overlap with certain reorganizations under Section 368 or contributions subject to tax deferral under Section 351. However, certain transactions could conceivably qualify for at least partial tax deferral under the Code but may not qualify as a GloBE Reorganisation. For example, it is not clear whether a cash boot-rich A reorganization, D reorganization or Section 351 contribution involving one or more non-US CE subsidiaries would meet the GloBE Reorganisation's requirement that the consideration be equity "in significant part." Similar incongruities may arise with respect to a transaction which would be taxable in such a CE's local jurisdiction (and therefore would not be

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94 Commentary to Art. 3.2.1 ¶17, at p. 46.

95 Art. 3.2.1(c). Art. 10.1.1 (definition of "Excluded Equity Gain or Loss").

96 Art. 3.2.1.

97 Art. 3.2.1(e).

98 Art. 6.3.2(a).

99 Art 6.3. Art. 10.1.1 (definition of "GloBE Reorganisation").

a GloBE Reorganisation) but which satisfies the requirements for tax deferral under Section 368 or Section 351. IRC realization could lag GloBE Income realization in such cases.

Third, adjustments are made to calculate GloBE Income using historical book bases (or "carrying values") in certain business combinations, rather than stepped-up or stepped-down book bases under purchase accounting. An acquiring CE in a GloBE Reorganisation determines its GloBE Income or Loss after the acquisition using the disposing entity's carrying values of the acquired assets and liabilities.[100] However, due to the differences in GloBE Reorganisations and tax deferral transactions under the Code, and because a disposing entity's carrying value in its assets and liabilities may not equal their bases under the Code, the acquiring entity's GloBE Income or Loss may similarly lag IRC realization. Moreover, no rule adjusts an acquiring entity's GloBE Income or Loss to take into account basis step-ups or step-downs that exist solely for U.S. federal income tax purposes (including because an election under Section 336(e), 338(g) or 338(h)(10) is made, or because the target is treated as a disregarded entity or a partnership that has made a Section 754 election).

e. Corporate Alternative Minimum Tax

The corporate alternative minimum tax under Sections 53, 55 and 59 of the Code ("**CAMT**") generally imposes a minimum tax on corporations that have annual AFSI (as defined below) in excess of $1 billion over a three-taxable-year period.[101] A corporation's "applicable financial statement income" or "**AFSI**" generally is its net income or loss reported on its AFS, subject to certain adjustments.[102] Because a corporation's net income or loss reported on an AFS is the starting point for computing AFSI, and because some of the adjustments to such net income or loss are of the same "book-to-tax" nature as those made to derive GloBE Income or Loss from Financial Accounting Net Income, analyzing realization of GloBE Income or Loss in light of IRC realization under CAMT may not raise some of the questions regarding deferral or separate treatment analyzed above in Part IV.B.1.c and IV.B.1.d. However, an MNE Group may be subject to a QDMTT (or other Pillar 2 tax) without being subject to CAMT. This could occur, for example, because the CAMT revenue threshold is different than the revenue threshold at which an MNE Group becomes subject to Pillar 2. There are also a range of differences in what income is treated as realized for purposes of computing a corporation's AFSI as compared to its GloBE Income and Loss, due to the importation of significant portions of the regular income tax regime into the rules for computing AFSI.

f. Insignificant Item Exception

The potential differences between GloBE Income realization and IRC realization above are examples of certain of the key differences. In view of these differences, a QDMTT (and the other Pillar 2 taxes) generally might not satisfy a strict application of the IRC realization test, unless the insignificant item exception applied. To satisfy the insignificant item exception, GloBE Income

[100] Art. 6.3.2(b).

[101] *See* Sections 55, 56A and 59(k)(1)(B)(i).

[102] *See* Section 56A(c).

attributable to nonrealization events under the Code would need to be insignificant relative to the gross receipts that satisfy IRC realization, based on the application of the QDMTT to all taxpayers in the relevant foreign jurisdiction. Due to the potential breadth of differences in realization under Pillar 2, it appears questionable whether taxpayers or Treasury will be able to test the application of the insignificant item exception to a QDMTT (or other Pillar 2 taxes) in the near future.

g. Policy Considerations

The realization requirement serves two purposes: (1) to help distinguish between an income tax and a non-income tax and (2) to help ensure that a credit is not afforded prematurely.[103] Prior to the issuance of the 2022 final regulations, Treasury regulations never required strict conformity between realization for foreign income tax purposes and IRC realization—rather, realization was tested under the predominant character standard. Case law predating the 1983 Treasury regulations similarly tested realization under the substantial equivalent standard.[104]

There seems to be no compelling policy reason to treat a QDMTT as failing the realization requirement on the grounds that it is more akin to a non-income tax than an income tax, as a QDMTT generally is imposed on gross receipts less certain costs recovered, as described in further detail in Parts IV.B.2 and IV.B.3 below. Similarly, relatively recent legislation to treat income realized for book purposes as realized for tax purposes, including the modifications to the all events test described above in Part IV.B.1.a and the enactment of CAMT, would endorse that Financial Accounting Net Income is realized in a substantially equivalent manner to income under the Code. Without specifically analyzing the realization requirement, courts have concluded that foreign taxes on profits calculated using financial accounting principles are creditable under Section 901.[105]

Moreover, while the book-to-tax adjustments to derive GloBE Income from Financial Accounting Net Income may accelerate realization of GloBE Income compared to IRC realization in certain circumstances, there are also circumstances in which deferral may too result. It is possible that this combination of acceleration of some items and deferral of others would mean that treating the QDMTT as satisfying the realization requirement would not raise the policy concern that any related credit would be allowed "prematurely," although the precise contours of such a determination are somewhat uncertain under the Treasury regulations as currently drafted.

h. Recommendation

Taking into to account the policy underpinning the foreign tax credit regime generally, the realization requirement specifically, and the judicial and administrative authorities under Section 901, we believe it is reasonable to treat a QDMTT as satisfying the realization requirement. However, we acknowledge that the QDMTT may not clearly satisfy a strict interpretation of the

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103 *See, e.g.*, Motland v. United States, 192 F. Supp 358 (N.D. Iowa 1961).

104 *See* Rev. Rul. 78-61, citing Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (3d Cir. 1943), Comm'r v. American Metal Co., 221 F.2d 134 (2d Cir. 1955) and Lanman & Kemp-Barclay & Co. of Colombia v. Comm'r, 26 T.C. 582 (1956).

105 *See* PPL v. Comm'r. at 1901.

realization requirement, as implemented in the 2022 final regulations, unless the insignificant item exception applies. Testing the insignificant item exception would require taxpayers and Treasury to undertake the type of potentially costly and complex analysis that the 2022 final regulations were intended to avoid. Given this uncertainty and potential cost and complexity, we recommend revising the realization requirement in the Treasury regulations to either include an example or a safe harbor providing that a QDMTT satisfies the realization requirement. We believe this approach, and the approach we recommend with respect to the other net gain elements discussed herein, would benefit both Treasury and taxpayers in ensuring the clear application of the Section 901 rules.

2. Gross Receipts

As described above, the base on which a QDMTT is imposed begins with GloBE Income, and GloBE Income is Financial Accounting Net Income, subject to certain "book-to-tax" adjustments. As such, the QDMTT should be imposed on actual gross receipts of an MNE Group's CEs in the relevant jurisdiction.

3. Cost Recovery

A QDMTT would satisfy the cost recovery requirement if the gross receipts it is imposed on are further reduced for significant costs and expenses that are attributable, under reasonable principles, to such gross receipts.

a. Significant Costs and Expenses

As described above, the base on which a QDMTT is imposed begins with GloBE Income, and GloBE Income is Financial Accounting Net Income, subject to certain "book-to-tax" adjustments. Financial Accounting Net income is the *net* income of a CE (before any consolidation adjustments related to intra-group transactions) under the UPE's Consolidated Financial Statements. The book-to-tax adjustments required to arrive at CE's GloBE Income generally do not add-back a CE's costs and expenses in a manner such that GloBE Income would be gross of many items of cost and expense.

Certain costs and expenses are added back in determining GloBE Income or Loss (i.e., such costs and expenses are not treated as recovered for purposes of determining the relevant GloBE Tax). For example, GloBE Income or Loss excludes any expense attributable to certain "Intragroup Financing Arrangements" that can reasonably be anticipated to increase the amount of expenses taken into account to determine GloBE Income or Loss of a Low-Taxed CE without resulting in a commensurate increase in the taxable income of a high-tax CE.[106] That is, intercompany financing payments that would increase the ETR of a Low-Taxed CE (and therefore would decrease the potential GloBE Tax) at no tax cost to the MNE Group are added back to determine the payor-CE's GloBE Income. Certain illegal payments and fines and penalties are also added back in determining GloBE Income or Loss as "Policy Disallowed Expenses."[107]

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[106] Art. 3.2.7.

[107] Art. 3.2.1(g).

However, foreign tax law satisfies the cost recovery requirement even if recovery of all or a portion of certain costs and expenses is disallowed, if such disallowance is consistent with Code principles, including the principles of limiting base erosion or profit shifting and public policy concerns.[108]

Other costs and expenses are added back in determining GloBE Income or Loss due to the overall structure of Pillar 2. For example, loss from a GloBE Reorganization or from the sale of certain Portfolio Shareholdings[109] generally are added back, whereas losses attributable to identical transactions may not be added back to determine taxable income under the Code.[110]

A cost or expense is significant for purposes of the cost recovery requirement if, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayer's total costs and expenses.[111] Analysis of whether costs or expenses are significant raises potential complexities and concerns identical to those described in Part IV.B.1.f above for the insignificant item exception to the realization requirement.

b. Blending of CEs' Jurisdictional GloBE Loss

GloBE Income is further refined to reach the base on which a QDMTT is imposed. GloBE Income for all CEs in a relevant jurisdiction generally first is summed and is then reduced by the GloBE Losses of all other CEs in such jurisdiction to reach Net GloBE Income. The QDMTT generally is imposed on the Net GloBE Income of such CEs, less any jurisdictional SBIE (i.e., on Excess Profits).

> Example 2. U.S. Parent ("USP") owns 100% of the stock of CFC1 and CFC2, which are sibling companies. CFC1 and CFC2 are organized in Country X, which has adopted the Pillar 2 rules and imposes an QDMTT. In addition, (1) none of CFC1 or CFC2 has any SBIE, (2) CFC1 earns \$100 of GloBE Income, and (3) CFC2 has \$50 of GloBE Loss. Neither CFC1 nor CFC2 pays any income tax prior to the application of the QDMTT.
>
> CFC1's GloBE Income of \$100 is reduced by CFC2's GloBE Loss of \$50 to reach Country X Net Globe Income of \$50. The QDMTT

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[108] Treas. Reg. § 1.902-2(b)(4)(i)(C)(1). The base erosion and anti-abuse tax under Section 59A operates by denying deductions to the payor in such an intercompany financing arrangement in a somewhat similar manner.

