

Foreign Tax Credits for Multinationals Involve a Winding Path

Documents

📄 Notice 2023-80

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KPMG's Daren Gottlieb, Kevin Brogan, and Chris Riccardi analyze businesses' ability to credit qualified domestic minimum top-up taxes, based on new IRS and US Treasury guidance.

Long-awaited guidance from the IRS and Treasury Department provides some comfort that US businesses will be eligible for a foreign tax credit for qualified domestic minimum top-up taxes imposed under the new 15% global minimum tax deal known as Pillar Two.

The guidance, which outlines how the foreign tax credit and the global minimum tax will work together, also provides that a tax imposed on majority-owned income of a US multinational under the income inclusion rule generally won't be creditable.

To the extent that QDMTTs predominate over the rule, its noncredibility will have limited significance for US multinationals. So a US multinational's answer to "do you have a Pillar Two problem?" will depend on whether it has capacity to claim a foreign tax credit for imposed QDMTTs.

US multinationals may not have sufficient limitation to credit QDMTTs that are imposed on global intangible low-taxed income, known as GILTI, or on branch basket income, so they should focus on assessing capacity in both baskets as part of the next wave of preparation for Pillar Two.

General Credibility

To be a creditable net income tax, a foreign levy must meet a series of requirements, including the net gain requirement provided in Reg. Section 1.901-2(b). A foreign levy that's not a net income tax in some cases may be creditable as an "in lieu of" tax.

These requirements are tested separately for each foreign levy, and the failure of one levy to be creditable doesn't impact the creditability of a separate levy.

The guidance issued Dec. 11 announced Treasury's intention to propose regulations providing that each form of Pillar Two tax—the QDMTT, the IIR, and the undertaxed payments rule, or UTPR—constitutes a separate levy.

The guidance doesn't directly answer whether Pillar Two taxes satisfy general credibility requirements, leaving taxpayers to analyze each individual top-up tax for creditability. This isn't overly concerning for QDMTTs, which broadly appear to satisfy the net gain requirement.

A QDMTT is a book-based tax, like the US corporate alternative minimum tax, and is calculated generally by realization events based on gross receipts. It also allows for recovery of all relevant expenses. As a tax imposed on residents, QDMTTs would satisfy the attribution requirement, which allows for tax to be imposed on a resident's worldwide income.

Taxpayers are afforded temporary relief from some of these requirements under Notice 2023-55, as extended by the foreign tax credit notice.

An IIR tax similarly appears to meet the net gain requirement. However, concerns have centered on whether the circularity that would result from allowing a credit for a US business whose federal income tax liability is considered in calculating liability under the IIR tax should render it noncreditable.

In particular, the IIR accounts for US taxes imposed on GILTI or Subpart F income of a controlled foreign corporation through a push-down mechanism, in computing the effective tax rate of the controlled foreign corporation.

As such, US controlled foreign corporations are afforded priority over an IIR, and denying a credit against US tax for IIRs appears intended to preserve this priority.

The notice doesn't directly address the creditability of top-up tax imposed under a UTPR. Presumably, this is due to uncertainty about whether a UTPR tax is a foreign income tax under existing regulations because it may arise from a broad disallowance of deductions or phantom income not tied to realization events or based on gross receipts.

Final Top-Up Taxes

Creditable QDMTTs and non-creditable IIRs will be distinguished through an additional hurdle adopted in future regulations.

Specifically, a US taxpayer may not credit a tax if it's a final top-up tax and if that particular taxpayer's US federal income tax liability could be considered when computing liability under the tax.

The guidance provides that a foreign income tax (the tested tax) is a final top-up tax when liability for the tested tax considers:

- Tax that another country imposes on the direct or indirect owners of the entity subject to the tax with respect to the entity's income that's subject to the tested tax, or
- Tax imposed by an entity's country of residence on income attributable to a foreign branch and subject to the tested tax in the country in which the foreign branch is located.

A QDMTT isn't considered a final top-up tax under the guidance because it doesn't account for cross-border taxes.

An IIR tax is considered a final top-up tax because it accounts for cross-border taxes paid by a member of the same multinational entity group. Therefore, it's only potentially creditable by a taxpayer who isn't a member of the payor's multinational group, such as an individual or minority corporate owner.

Credit Limitations

In addition to carefully analyzing whether each relevant QDMTT or non-circular IIR tax is a creditable foreign income tax, a US multinational must have sufficient foreign tax credit limitation to use the credit. Businesses should consider methods to increase their foreign tax credit limitation.

They could consider allocating and apportioning controlled foreign corporation interest expense under the asset method—instead of the more commonly used modified gross income method—if the controlled foreign corporation's assets producing tested income have a low-tax book value in order to improve GILTI limitation.

Additionally, businesses with tangible assets subject to accelerated US tax depreciation could consider using alternative tax book value to apportion US shareholder interest expense. Doing so would increase tax book value of these tangible assets, attracting more interest expense to US source income and away from the GILTI and branch baskets.

Other strategies are more difficult and highly taxpayer-specific. For example, taking a fresh look at value chains and foreign operations with an eye toward minimizing Pillar Two taxes and maximizing foreign source income are time-tested and advisable reactions to the implementation of those taxes.

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