[109] *See* Art. 10.1.1 (defining Portfolio Shareholding as "ownership interests in an entity that are held by the MNE Group and that carry rights to less than 10% of the profits, capital, reserves, or voting rights of that Entity at the date of the distribution or disposition.").

[110] *See* Part IV.B.1.d, *supra*.

[111] Treas. Reg. § 1.901-2(b)(4)(i)(C)(i).

equals $7.50 (i.e., the 15% Minimum Rate multiplied by $50). Assume all of such QDMTT is imposed on CFC1.[112]

In Example 2, the blending of GloBE Loss could potentially be viewed as attributing the significant costs and expenses of one foreign taxpayer to another for purposes of determining the latter's foreign tax base. Moreover, this attribution of costs and expenses can occur such that costs and expenses of a foreign taxpayer that are not incurred, indirectly, by a U.S. shareholder nonetheless reduce such U.S. shareholder's indirect share of a QDMTT.

> Example 3. Assume the same facts as in Example 2 above, except that a domestic corporation ("USP2") that is unrelated to USP owns 49% of the stock of CFC1, and that USP owns 51% of the stock of CFC1.
>
> CFC1's GloBE Income of $100 is reduced by CFC2's GloBE Loss of $50 to reach Country X Net Globe Income of $50. The QDMTT equals $7.50 (i.e., the 15% Minimum Rate multiplied by $50). All of such QDMTT may be imposed on CFC1, 49% of which would be borne, indirectly, by USP2.

Query whether the blending of jurisdictional GloBE Loss in determining the QDMTT applicable to a GloBE Taxpayer means that the QDMTT's base is not computed by reducing gross receipts by significant costs and expenses attributable to such gross receipts, as would be required to satisfy the cost recovery requirement. If one views the QDMTT imposed on an MNE Group by a jurisdiction as a single separate levy imposed on Net GloBE Income in such jurisdiction, irrespective of how it is subsequently apportioned among the various CEs in such jurisdiction, such costs and expenses (i.e., the blended GloBE Losses of such jurisdiction) would seem clearly to be attributable to such gross receipts (i.e., the blended GloBE Income of such jurisdiction). On the other hand, viewed from the lens that QDMTT apportioned among individual GloBE Taxpayers in a jurisdiction may be calculated on the basis of one taxpayer's gross receipts less another's costs and expenses, it may be less clear such attribution requirement is satisfied.

However, the cost recovery requirement provides that "it is immaterial whether foreign tax law permits . . . consolidation of profits and losses of related persons, unless foreign tax law requires separate entities to be used to carry on separate activities in the same trade or business."[113] Moreover, the Treasury regulations provide that a foreign tax that is imposed on the combined income of two or more persons is allocated among, and considered paid by, such persons on a *pro*

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[112] Pillar 2 affords jurisdictions some flexibility in allocating legal liability for a QDMTT among the CEs in the relevant jurisdiction. *See* Art. 5.1.3 of the Administrative Guidance. This point is discussed further in Part IV.E.2 below.

[113] Treas. Reg. § 1.901-2(b)(4)(i)(D)(ii). The Treasury regulations also provide that "if foreign tax law provides an option or election for one foreign entity to . . . surrender its loss in order to offset the income of another foreign entity pursuant to a foreign group relief or other loss-sharing regime, a taxpayer's decision whether to . . . surrender a loss, or whether to use a surrendered loss, is not considered to increase the taxpayer's liability" for purposes of the compulsory payment requirement. Treas. Reg. § 1.901-2(e)(5)(iii)(B)(2).

rata based on their respective portions of the combined income, as determined under foreign law.[114] Any such foreign tax regime would seem to permit the expenses of one taxpayer to reduce the taxes of another.

Therefore, the Treasury regulations under Section 901 presuppose that the shifting of costs and expenses among related foreign taxpayers for purposes of calculating a foreign income tax does not preclude creditability, and the fact that GloBE Loss may be blended among CEs in a jurisdiction should not prevent the QDMTT from satisfying the cost recovery requirement.

c. SBIE

Once the Net GloBE Income for a jurisdiction is determined, it is then reduced by the SBIE of all CE's in the relevant jurisdiction to determine Excess Profits.[115] The QDMTT is imposed on Excess Profits.

Somewhat similar to a U.S. shareholder's net deemed tangible income return ("**NDTIR**") for purposes of calculating GILTI, SBIE generally is calculated a percentage of a CE's payroll costs and tangible assets.[116] SBIE is not cost recovery—it is a fixed percentage of costs that have already been recovered (e.g., payroll) and costs that may be recovered in the future (e.g., tangible assets). Rather, SBIE sets the ceiling at which a CE's return on its substantive activities within a jurisdiction are assumed to stop; inversely stated, SBIE sets the floor at which a CE's returns within a jurisdiction are assumed to result from base erosion or profit shifting.[117]

There are aspects of the reduction of Net GloBE Income by the SBIE (i.e., the policy-driven floor) that are unorthodox. Similar to the jurisdictional blending of GloBE Income and Loss, these aspects spring from the overall structure of Pillar 2. In practice, the SBIE attributable to one CE's SBIE in such jurisdiction could reduce the QDMTT payable by another CE in such jurisdiction, if a jurisdiction apportions QDMTT in such a manner. Consider the following example:

> Example 4. U.S. Parent ("USP") owns 100% of the stock of CFC1 and CFC2, which are sibling companies. Assume that CFC1 and CFC2 are organized in Country X, which has adopted the Pillar 2 rules and imposes an QDMTT. Further assume that (1) CFC1 earns $100 of GloBE Income, (2) CFC2 earns $50 of GloBE Income, (3) CFC1 has $50 of SBIE and CFC2 has $0 of SBIE, and neither CFC1 nor CFC2 pays any income tax prior to the application of the QDMTT.

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[114] *See* Treas. Reg. § 1.901-2(f)(3).

[115] *See* Art. 10.1.1 (definition of "Qualified Domestic Minimum Top-up Tax"), Art. 5.2.2 and Art. 5.3.

[116] *See* Art. 5.3.

[117] *See* Introduction to Commentary to Art. 5.3 ¶25, at p. 119.

> CFC1 and CFC2's GloBE Income is summed to $150 and is reduced by $50 of CFC1's SBIE to reach $100 of Country X Net GloBE Income. The QDMTT equals $15 (i.e., the 15% Minimum Rate multiplied by $100). Two-thirds of such QDMTT ($10) may be imposed on CFC1 and the remaining one-third of such QDMTT may be imposed on CFC2 ($5). If such jurisdictional blending did not occur and CFC1's SBIE reduced only its GloBE Income, and the QDMTT were apportioned based on CFC1 and CFC2's respective Excess Profits, CFC1 and CFC2 would each pay $7.50 of QDMTT.

We do not believe that this unorthodox aspect of the Pillar 2 rules vitiates the QDMTT's status as an income tax under Section 901. The blending of the SBIE among CEs in the relevant jurisdiction results from deliberate policy considerations that underpin Pillar 2 generally: imposing a minimum tax on a jurisdictional basis,[118] exempting a deemed return on certain activities and assets that do not present a meaningful profit-shifting, calculating such tax using Consolidated Financial Statements to support uniformity, and reducing compliance costs.[119] Although SBIE is not a cost recovery, this sharing of SBIE among entities in a jurisdiction appears similar, as a conceptual matter, to the sharing of costs or expenses among entities in a jurisdiction pursuant to a consolidation or loss sharing regime, which is expressly recognized by the Section 901 regulations as described in Part IV.B.3.b. Moreover, such sharing would not seem to raise any policy considerations which would militate against creditability under Section 901.

d. Recommendation

We believe that the QDMTT in principle should satisfy the cost recovery requirement. However, similar to the realization requirement, we believe the regulations should be revised to provide a clear way to reach that conclusion without needing to establish that only insignificant costs and expenses are nonrecoverable, as that would be a potentially costly and complex undertaking. Moreover, while we believe the Treasury regulations do not prevent the cost recovery requirement from being satisfied due to the jurisdictional blending of GloBE Loss and SBIE, there is a lack of clear written authority in the cost recovery requirement itself mandating such outcome. Accordingly, we recommend revising the cost recovery requirement in the Treasury regulations to either include an example or a safe harbor confirming that a QDMTT satisfies the cost recovery requirement.

4. Attribution

A QDMTT is both determined based on the Excess Profits of CEs in a given jurisdiction and is imposed on CEs in such jurisdiction. Moreover, Net GloBE Income generally is not determined by allocating income or loss between affiliates located in different jurisdictions under non-arm's length principles, which could violate the attribution requirement. Rather, any transaction between CEs located in different jurisdictions that are not consistent with the "Arm's

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[118] *See* Introduction to Commentary ¶1, at p. 8.

[119] *See* Introduction to Commentary ¶7, at p. 9.

Length Principle" must be adjusted so as to be in the same amount and consistent with the Arm's Length Principle.[120] Therefore, the QDMTT should satisfy the attribution requirement.

5. Soak-Up Tax Limitation

A QDMTT is imposed irrespective of whether a credit for such tax is afforded in another jurisdiction (i.e., it is not imposed *only if* such a credit is available). Therefore, a QDMTT would not be a soak-up tax. Nonetheless, a QDMTT could be akin to a classic soak-up tax in effect, depending on the ultimate application of the push-down of Covered Taxes under a CFC Tax Regime to determine a QDMTT.

Covered Taxes imposed on a CE-owner's share of the subsidiary-CE's income under a CFC Tax Regime generally are "pushed-down" to such subsidiary-CE and are treated as Covered Taxes of the subsidiary-CE, not the CE-owner.[121] As illustrated by Example 1 above, this push-down generally increases the ETR of the subsidiary-CE, and therefore generally decreases any jurisdictional Top-up Tax imposed on the subsidiary-CE. If such push-down is required to be taken into account *before* calculating a subsidiary-CE's QDMTT, crediting any foreign income taxes paid by such subsidiary-CE against such CE-owner's CFC taxes reduces the amount of Covered Taxes pushed-down to subsidiary-CE, which decreases its ETR and increases its QDMTT. However, the Administrative Guidance provides that a QDMTT shall exclude tax paid or incurred by a CE-owner under a CFC Tax Regime.[122]

On that basis, the QDMTT should not be a soak-up tax or raise the concerns discussed in Part III.D above or Part IV.C.5 below with respect to the IIR.

6. Conclusion

We believe that a QDMTT should qualify as a creditable foreign income tax under Section 901, on the basis that it satisfies the net gain requirement. While we believe that the 2022 final regulations, as drafted, generally accord with this view, we believe that certainty can be provided (and therefore costs of compliance can be decreased) to both taxpayers and Treasury by revising the 2022 final regulations as recommended above.

C. IIR

In this section we analyze the potential creditability of the IIR under the requirements described above, and we propose potential clarifications of the net gain rules under the Section 901 regulations to confirm its creditability as a general matter. We also propose a new rule under

[120] Art. 3.2.3, Art. 10.1.1 (defining Arm's Length Principle as "the principle under which transactions between [CEs] must be recorded by reference to the conditions that would have been obtained between independent enterprises in comparable transactions and under comparable circumstances.").

[121] *See* Art. 4.3.2.

[122] *See* Art. 5.1.2 of the Administrative Guidance ¶118.28, at p. 105.

such Treasury regulations that would deny creditability where failing to do so would cede the U.S. international tax regime's residual taxation to a Pillar 2 jurisdiction.

1. Realization

a. CFC Realization

Like the QDMTT, imposition of the IIR begins with GloBE Income. Therefore, the same analysis (and our same recommendations) described in Part IV.B.1 above apply with respect to the IIR. A key difference between the IIR and the QDMTT, however, is that the IIR generally is imposed on a Parent Entity in respect of Net GloBE Income of subsidiary-CEs resident in one or more jurisdictions different than the Parent Entity's jurisdiction. Such Net GloBE Income generally would not satisfy the general IRC realization test at the CE-owner level at the time of the relevant levy.

In this regard, the IIR resembles a tax imposed by a jurisdiction under a CFC regime on a company resident in such jurisdiction that owns a low-taxed subsidiary in another jurisdiction. The 2022 final regulations contemplate a special application of the realization requirement with respect to taxes imposed under foreign jurisdictions' CFC regimes under the "CFC realization" test.[123] Under CFC realization, the Parent Entity would be treated as satisfying the realization requirement if (A) the IIR imposed on such Net GloBE Income relates to a deemed distribution or income inclusion (e.g., under a CFC regime) of amounts that meet the realization requirements in the hands of the subsidiary-CE and are deemed distributed by such subsidiary-CE, and (B) the Parent Entity's jurisdiction does not later impose a second tax, without credit, on the relevant income. Whether the IIR satisfies CFC realization raises important considerations concerning the basic nature of the IIR.

While the IIR imposed relates to Net GloBE Income from a subsidiary-CE that we believe should, at least as a policy matter, be treated as realized in the hands of such subsidiary-CE (see Part IV.B.1.h above), the subsidiary-CE is not deemed to distribute such amounts to its Parent Entity under Pillar 2. Indeed, despite its name, the IIR is not in fact an income inclusion regime: the relevant Parent Entity does not have any type of income inclusion that adds to its overall taxable income. Rather, the Parent Entity pays a Top-up Tax based on its share of a subsidiary-CE's income, deductions and other relevant items that arise in the jurisdiction in which such subsidiary-CE is tax resident.

The wording of the CFC realization test fits somewhat awkwardly with this construct. First, whether it is a strict requirement of such test that the foreign CFC regime must deem the foreign CFC to distribute the amounts realized in its hands arguably is unclear. The concept that CFC realization can be satisfied by either "a deemed distribution (e.g., by a corporation to a shareholder) *or inclusion (for example, under a controlled foreign corporation inclusion regime)*" would seem unusually drafted, if a deemed distribution were a strict requirement; however, the

[123] *See* Treas. Reg. § 1.901-2(b)(2)(i)(C)(3) (testing realization in the case of "a deemed distribution (for example, by a corporation to a shareholder) or inclusion (for example, under a controlled foreign corporation inclusion regime) of amounts (such as earnings and profits) that meet the realization requirement in paragraph (b)(2) of this section in the hands of the person that, under foreign tax law, is deemed to distribute such amounts").

words just quoted are immediately followed by the phrase "of amounts (such as earnings and profits) that meet the realization requirement in the hands of the foreign person that, under foreign tax law, *is deemed to distribute it*." The most sensible reading would seem to be that a CFC inclusion regime satisfies this aspect of CFC realization, provided the amounts are realized in the relevant CFC's hands, regardless of whether foreign tax law stipulates that there is a deemed distribution by it.

CFC realization in the 2022 regulations is a reformulation of a rule in the 1983 regulations that treated the realization test as satisfied where "deemed distributions" are included in income by a shareholder under foreign tax law.[124] CFC realization is designed to permit crediting of taxes imposed under foreign CFC regimes that have the predominant character of taxes imposed under the subpart F rules, which, in certain respects, tax a U.S. shareholder as if it received a deemed distribution of income from one or more CFCs.[125] However, the international tax principles under the Code have developed considerably since the "deemed distribution" rule was first conceived in 1983. Most notable are the TCJA changes that generally moved U.S. international taxation away from a system that deferred realization of a corporate U.S. shareholder's income from its CFCs until repatriation (at which point it was taxed as a dividend) to a system which generally taxes a portion of such income when realized as GILTI, but which generally eliminates repatriation taxation under the Section 245A participation exemption. Due to these changes, the relevance of a deemed distribution under a CFC regime to realization "in the U.S. sense" is now limited.[126] Thus, the insertion in the 2022 regulations of the "or inclusion" phrase quoted above appears to be

[124] *See* Treas. Reg. § 1.901-2(b)(2)(ii) of the 1983 regulations (A foreign tax is "considered to meet the realization requirement if it is imposed with respect to a deemed distribution (e.g., by a corporation to a shareholder) of amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount."). The preamble to the 2020 proposed regulations under Section 901 stated that "§ 1.901-2(b)(2)(i)(C) consolidates the rules relating to pre-realization timing differences, including the rule currently in § 1.901-2(b)(2)(ii) that foreign taxes imposed on a shareholder on deemed distributions or inclusions (such as inclusions similar to those imposed by U.S. law under subpart F) of income realized by the distributing entity satisfy the realization requirement." Federal Register Vol. 85, No. 219, November 12, 2020, 72085.

[125] *See id*. and § 951(a)(1)(A) and (a)(2)(A) (generally providing that a U.S. shareholder includes in income his *pro rata* share of a CFC's subpart F income for such year, determined as if such CFC had distributed such subpart F income to its shareholders on the last day of its taxable year). *See also* Section 952(c)(1)(A) and Treas. Reg. § 1.952-1(e) (generally limiting a U.S. shareholder's inclusion of subpart F income to the relevant CFC's earnings and profits). *But see* Rodriguez v. Comm'r, 722 F.3d 306 (5th Cir. 2013) (holding that subpart F inclusions are not deemed dividends).

[126] Following the TCJA, a U.S. shareholder's realization of GILTI income is not limited to a CFC's earnings and profits. *See* § 951A. In that respect, realization of GILTI is significantly different from realization of a deemed distribution. In addition, whether a CFC's income is treated as "realized" to a corporate U.S. shareholder when distributed may not affect such U.S. shareholder's net taxable income; Section 245A generally would allow a dollar-for-dollar deduction for many, if not most, of such distributions. In that sense, the U.S. international tax system has moved closer towards the international tax systems in Inclusive Framework jurisdictions that implement the participation or substantial shareholding exemptions discussed above.

a deliberate decision to affirm that a foreign CFC regime need not specifically provide for a notional distribution to a shareholder.[127]

However, as noted, the IIR does not provide for any type of income inclusion (deemed distribution or otherwise) by the Parent Entity of a Low-Taxed CE. From one perspective, the lack of a formal increase to the Parent Entity's taxable income for Pillar 2 purposes does not seem to be a substantive departure from an actual income inclusion under a traditional foreign CFC regime. The IIR in effect simply skips the step of adding to the Parent Entity's income an inclusion with respect to the Low-Taxed CE, and then subjecting the Parent Entity to tax on such income; rather, Pillar 2 calculates the Top-up Tax based on the Low-Taxed CE's Net GloBE Income (or, more precisely, its Excess Profits), and imposes such Top-up Tax as an IIR on the Parent Entity based on its "Inclusion Ratio" for the Low-Taxed CE.[128] Mathematically, this is equivalent to the imposition of a separate levy on the Parent Entity with respect to its Inclusion Ratio share of such Net GloBE Income had it been included in such Parent Entity's income directly. Courts have taken a permissive view toward calculating foreign creditable income taxes in somewhat similar cases of mathematical equivalence.[129]

From another perspective, however, the imposition of the IIR on a Parent Entity can be viewed not as equivalent to tax imposed on an income inclusion of such Parent Entity, but rather as an arbitrary apportionment among the members of the MNE Group of the amount of Top-up Taxes imposed in respect of a Low-Taxed CE's income, under Pillar 2's hierarchical system for dividing up legal liability for such amount of tax among the group members. By comparison, a reasonable view of a foreign CFC income inclusion regime is that the residence country imposes CFC taxes due to a traditionally recognized economic connection between the shareholder of the CFC and the relevant CFC's income, and therefore that the shareholder's tax liability is not coincidental to the broader group's structure. In such cases, the CFC tax can be viewed as being imposed on the CFC shareholder because it derives an indirect economic benefit in its shareholder capacity from the income realized by the CFC. Though foreign law need not provide specifically for a deemed distribution, this basic concept of a shareholder benefit appears to remain part of the CFC realization test.[130]

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[127] Consistent with this view, we note that the foreign tax credit basketing rules contemplate taxes imposed under foreign CFC inclusion regimes that operate "whether or not the foreign law deems the entity's earnings to be distributed," implying that a deemed distribution is not required for CFC realization. *See* Part IV.E.1 *infra*.

[128] *See also* Commentary to Art. 2.2.2 ¶29 at p. 29, providing "The Inclusion Ratio is, in essence, the ratio of the Parent Entity's share of [a Low-Taxed CE's] GloBE Income to its total GloBE Income for the Fiscal Year," further supporting a view that the IIR is akin to an income inclusion regime.

[129] *Cf.* PPL v. Comm'r.

[130] In this regard, we note that the CFC realization test is part of a provision titled "Pre-Realization Timing Difference Events." Consistent with that title, the CFC realization test includes rules which are premised on the concept that upon a subsequent, traditional realization event (e.g., an actual distribution of cash or property to the shareholder, or a sale of CFC shares), the shareholder's tax imposed by the relevant jurisdiction at such time must be reduced, in a manner that recognizes the shareholder has accelerated the inclusion of income which would otherwise be taxed at the time of that subsequent event. *See* Treas. Reg. § 1.901-2(b)(2)(i)(C).

The lack of importance of a shareholder benefit in levying the IIR arguably is highlighted by the push-down of CFC Tax Regime taxes to a Low-Taxed CE. Where a Low-Taxed CE is owned by an intermediate CE-owner which, in turn, is owned by a Parent Entity that is a resident of a jurisdiction that has not enacted Pillar 2 taxes, and the Parent Entity incurs CFC Tax Regime taxes which are pushed-down to the Low-Taxed CE to reduce the Top-up Tax on such CE's Net GloBE Income, the intermediate CE-owner's IIR liability with respect to the Low-Taxed CE is reduced, notwithstanding that the economic benefit that such intermediate CE-owner derives indirectly from the Low-Taxed CE remains the same.

b. Recommendation

On balance, given the resemblance of the IIR to the CFC inclusion regimes expressly mentioned in the CFC realization test, we believe it is reasonable to treat the IIR as being imposed on an income inclusion to the relevant GloBE Taxpayer, despite the differences in the analytical underpinnings of the IIR and traditional CFC inclusion regimes.[131] However, given the ambiguity discussed above, we recommend that (A) the CFC realization rule should be clarified to provide that CFC realization may be satisfied by the IIR or (B) the Treasury regulations should be revised to include an example or a safe harbor providing that an IIR satisfies the realization requirement.

2. Gross Receipts

As described in Part IV.B.2, foreign taxes imposed in respect of Net GloBE Income should satisfy the gross receipts requirement. As an IIR generally is imposed on a CE-owner in respect of Net GloBE Income of a subsidiary-CE, an IIR would satisfy the gross receipts requirement where such CE-owner is deemed to realize such gross receipts under the CFC realization test.[132] Therefore, an IIR should satisfy the gross receipts requirement, provided that it also satisfies CFC realization.

3. Cost Recovery

For the reasons set forth in Part IV.B.3 above, an IIR should satisfy the cost recovery requirement, provided that it satisfies the gross receipts requirement.

4. Attribution

On balance, because the IIR is imposed by the jurisdiction in which the relevant CE-owner resides, and because the IIR is akin to a CFC inclusion regime, it appears the IIR should satisfy the attribution requirement. We note, however, this is not an entirely self-evident conclusion. As indicated above, the IIR resembles a CFC inclusion regime in that it arguably imposes tax on a CFC shareholder with respect to its CFC's low-taxed income. Although the attribution requirement does not expressly reference CFC realization, the Treasury regulations indicate the attribution requirement is satisfied when a tax is imposed by a shareholder's country of residence on amounts satisfying the gross receipts test, which would include amounts realized under a CFC

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[131] As discussed further in Part IV.D.1 *infra*, we do not believe the same is true of the UTPR.

[132] *See* Treas. Reg. § 1.901-2(b)(3)(i)(D).

regime.[133] However, as we also have noted, an IIR can reasonably be viewed as being imposed pursuant to an arbitrary apportionment of Top-up Taxes among an MNE Group, rather than by reason of the CE-owner's economic connection as a shareholder to the income realized by the subsidiary-CE. Viewed from that perspective, the IIR arguably is imposed based on too remote a connection to satisfy the attribution requirement.[134]

Similar to our conclusion with respect to the realization requirement, we believe that despite the differences between the conceptual foundation for an IIR and for traditional CFC inclusion regimes, it is reasonable to treat an IIR as satisfying the attribution requirement due to its resemblance to such CFC regimes. However, as discussed immediately below, in cases where the U.S.'s residual taxing jurisdiction would come into conflict with the residual taxing jurisdiction exercised by a country imposing an IIR, in our view a credit cannot be justified under the established U.S. policies that underlie the foreign tax credit rules.

5. Soak-Up Tax Limitation

Similar to a QDMTT, the IIR is imposed irrespective of whether a credit for such tax is afforded in another jurisdiction, and is therefore not a soak-up tax. Nonetheless, the IIR can be akin to a classic soak-up tax in effect. As discussed in Part III.D above, this results from a structural conflict between Pillar 2 and the U.S. international tax regime, and this conflict raises fundamental questions of when and how to credit Pillar 2 taxes under the U.S. international tax rules.

a. Similarities to a Soak-Up Tax

The IIR is a jurisdictional Top-up Tax and is calculated after Covered Taxes imposed on a CE-owner under a CFC Tax Regime are pushed-down to its subsidiary-CEs. The push-down of CFC Tax Regime taxes can reduce the amount of Top-up Tax payable by the relevant GloBE Taxpayer, which can have an effect similar to a soak-up tax. An example of the CFC push-down is as follows:

> Example 5. USP owns 100% of the stock of CFC1, which in turn owns 100% of the stock of CFC2. Assume that CFC1 is organized in a jurisdiction that has adopted the Pillar 2 rules and imposes an IIR, while CFC2 is organized in a jurisdiction that has not. Further assume that (1) CFC2 has no SBIE and USP has no NDTIR and (2) CFC2 earns $200 of tested income and $100 of Net GloBE Income.
>
> USP is initially subject to GILTI tax of $21, assuming a 50% Section 250 deduction (i.e., $200 x 10.5%). USP's $21 is a "Covered Tax"

[133] *See* Treas. Reg. § 1.901-2(b)(5)(ii). Moreover, the foreign tax credit basketing rules contemplate that taxes imposed under certain CFC inclusion regimes may be creditable. *See* Part IV.E.1 *infra*.

[134] *See* Part IV.D.4 *infra*, discussing a similar issue for the UTPR.

that is pushed-down to CFC2, and as a result CFC1 would not be required to pay any IIR.

By comparison, the U.S. income tax imposed on a U.S. shareholder of a CFC is not always pushed-down for purposes of determining the amount of IIR imposed.

Example 6. The facts are the same as in Example 5 except that USP is instead a U.S. individual. Further, assume for purposes of this example that an IIR is not a creditable foreign income tax.

USP is subject to U.S. federal income tax on CFC2's tested income of $74, assuming USP is subject to the highest marginal federal income tax rate (i.e., $200 x 37%). CFC1 is subject to an IIR equal to $15 (i.e., $100 Net GloBE Income, subject to $0 of pushed-down Covered Taxes because USP is not a member of CFC1 and CFC2's MNE Group, topped-up to the 15% Minimum Rate).

Examples 5 and 6 assume that the IIR is not a creditable foreign income tax. To the extent that an IIR resembles a tax imposed under a foreign CFC regime, which the United States generally treats as eligible for creditability, an argument could be made to treat the IIR as creditable.[135] However, unlike permitting a credit for a traditional foreign CFC regime tax, a soak-up tax effect with complex "circularity" can arise if a U.S. CE-owner is permitted to credit the IIR against its GILTI and subpart F taxes that are pushed-down to determine the amount of such IIR. If the U.S. CE-owner is entitled to a credit for the IIR against such U.S. income taxes, the U.S. CE-owner's GILTI and subpart F taxes that are "pushed-down" would in turn decrease, which would then increase the amount of any such IIR, which would then increase the credit against such CE-owner's GILTI and subpart F taxes, and so on.

As described in Part III.D above, this iterative or "circular" calculation illustrates a fundamental conflict between the Pillar 2 rules and the U.S. international tax regime. That conflict arises because the U.S. international tax regime generally attempts to impose a residual income tax on a U.S. person's *direct and indirect* foreign source income that is under-taxed by one or more foreign jurisdictions, while the Pillar 2 rules generally attempt to impose a residual Top-up Tax on an *MNE Group's* income that is under-taxed by one or more jurisdictions, irrespective of whether the GloBE Taxpayer directly or indirectly derives such income. These differing structures for imposing a residual tax can fundamentally conflict and, by providing credit for an IIR, the United States generally would cede its right to impose such a residual tax to the benefit of the fisc of the GloBE Taxpayer's residence jurisdiction in many circumstances.

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[135] It is arguable that neither the United States nor CFC1's jurisdiction in Example 6 has any closer a connection to CFC2's income than the other, such that permitting a credit for foreign CFC taxes imposed in CFC1's jurisdiction would result in a somewhat arbitrary ceding of the United States' jurisdiction to impose a residual tax on CFC2's earnings to CFC1's jurisdiction; however, and presumably based in part on a goal to reduce double taxation and on the fact that CFC2's income must first be distributed to CFC1 before it can be repatriated to the United States, foreign CFC regime taxes generally are treated as eligible for creditability under Section 901 (and appear to have been so treated since 1983, *see supra* note 124).

The Commentary foresees such a structural conflict and advises that jurisdictions implementing Pillar 2 should not provide a credit for an IIR or UTPR to avoid circularity. There are instances, however, in which providing a credit for an IIR would not raise circularity concerns. For example, taxes imposed under a CFC Tax Regime on an individual or a corporate shareholder that is not a member of the CE's MNE Group are not pushed-down to such CE. Allowing a credit to either such person for an IIR does not result in any circularity. Moreover, failing to allow a credit for an IIR in such circumstances can give rise to double taxation.[136]

> Example 7. U.S. owner 1, a domestic corporation ("US1"), owns 75% of the stock of CFC1 and U.S. owner 2, a domestic corporation ("US2") owns 25% of the stock of CFC1. CFC1 in turn owns 100% of the stock of CFC2. Assume that US1, CFC1 and CFC2 are part of the same MNE Group, and that CFC1 is organized in a jurisdiction that imposes an IIR, while CFC2 is organized in a jurisdiction that has not enacted Pillar 2. CFC2 earns $100 of tested income and $100 of Net GloBE Income. Under local law, CFC2 is not subject to tax on its income.
>
> US1 includes 75% of CFC2's tested income and is subject to GILTI tax of $7.88, assuming a 50% Section 250 deduction and no foreign tax credit for the IIR (i.e., $75 x 10.5%). US2 is subject to GILTI tax of $2.62 on the same basis (i.e., $25 x 10.5%). While US1's $7.88 of GILTI tax is pushed-down to CFC2 as a Covered Tax and effectively reduces any IIR imposed upon CFC1, US2's GILTI tax is not (because US2 is not a member of the US1 MNE Group). Therefore, CFC1 is obligated to pay $7.12 in IIR (i.e., $100 Net GloBE Income, subject to $7.88 of pushed-down Covered Taxes, topped-up to the 15% Minimum Rate). The overall tax liability with respect to CFC2's $100 of Net GloBE Income is $17.62 (i.e., $7.88 payable by US1, $2.62 payable by US2, and $7.12 payable by CFC1). $25 of CFC2's Net GloBE Income is taxed, directly and indirectly, under both the IIR and the GILTI regime in US2's hands because US2's GILTI tax cannot be pushed-down to CFC2.

While a minority owner of an MNE Group that resides in a high-tax jurisdiction can be disadvantaged by Pillar 2's structure, which only takes Covered Taxes of MNE Group members into account in determining Top-up Taxes, there are circumstances in which minority owners of MNE Groups can benefit from such structural aspects of Pillar 2.

> Example 8. Assume the facts are the same as in Example 7, except that US2 is instead foreign owner 2 ("FO2"), an entity organized in a non-U.S. jurisdiction that does not have a CFC Tax Regime analogous to Section 951A. The results are the same as in Example 7, but economically FO2 has arguably received a windfall in that

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[136] *See* Example 11 in Part IV.E.3 *infra*.

> FO2's 25% of the IIR has been reduced as a result of US1's GILTI taxes without any economic cost to FO2. In other words, CFC1 has $7.88 more than it would have had absent US1's GILTI tax, but FO2 has economically benefited by $1.97 (i.e., 25% of $7.88) as a result of such GILTI tax.

As discussed in greater detail below, the direct or indirect equityholders of an entity to which Covered Taxes are allocated under the Pillar 2 rules may consider commercial arrangements (e.g., tax sharing agreements) to take account of this feature of the Pillar 2 rules. However, absent any such commercial arrangement Pillar 2 provides for the economic shifting described in Example 8.

b. Recommendation

Although an IIR is not a true soak-up tax, affording a foreign tax credit for an IIR could lead to a soak-up tax-like result where the IIR is determined after a U.S. shareholder-CE's GILTI or subpart F taxes are pushed-down to a subsidiary-CE. Affording a credit in such circumstances would, at least in part, cede the U.S. international tax regime's taxation of the residual to the Pillar 2 jurisdiction since overall U.S. tax liability would decrease and the IIR would increase. Therefore, we recommend expanding the soak-up tax limitation in the Treasury regulations to provide an analogous rule that a foreign tax is not an "amount of foreign income tax paid" with respect to any U.S. person whose U.S. tax liability is taken into account in measuring the amount of such foreign tax to be imposed.

Such an approach would permit a credit for the IIR, where it is calculated in a manner that is similar to taxes imposed under foreign CFC regimes that do not result in a soak-up tax effect. This form of limitation (rather than denying a credit for the IIR generally) would avoid double taxation. For instance, in a case like that of the U.S. individual in Example 6, the individual would be entitled to a foreign tax credit for the IIR, if they make a Section 962 election; and a non-CE corporate U.S. shareholder of a CFC, like US2 in Example 7, also would be entitled to a foreign tax credit.

6. Conclusion

Similar to the QDMTT, we believe that an IIR should qualify as a creditable foreign income tax under Section 901, to the extent that providing such a credit could not increase the IIR under the laws of the foreign jurisdiction imposing such IIR. Similar to the QDMTT, while we believe that the 2022 final regulations, as drafted, generally accord with this view, we believe that certainty can be provided (and therefore costs of compliance can be decreased) to both taxpayers and Treasury by revising the 2022 final regulations as recommended above. Moreover, we believe that by expanding the soak-up tax limitation as recommended above, that the United States can both maintain its existing residual income tax system and alleviate the potential for double taxation where no concerns regarding the right to tax the residual can arise.

D. UTPR

1. Realization

Like the QDMTT and the IIR, the imposition of the UTPR begins with GloBE Income. However, unlike the QDMTT, the GloBE Income with respect to which the UTPR is charged does not arise in the jurisdiction imposing the UTPR. Furthermore, the UTPR generally does not (at least necessarily) apply to GloBE Income earned directly or indirectly by the GloBE Taxpayer's subsidiary-CEs. Therefore, the UTPR is not akin to a CFC regime. Rather, the UTPR generally applies to income of sibling-CEs of the relevant Low-Taxed CE, as illustrated by the following example.

> Example 9. Foreign Parent ("FP") is organized in Country X, a jurisdiction that does not impose an income tax and that has not enacted Pillar 2. FP owns 100% of foreign subsidiary 1 ("FS1"), which is organized in Country Y, a jurisdiction that has adopted the Pillar 2 rules. FP also owns 100% of foreign subsidiary 2 ("FS2"), which is organized in Country X and generates $100 of Net GloBE Income. FP does not generate any GloBE Income or Loss. Neither FP nor FS2 have any SBIE.
>
> The jurisdictional Top-up Tax with respect to Country X is $15, all of which is allocable to FS2's undertaxed Net GloBE Income. Under the Country Y UTPR, FS1 is disallowed deductions to increase FS1's cash tax liability by $15, notwithstanding that FS1 is neither directly nor indirectly entitled to FS2's income.

It is important to note why it matters whether FS1 is a sibling-CE, rather than a subsidiary-CE, of FS2. Unlike the UTPR, the U.S. international tax regime generally does not impute income from a foreign parent entity or sibling entity to a U.S. corporation. Instead, the U.S. international tax regime generally taxes only foreign source income earned by the U.S. corporation directly, or indirectly through entities in which it owns a stake (i.e., income that accrues to the U.S. corporation's economic benefit either directly, or indirectly as the owner of an equity interest). By comparison, in the case of the sibling-CEs in Example 9 above, FS1 receives no direct or indirect economic benefit from FS2's income, as conventionally understood. It may be the case that FS1 is better off as a result of being part of the MNE Group that includes FS2, because the MNE Group now has more assets that could potentially be invested in FS1. However, this is a benefit that all members of the corporate group enjoy. Such benefit is sufficiently attenuated, and sufficiently different from the benefits that trigger realization of income under the U.S. CFC rules or the rest of the U.S. tax system, that it is difficult to conceive that FS1 realizes income here in the U.S. sense.[137] As such, we believe that the UTPR does not satisfy the realization requirement.

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[137] The same concerns would arise if, in Example 9, FP were the Low-Taxed CE rather than FS2.

2. Gross Receipts

As Example 9 above illustrates, the gross receipts of a GloBE Taxpayer CE, any other CEs in its jurisdiction and any of their direct and indirect subsidiary CEs (for purposes of applying a CFC regime) generally are irrelevant in determining such Globe Taxpayer CE's UTPR. Rather, the gross receipts of sibling-CEs, or even parent entities, of the GloBE Taxpayer CE generally determine the UTPR. Therefore, we believe that the UTPR does not satisfy the gross receipts requirement.

3. Cost Recovery

Similar to the analysis described above with respect to gross receipts, the significant costs and expenses associated with the gross receipts that give rise to the UTPR generally are borne neither directly nor indirectly by GloBE Taxpayer subject to the UTPR, any other CEs in its jurisdiction or any CFCs thereof (under a CFC regime). Therefore, we believe that the UTPR does not satisfy the cost recovery requirement.

Where a UTPR is imposed by denying deductions to the GloBE Taxpayer under the corporate income tax regime of its jurisdiction of residence,[138] it could be asked whether such corporate income tax itself fails the cost recovery requirement, such that none of that tax is eligible for a foreign tax credit. In our view, it is correct to view a UTPR imposed in this manner as a separate levy from the general corporate income tax. The UTPR is imposed on a separate class of taxpayers than the general corporate income tax (i.e., only on CEs in an MNE Group that satisfies Pillar 2's revenue threshold), and also is imposed on a different taxable base.[139] Specifically, the taxable base in such a case is the lesser of (x) an amount of gross income of the GloBE Taxpayer that, when subjected to tax at the general corporate income tax rate, will equal the Top-Up Tax owed with respect to the relevant Low-Taxed CE's Excess Profit, and (y) the amount of the GloBE Taxpayer's gross income that has been offset by deductions under the general corporate income tax rules in the GloBE Taxpayer's residence country. Thus, the general corporate income tax is, or is not, creditable to the same extent it would be if no UTPR had been imposed, and the creditability of the UTPR must be separately analyzed.

4. Attribution

The UTPR can be characterized as reallocating Net GloBE Income from a Low-Taxed CE to the Globe Taxpayer CE, where such Net GloBE Income is taxed by the GloBE Taxpayer's jurisdiction, under principles that violate traditional international tax sourcing norms. The purpose of the attribution requirement generally is to provide that such taxes do not satisfy the net gain requirement and are not creditable foreign income taxes under Section 901.[140] Moreover, the 2022 final regulations include an example in which a foreign tax that is imposed by (1) deeming a

[138] *See* Art. 2.4.1. Imposition of the UTPR in this manner further highlights the absence of a connection between costs and expenses of the GloBE Taxpayer and the determination of the UTPR which it must pay.

[139] *See* Treas. Reg. § 1.901-2(d)(1); *cf.* Treas. Reg. § 1.901-2(d)(3)(vi) Example 6.

[140] *See* T.D. 9959, 26 - 28.

permanent establishment to exist, (2) reallocating a taxpayer's income to such deemed permanent establishment using a method that violates traditional international tax sourcing norms and (3) taxing such reallocated income, is found not to satisfy the attribution requirement.[141] Due to the similarity between the UTPR and such a tax, and because the UTPR is not imposed on income that is allocated to the GloBE Taxpayer under arm's length principles, we believe that the UTPR does not satisfy the attribution requirement.

5. Soak-Up Tax Limitation

Like the IIR and the QDMTT, a UTPR is not a soak-up tax, but can be akin to one in effect for the same reason described in Parts III.D and IV.C.5.a above. It may also give rise to double taxation on the same income.

> Example 10. Assume the same facts as in Example 9, except that FP is owned 75% by U.S. owner 1, a domestic corporation ("US1") and 25% by U.S. owner 2, a domestic corporation ("US2"), neither of which have any NDTIR or other subsidiaries. FS2's $100 of Net GloBE Income also results in $100 of tested income under Section 951A of the Code, with respect to which US1 pays $7.88 after taking into account the deduction under Section 250 (i.e., $75 x 10.5%) and US2 pays $2.62 (i.e., $25 x 10.5%).
>
> Because US1's $7.88 GILTI tax is pushed-down to FS2, the aggregate UTPR liability for FS1 is reduced to $7.12. However, US2's GILTI tax is not pushed-down, and US2's GILTI tax and its indirect share of such UTPR gives rise to double taxation of FS2's income. FS2's income is subject to an overall tax liability of $17.62 ($7.88 payable by US1, $2.62 payable by US2, and $7.12 payable by FS1), which exceeds the 15% Minimum Rate.

To the extent that potential double taxation or the UTPR's reference to parent tax liabilities were relevant to overall creditability, the analysis described in Part IV.C.5 would suggest that the soak-up tax limitation should not apply to the extent of double taxation of U.S. persons. However, given the potential restrictions on creditability described above, the soak-up tax limitation may be of limited relevance with respect to the UTPR.

6. Conclusion

Unlike the QDMTT and the IIR described above, the UTPR bears many features that are more consistent with an anti-avoidance tax, an excise tax, or a tax on diverted profits, which are generally not creditable under the 2022 final regulations. Moreover, the UTPR does not otherwise seem to be an income, war profits, and excess profits taxes "in the U.S. sense." Instead of beginning with gross receipts, reducing such gross receipts for significant costs and expenses, and

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[141] Treas. Reg. § 1.901-2(b)(5)(iii)(A) Example 1. *See also* Treas. Reg. § 1.901-2(d)(3)(vii) Example 7, describing the similar application of a "diverted profits tax," which have also been targeted for credit disallowance under jurisdictional nexus concerns. *See* Federal Register Vol. 85, No. 219, November 12, 2020 at 72089 and 72106.

determining how much tax is imposed on such base, as foreign creditable income taxes generally operate, the UTPR in effect operates in the reverse order: it begins with a fixed amount of tax to impose, and then disallows deduction of significant costs and expenses of the GloBE Taxpayer against gross receipts, until the resulting tax base generates a sufficient amount of UTPR. In addition, the amount of UTPR imposed is calculated solely with respect to gross receipts and costs and expenses of Low-Taxed CEs located in jurisdictions other than the GloBE Taxpayer's, and none of those gross receipts or costs and expenses may be incurred directly or indirectly by the GloBE Taxpayer. Therefore, we do not believe that the UTPR is a creditable foreign tax under Section 901.[142]

We recommend that the UTPR not be treated as creditable for U.S. federal income tax purposes under any circumstance. While the UTPR could in certain cases result in double taxation of income of a non-U.S. entity in which a U.S. taxpayer was invested, given the nature of the UTPR as an anti-abuse tax imposed largely without regard to the gross receipts or expenses of the entity subject to the UTPR, we do not see a meaningful justification for treating the UTPR as a creditable foreign tax under any future Treasury regulations.

E. Technical Considerations with Respect to Creditable Pillar 2 Taxes

If Treasury concludes, consistent with our recommendation, that the IIR and QDMTT should be (at least in part) creditable, significant technical questions must be addressed in terms of determining the amount and allocation of any foreign tax credit that is allowed. The fundamental goal of the foreign tax credit system is to prevent double taxation of the same income, but the structure of the IIR and QDMTT often makes it challenging to determine which income is in fact subject to double taxation and to what extent. While technical clarifications to existing regulations under Sections 861, 901and 904 may resolve some of the pertinent issues, a deeper and more challenging set of questions arises with respect to the allocation of creditable Pillar 2 taxes incurred by a CFC among its U.S. shareholders under Section 960.

First, under Section 960, foreign income taxes imposed on a CFC are allocated and apportioned among the different categories of income (net of attributable expenses) of that CFC, including tested income and different types of subpart F income.[143] For this purpose, Section 960 generally looks to Treasury regulations under Sections 861 and 904.[144] Clarifications to those regulations may be appropriate to address structural differences between the U.S. international tax regime and Pillar 2.

Second, the "technical taxpayer" rules under Section 901 should be updated in order to provide which CEs are considered to incur legal liability for a QDMTT and in what proportions.

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[142] The UTPR also does not qualify as an "in lieu of" tax that is creditable under Section 903. The UTPR is not imposed on a GloBE Taxpayer in substitution for a generally-imposed net income tax levied by the relevant jurisdiction on its residents; and it also is not a withholding tax imposed on gross income. *See* Treas. Reg. § 1.903-1(c).

[143] *See* Treas. Reg. § 1.960-1(c)(1)(i) – (iii).

[144] *See* Treas. Reg. § 1.960-1(d)(3)(ii).

Third, Section 960 determines an allocable share of foreign income taxes imposed on a CFC for each U.S. shareholder of such CFC, and a deep and challenging set of issues arises with respect to the proper methodology to be used to make that allocation for an IIR.[145] Similar issues arise with respect to allocation of an IIR incurred by an entity treated as a partnership for U.S. federal income tax purposes among its partners. We discuss each of these issues below.

1. Allocation and Apportionment of Pillar 2 Taxes Among Categories of Income: Section 861 and Section 904 Considerations

Existing Treasury regulations under Sections 861 and 904 provide a roadmap for allocating and apportioning foreign income taxes, and for assigning those foreign income taxes to appropriate baskets for purposes of Section 904.[146] These Regulations specifically address foreign income taxes imposed under a "foreign law inclusion regime," which the Regulations define as:

> [A] foreign law tax regime similar to the subpart F or GILTI regime described in sections 951 through 959, or the PFIC regime described in sections 1293 through 1295 (relating to qualified electing funds), that imposes a tax on a shareholder of an entity based on an inclusion in the shareholder's taxable income of certain of the entity's current earnings, whether or not the foreign law deems the entity's earnings to be distributed.[147]

The Regulations go on to describe the manner in which income, deductions and substantive tax liability arising under a "foreign law inclusion regime" are allocated, apportioned and separated into appropriate Section 904 baskets.[148]

While the IIR strictly speaking is not an income inclusion regime,[149] for the reasons described in IV.C.1 above we believe that the IIR is sufficiently similar to a CFC inclusion regime that it is reasonable to treat the IIR as a "foreign law inclusion regime" for purposes of Sections 861 and 904. However, given the dissimilarities between the IIR and a more traditional CFC inclusion regime, and similar to our recommendation in Part IV.C.1.b above, we recommend revising the definition of "foreign law inclusion regime" to clarify that the IIR should be treated as such. As a result, the IIR would more clearly be captured by the existing framework under

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145 *See* Treas. Reg. §§ 1.960-1(c)(1)(iv), 1.960-2.

146 *See* Treas. Reg. § 1.861-20; Treas. Reg. § 1.904-6.

147 Treas. Reg. § 1.861-20(b)(11).

148 Treas. Reg. § 1.861-20(d)(3)(iii); Treas. Reg. § 1.904-6(f). In general, the tax is allocated and apportioned to the same category of income, as the underlying income of the foreign corporation which gives rise to the tax under the applicable foreign law inclusion regime.

149 *See* Part IV.C.1.a *supra* for a detailed analysis.

Sections 861 and 904, which we believe represents an appropriate starting point for crediting a portion of the IIR in appropriate circumstances.[150]

2. Allocating Creditable Pillar 2 Taxes Among CEs for Section 901 Purposes

As noted above, the Pillar 2 rules generally contemplate a jurisdiction-by-jurisdiction analysis that aggregates all applicable CEs' income, deductions and tax paid within the jurisdiction. Particularly in the case of a QDMTT, it is possible that a given jurisdiction could allocate the QDMTT amount to CEs in that jurisdiction however it sees fit. For example, the jurisdiction could require a CE without any U.S. shareholders to pay QDMTT with respect to income earned by a CE within the same MNE Group that does have U.S. shareholders (e.g., an affiliate with a 10% U.S. owner) or *vice versa*. In such a case, how should the amount of QDMTT for each applicable CE be determined?

One option would be to follow the conventions of the jurisdiction imposing the QDMTT. To the extent that the local allocation of QDMTT represents a good faith approximation of each entity's contribution to the QDMTT liability (e.g., a measurement based on respective contributions to Net GloBE Income less regular tax paid on such Net GloBe Income), deferring to local law is likely an administratively expedient outcome that provides rational results under Section 901.

However, to the extent that a given jurisdiction's allocation of QDMTT is based on administrative convenience or to the extent QDMTT is artificially over-allocated to certain CEs (e.g., CEs that have U.S. shareholders), we believe such an allocation should be disregarded and instead Treasury regulations should provide for a reallocation of the QDMTT among the relevant entities. In particular, we recommend that Treasury regulations provide examples of acceptable methodologies by which a U.S. shareholder can associate QDMTT with a specific CFC, thereby providing taxpayers additional clarity while avoiding the opportunity for gamesmanship or unfair results.

3. U.S. Shareholder's Allocable Share Under Section 960 of an IIR Imposed on a CFC

Section 960 generally contemplates that a U.S. shareholder will be deemed to have paid so much of the foreign corporation's foreign income taxes as are "properly attributable" to a given

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[150] Sections 960(a) and (d) by their terms provide that if a U.S. corporation includes an item of income under Sections 951(a)(1) or 951A with respect to a CFC with respect to which that corporation is a U.S. shareholder, then the U.S. corporation is entitled to a tax credit for the portion of the CFC's foreign income taxes that is properly attributable to such item of income. Thus, in a case where (for example) USP owns CFC1, which in a given year has no tested income or subpart F income and which pays an IIR with respect to CFC2, its subsidiary-CE, USP would not be entitled to a foreign tax credit under Sections 960(a) or (d) for the IIR paid by CFC1. A similar result may arise with respect to QDMTT paid by a CFC that has no tested income or subpart F income for the year.

This issue is not unique to Pillar 2 taxes. The same issue would arise in the fact pattern just described if CFC1 is subject to tax in its jurisdiction of residence under a traditional CFC inclusion regime, rather than an IIR.

item of income. Existing regulations under Section 960 generally contemplate that both subpart F inclusions and GILTI inclusions of U.S. shareholders drive the allocation of creditable foreign tax credits (i.e., each U.S. shareholder is generally deemed to pay a percentage of creditable foreign taxes equal to the percentage of the subpart F or GILTI income taken into account by that U.S. shareholder).[151] For foreign income taxes that are not similar to soak-up taxes, this approach generally represents a sensible allocation among U.S. shareholders.

But the IIR is different. Taxes imposed on subpart F or GILTI of a U.S. shareholder that is a member of the MNE Group are pushed-down to CE-CFCs, and so to the extent Section 960 permits an allocation of creditable IIR to such a U.S. shareholder with respect such CE-CFCs, the resulting circularity raises the concerns discussed in Part IV.C.5 above.

> Example 11. Assume the same facts as in Example 7: US1 owns 75% of the stock of CFC1, US2 owns 25% of the stock of CFC1 and CFC1 in turn owns 100% of the stock of CFC2. US1 has $7.88 of GILTI tax, US2 has $2.62 of GILTI tax and CFC1 has IIR of $7.12, in each case, in respect of CFC2's Net GloBE Income (assuming the IIR is not a creditable foreign tax).
>
> If the IIR were treated in part as a creditable foreign tax and Section 960 in turn allocated such credit to US1 and US2 *pro rata* based on GILTI inclusions, US1 would be entitled to a credit equal to 75% of CFC1's IIR. However, as US1 utilizes a foreign tax credit to reduce its GILTI taxes for such IIR (and such IIR does not count as an expense that reduces tested income), the amount of Covered Taxes of US1 that are pushed-down to CFC2 decrease. This increases CFC1's IIR by a corresponding amount. This would in turn require further iterative calculations and would ultimately appear to result in $15 of IIR being imposed on CFC1, all of which would be creditable to US1 and US2 (resulting in a "soak-up" effect).

The results of Example 11 make little sense in the context of Pillar 2 and the U.S. foreign tax credit system generally. We encourage Treasury to adopt regulations that prevent any allocation of IIR to a U.S. shareholder whose subpart F or GILTI taxes are "pushed-down" to a CE-CFC, which therefore would prevent any U.S. member of an MNE Group from crediting IIR imposed on MNE Group members.

In cases other than a simple one like Example 11, it may be hard to precisely compute the "soak-up" effect (i.e., the exact amount by which the IIR would be creditable that results in a reduction in US1's GILTI tax liability that would otherwise be pushed-down to CFC2, which in turn results in an increase in the IIR). For soak-up taxes, the regulations as currently drafted deny creditability only to the extent there is a "soak-up" effect. Because US1's share of the IIR is conceptually similar to a soak-up tax, as a simplifying matter, we believe US1 should not be entitled to any credit for such tax without requiring a calculation. Example 11 illustrates a case in

[151] Treas. Reg. §§ 1.960-2(b)(3), -2(c)(5).

which a "soak-up" effect is possible, and we are not recommending denial of a tax credit in respect of an IIR to the precise mathematical extent there is a "soak-up" effect. Our recommendation is to take a binary (wholly-creditable or not) approach that determines creditability shareholder-by-shareholder.

Turning to non-CE U.S. shareholders of a CFC subject to the Pillar 2 rules ("**Non-CE U.S. Shareholders**"), for the reasons discussed in Part IV.C they should be entitled to a credit, under Section 960, for their proportionate share of an IIR imposed on the CFC. However, the choice of a method to determine a Non-CE U.S. Shareholder's proportionate share of such tax implicates some challenging policy decisions for Treasury. Several approaches that may be considered to allocate a CFC's IIR to its Non-CE U.S. Shareholders under Section 960 are outlined below.

a. Approach #1A: Traditional Approach

The first potential approach to allocating creditable IIR to a Non-CE U.S. Shareholder contemplates the simple application of the existing Section 960 regulations as it relates to IIR and a non-CE U.S. shareholder (the "**Traditional Approach**"). Thus, a Non-CE U.S. Shareholder would generally be deemed to pay a percentage of the IIR based on the entity's percentage of subpart F or GILTI inclusions.

> Example 12. Assume the same facts as in Example 11. Because US2 owns 25% of CFC, US2 would be allocated 25% of the IIR actually paid by CFC and be allocated $1.78 of the IIR (i.e., 25% of $7.12). None of the remaining IIR would be creditable to US1.

The chief virtue of the Traditional Approach lies in its simplicity—existing regulations under Section 960 can largely operate as they are currently written with respect to the Non-CE U.S. Shareholder. However, the Traditional Approach does not necessarily alleviate double-taxation if a sufficient amount of Covered Taxes are pushed-down from a CE-owner under a CFC Tax Regime. Example 12 illustrates such a case. US2 has GILTI tax of $2.62, but is deemed to pay only $1.78. This amount would in turn be subject to the 20% GILTI haircut under Section 960(d), resulting in an aggregate foreign tax credit of only $1.42 and a residual U.S. tax of $1.20.

The Traditional Approach may further be defended as a "fair" economic result. After all, CFC1 only actually paid $7.12 and US2 owns 25% of CFC1 and therefore indirectly bears only 25% of the expense as 25% shareholder. This appears to be the basic logic driving the existing Section 960 regulations. Why shouldn't it apply to IIR? The answer to this question depends on how one conceptualizes the push-down of Covered Taxes under a CFC Tax Regime. For example, one might say of Example 11 that US1 initially bears 75% of the $15 of potential IIR (i.e., $11.25) and US 2 initially bears 25% of the $15 of potential IIR (i.e., $3.75). When $7.88 of US1's Covered Taxes are pushed-down to CFC2 and CFC1's IIR is reduced thereby, should this be conceptualized as a reduction solely in US1's $11.25 share of the potential IIR, or should this instead be conceptualized as a *pro rata* reduction in each shareholder's potential IIR?

This question highlights a challenging reality of the Pillar 2 rules: a CE-owner's CFC Tax Regime taxes provide for an indirect benefit to minority owners to the extent they are pushed-down to a lower-tier CE. This is a simple reality of Pillar 2's structure and is not limited to the

IIR. Minority owners can benefit from the blending of GloBE Losses of MNE Group members, as noted in Example 3 above. On the other hand, minority owners of GloBE Taxpayers can be burdened by UTPR charged in respect of MNE Group members with respect to which such minority owners have no economic interest. Absent any separate commercial arrangement among the parties, in Example 11 US2 receives an economic benefit from US1's Covered Taxes, supporting the view that the Traditional Approach represents the "correct" allocation of creditable foreign taxes under Section 960.

In practice, however, sophisticated parties would likely seek to reallocate the economic burden of IIR such that each party bears its *pro rata* share of IIR before taking into account any CFC Tax Regime push-down to a subsidiary-CE. These types of tax sharing agreements are common when the taxes or tax attributes of one equityholder benefit a non-wholly-owned affiliate, often requiring the benefited entity to reimburse the applicable equityholder for such benefit. If such an approach were applied in Example 11, CFC1 would reimburse US1 with respect to Covered Taxes pushed-down to CFC2, and after taking into account such an arrangement US1 would indirectly incur a net expense of $11.25 after taking into account the reimbursement, and US2 would bear a net expense of $3.75.

The question of who truly economically bears a given IIR thus becomes somewhat uncertain in practice. As a result, it is not clear that the Traditional Approach would fully take into account an owner's overall economic burden with respect to the IIR. And while economic obligations of the parties may be relevant to an allocation of creditable foreign taxes under Section 960, we do not view this as dispositive to the "right" policy result. Instead, it is merely a factor to be considered.

Finally, it is noteworthy that because the Traditional Approach may not completely eliminate a U.S. shareholder's U.S. tax liability with respect to income associated with the IIR, the aggregate amount of taxes paid with respect to the $100 of GloBE and GILTI income at CFC2 in Example 12 exceeds the 15% minimum tax rate contemplated by Pillar 2, taking together the U.S. tax paid by US1 of $7.88, IIR paid by CFC of $7.12, and U.S. tax paid by US2 of $1.20, the aggregate tax liability with respect to the $100 of income earned by CFC2 is $16.20.

Inversely, under the Traditional Approach it is possible that the overall tax liability of the relevant parties effectively dips below Pillar 2's 15% benchmark tax rate:

> <u>Example 13</u>. The facts are the same as in Example 11 except that CFC2 has $100 of net GloBE income and $0 of tested income and subpart F income. As a result, CFC1 has $15 of liability under the IIR without any reduction for CFC Tax Regime taxes paid by US1. Because US2 owns 25% of CFC, US2 would be allocated 25% of the IIR actually paid by CFC1 and be deemed to pay $3.75 (i.e., 25% of $15). Assume further that US2 owns 100% of the stock of CFC3, which is not organized in a Pillar 2 jurisdiction and which generates $1000 of tested income.

In Example 13, applying the Traditional Method effectively allows US2 to use the credit from the IIR to reduce unrelated U.S. federal income tax liabilities. Although CFC1 itself pays

$15 in IIR, as a result of that payment US2 is able to effectively cross-credit that IIR and reduce its U.S. tax liability by $3.00 (i.e., $3.75 minus the 20% GILTI "haircut"). Thus, arguably the true tax burden associated with the $100 of GloBE income of CFC2 is only $12 (i.e., $15 - $3.00).

The failure of the Traditional Method to perfectly dovetail with the goals of Pillar 2 is not necessarily fatal. There is no requirement under U.S. law that the foreign tax credit support another jurisdiction's policy priorities, and with the structural differences between the U.S. international tax regime and Pillar 2 it is inevitable that incongruities will arise. But to the extent Treasury seeks to maximize consistency with the Pillar 2 outcomes, alternative allocation approaches may be considered.

b. Approach #1B: Traditional Approach with Basketing

A variation on the above approach for addressing the allocation of taxes under Section 960 utilizes the framework of the existing U.S. foreign tax credit rules to separately basket the IIR to achieve results that are analogous (though not perfectly congruent) to Pillar 2 principles, effectively resulting in a combination of the Traditional Approach and the Targeted Approach described below (the "**Traditional Approach with Basketing**"). Under the Traditional Approach with Basketing, a Non-CE U.S. Shareholder is deemed to pay its *pro rata* portion of a CFC's obligations pursuant to the IIR in a manner consistent with the Traditional Approach, but the applicable foreign tax is separately basketed for purposes of Sections 861 and 904 such that the credit is only available to be utilized with respect to income inclusions of the Non-CE U.S. Shareholder that are subject to IIR liability:

> Example 14. The facts are the same as in Example 13. Under the Traditional Approach, US2 is entitled to a foreign tax credit equal to $3.00. However, such foreign tax credit is separately basketed and solely usable against income subject to the IIR.

The Traditional Approach with Basketing has aligns with the purposes of Pillar 2 by minimizing the extent to which the application of the IIR could result in a U.S. foreign tax credit benefit that results in an effective tax rate of less than Pillar 2's mandated 15% rate when accounting for potential cross-crediting under the U.S. foreign tax credit rules. This basketing approach means that Pillar 2 principles, rather than traditional U.S. foreign tax credit principles, carry the day and avoid a situation in which the overall tax liability with respect to income subject to an IIR is less than 15%. Such an approach is attractive to the extent that Treasury determines that guarding the policy goals of Pillar 2 is a worthwhile endeavor. But the Traditional Approach with Basketing limits the type of cross-crediting that is implicitly blessed in the U.S. foreign tax credit system as currently applied with respect to foreign taxes imposed under more common foreign CFC inclusion regimes. Whether such an approach is attractive depends on the extent to which Treasury seeks to adjust existing foreign tax credit guidance to align with the policy goals of Pillar 2.

c. Approach #2: Targeted Approach

A second alternative to Section 960 allocation would focus on precisely limiting the double-tax potential of the IIR by allocating creditable foreign taxes to Non-CE U.S. Shareholders

that are U.S. shareholders in an amount that perfectly offsets U.S. tax liability with respect to income that was subject to an IIR (the "**Targeted Approach**").

> Example 15. The facts are the same as in Example 11 (i.e., US2 incurs a U.S. tax liability of $2.62 before taking into account foreign tax credits). Under the Targeted Approach, Section 960 would allocate a foreign tax credit of $3.28 to US2 such that, after the 20% GILTI haircut, US2 has $0 of U.S. tax liability associated with the income of CFC2.

The main benefit of using the Targeted Approach is that by tying the allocation of creditable foreign taxes to actual U.S. tax liability, Treasury has the ability to maximize conformity in intended outcomes under U.S. tax law and the Pillar 2 rules while minimizing the possibility of cross-crediting since the Targeted Approach is explicitly tied to the Non-CE U.S. Shareholder's U.S. tax liability with respect to the income of CFC2. As noted above whether this is in fact a desirable outcome involves a policy determination as to the extent to which U.S. tax rules should seek conformity with Pillar 2 principles, but to the extent Treasury does seek to prioritize conformity, the Targeted Approach is the best suited to achieve this goal.

The devil resides in the details. As an initial matter, there is no mechanic that exists today for associating a specific amount of U.S. tax liability with a given CFC's tested income or subpart F inclusions. The Pillar 2 rules themselves will eventually require a methodology for making such allocations since Pillar 2 contemplates that CFC Tax Regime liabilities be pushed-down to specific CEs within an MNE Group. However, while a simplified safe harbor is available with respect to GILTI tax under the Pillar 2 rules on a transitional basis, no fulsome methodology exists today, and the complexity associated with constructing such a framework from whole cloth are significant.

Of course, this complex undertaking may also be viewed as an opportunity. Treasury's expertise in the IRC and the nuances of Sections 951 and 951A make it the taxing authority best equipped to tackle the difficult challenges associated with the U.S. international tax system. Associating income inclusions in the United States under the subpart F regime with a specific CE is likely a simpler task than allocating GILTI tax liability, given that the subpart F regime focuses on specific CFCs, whereas the GILTI regime calculates a single inclusion of taxable income based on worldwide tested income and tested loss, effectively blending income of CFCs owned by a U.S. shareholder. A natural springboard for such a framework likely resides in the rules under Treas. Reg. § 1.960-3, which allocates previously taxed earnings and profits ("**PTEP**") among CFCs. But even if the PTEP rules present a suitable foundation, substantial additional work will be required—by their terms the PTEP rules only associate income (not substantive U.S. tax liability) with a specific entity. The PTEP rules also naturally and appropriately adopt U.S. tax concepts, taking into account entity classification elections pursuant to Treas. Reg. § 301.7701-3 that conflict with the Pillar 2 rules that generally regard all CEs within an MNE Group as separate entities. The allocation of foreign tax credits, limitations under Section 904 and deductions under Section 250 of the Code present additional technical hurdles to establishing a workable framework. While we do not discuss these challenges in further detail in this Report, we welcome the opportunity to supplement with an additional report to the extent Treasury seeks to pursue the Targeted Approach.

An additional limitation of the Targeted Approach emerges when considering income that is taxed in the U.S. at a rate in excess of Pillar 2's 15% minimum rate. Suppose that, contrary to the facts of Example 11, US2 were subject to the subpart F regime on its $25 of income associated with CFC2. This income would be taxed at a 21% rate and result in an aggregate liability of $5.25. While it seems appropriate to specially allocate IIR against U.S. taxable income when the effective U.S. tax rate is less than 15%, should taxpayers receive additional foreign tax credits to the extent the effective U.S. tax rate exceeds 15%? This would be consistent with the Pillar 2 goal of a flat 15% minimum tax, but it appears to be plainly inconsistent with the foundations of the U.S. foreign tax credit regime, including the limitations reflected under Section 904. This tension may be partially addressed by capping the allocation of U.S. foreign tax credits to avoid over-crediting, but it is not immediately clear under the theory of the Targeted Approach where over-crediting in fact begins or how such a cap should be mechanically set.

d. Approach #3: Gross-Up Approach

A third option for allocating taxes under Section 960 involves a hybrid approach in which a Non-CE U.S. Shareholder is allocated the lesser of (i) its allocable share of IIR measured without regard to any reduction for Covered Taxes reallocated to the CE-CFC and (ii) the total IIR paid by the GloBE Taxpayer CE (the "**Gross-Up Approach**").

The Gross-Up Approach is grounded in the view that each of the shareholders of an entity with potential IIR liability should be attributed a portion of that potential IIR liability before the push-down of any Covered Taxes paid by a CE-owner. As discussed above, although Pillar 2 by its terms effectively allows each shareholder of a CE to indirectly economically benefit from taxes paid by a CE-owner, it is reasonable to expect that in many cases equityholders will enter into tax sharing agreements that will effectively result in each equityholder bearing its *pro rata* share of IIR liability before taking into account Covered Taxes of a CE-owner.

> Example 16. The facts are the same as in Example 11 except that US1, US2 and CFC1 enter into a tax sharing agreement pursuant to which CFC1 agrees to make payments to US1 to the extent US1's Covered Taxes reduce CFC1's IIR liability. Because US1's Covered Taxes of $7.88 are pushed-down to CFC2 and therefore reduce CFC1's IIR liability by $7.88, CFC1 makes a payment of $7.88 to US1 and as a result CFC1's aggregate out of pocket expenditure with respect to the IIR is $15 (i.e., $7.88 in payments to US1 under the tax sharing agreement and $7.12 in actual IIR). As a result, US1's overall economic outlay with respect to the IIR is $11.25 (i.e., $15 x 75%) and US2's economic outlay with respect to the IIR is $3.75 (i.e., $15 x 25%).
>
> Under the Gross-Up Approach, US2 would be allocated the lesser of (i) its allocable share of IIR measured without regard to any reduction for Covered Taxes pushed-down to CFC2 and (ii) the total IIR paid by CFC1. Accordingly, US2 claims $3.75 of creditable IIR. Although subject to the 20% GILTI "haircut" under Section

960(d), US2 claims a $3.00 foreign tax credit which fully offsets US2's GILTI liability of $2.62.

The results in this example highlight an important feature of the Gross-Up Approach. Because IIR is effectively deemed paid at a 15% rate, the Gross-Up Approach will often result in an allocation of creditable foreign taxes that exceed any GILTI liability to which the applicable income relates, and therefore permits potential cross-crediting of IIR against other income of the applicable U.S. shareholder. The Gross-Up Approach in fact presents the highest likelihood of cross-crediting since it will, by design, result in an allocation of IIR that either equals or exceeds the allocation under the Traditional Approach.

This type of cross-crediting may be viewed more as a feature of the Gross-Up Approach than a bug. By design the U.S. tax system aggregates foreign tax credits and, subject to the limitations of Section 904, allows these foreign tax credits to be used to reduce U.S. federal income tax liability without requiring any specific association with a given item of income or tax liability. Proponents of the Pillar 2 rules may object that by permitting this cross-crediting the aggregate amount of tax paid with respect to a given CE's income may effectively be reduced below the targeted 15% rate for the IIR. As discussed above, whether and to what extent the U.S. tax rules should be refined to generate results consistent with Pillar 2's goals is a policy question that Treasury can consider in modifying regulations under Section 960.

The Gross-Up Approach is naturally limited by the aggregate amount of IIR actually paid by an applicable CE. This is an unavoidable result from a technical perspective (one cannot allocate a creditable foreign tax that is not actually paid), but it does raise the prospect that the owners of a given CE will ultimately have an economic outlay substantially in excess of Pillar 2's targeted 15% rate after taking into account this natural cap.

> Example 17. The facts are the same as in Example 16 except that instead of CFC2 generating $100 of tested income, CFC2 generates $100 of subpart F income subject to U.S. tax at a 21% rate. US1 therefore incurs a U.S. tax liability of $15.75 (i.e., $75 x 21%) and US2 incurs a U.S. tax liability of $5.25 (i.e., $25 x 21%). US1's payment of $15.75 constitutes a Covered Tax that is pushed-down to CFC2, reducing CFC1's IIR liability from $15 to $0. CFC1 therefore makes a payment of $15 to US1 pursuant to the tax sharing agreement among US1, US2 and CFC1.
>
> US2's economic outlay with respect to the IIR is $3.75 (i.e., $15 x 25%) after taking into account CFC1's obligations pursuant to the tax sharing agreement. However, because there is no creditable foreign tax to be allocated to US2, US2 also pays $5.25 in U.S. federal income taxes, resulting in an overall economic burden for US2 of $9 (i.e., $3.75 + $5.25).

As Example 17 reflects, the inability to allocate any foreign tax credit to US2 means that US2 is effectively paying both a 15% IIR on its share of the $100 of Net GloBE Income by virtue of the tax sharing agreement and then also paying U.S. federal income taxes at a 21% rate, for an

effective combined rate of 36% (taking into account the tax sharing agreement). This result is not unique to the Gross-Up Approach—both the Traditional Approach and the Targeted Approach would each have the same outcome on these facts. However, this may be seen as a more meaningful flaw in the context of the Gross-Up Approach, which is founded on the idea that a Non-CE U.S. Shareholder should be allocated foreign tax credits based on its economic burden associated with IIR before the push-down of any Covered Taxes from CE owners. In Example 17, US2 economically bears $3.75 as a result of the imposition of an IIR regime in CFC1's jurisdiction of organization, but this economic burden is fundamentally contractual rather than a substantive tax liability, and so US2 must either live with these results or perhaps consider an alternative commercial arrangement under the tax sharing agreement.

One might theorize that the results in Example 17 could be avoided under the Gross-Up Approach and US2 could be allocated a foreign tax credit of $3.75 to the extent that the U.S. adopts rules that are analogous to the reallocation concepts of Pillar 2, effectively treating US1's payment of $15 of U.S. federal income taxes as a payment of taxes by CFC1 since this $15 payment reduces CFC1's overall IIR liability. However, we view such an approach as unworkable from a practical perspective—this would amount to a foreign tax credit on taxes that are in fact paid to the United States. This type of reallocation would also present complex questions as to what the appropriate U.S. tax treatment of such a payment would be: is US1 deemed to make a capital contribution to CFC1 to the extent its U.S. tax liability reduces CFC1's IIR inclusion? If so, does this mean that, as a result of paying its direct U.S. federal income tax liability, US1 would also generate additional tax basis that could reduce future income or gain? Such a reallocation also appears to be flatly inconsistent with the attribution (or jurisdictional nexus) requirement describe above. Accordingly, we believe that the Gross-Up Approach must operate as described above, and equityholders of CEs subject to the IIR would simply need to take into account the limitations of the Gross-Up Approach in arranging their commercial affairs.

4. Section 704 and Partnership Allocations of Creditable Foreign Tax Expenditures

Before concluding this discussion, we pause to note that the considerations described above with respect to the application of Section 960 apply with equal significance in the allocation of creditable foreign tax expenditures attributable to an IIR pursuant to Treas. Reg. § 1.704-1(b)(4)(viii)(b). Whatever approach Treasury chooses to utilize in the context of Section 960, we strongly recommend conforming changes to the CFTE allocation rules such that entities treated as partnerships for U.S. federal income tax purposes and entities treated as corporations for U.S. federal income tax purposes produce the same result with respect to the allocation of creditable IIR.