A NOTE FROM THE

EDITOR-IN-CHIEF

Tax Incentives and the Foreign Tax Credit in a Pillar 2 World

By Brian Jenn

As countries around the world implement the tax regimes developed under Pillar 2 of the Organisation for Economic Co-operation and Development's ("OECD's") (purportedly) two-pillar plan for ensuring … something … taxpayers are finding that traditional tax incentives offered by countries to attract capital investment no longer pack any punch. Whether that incentive is a simple nonrefundable tax credit or a ruling providing a lower-than-normal rate, the tax benefit of that incentive is now effectively subject to recapture through another jurisdiction's Income Inclusion Rule ("IIR") or Undertaxed Payment Rule ("UTPR"), if not by the qualified domestic minimum top-up tax ("QDMTT") of the very jurisdiction offering the incentive.

Seeing as how this situation serves the interests of neither the country offering the incentive nor the taxpayer receiving it, there should be no surprise that countries and taxpayers are exploring alternative incentive regimes that can retain their effectiveness in the face of the Pillar 2 (or global anti-base erosion ("GloBE")) model rules. The GloBE rules themselves provide one model for an acceptable incentive in the form of a qualified refundable tax credit ("QRTC"). At the same time, the GloBE rules attempt to chill countries' consideration of other incentives that would blunt the impact of Pillar 2, warning that IIRs might not count as "Qualified IIRs" and domestic top-up taxes might not count as "QDMTTs," in the event that a country "provide[s] any benefits that are related to" the new regime it has implemented."[1] These "benefits" could include credits, incentives, grants, and subsidies,[2] all of which are on the menu as countries contemplate how to preserve capital investment in the face of Pillar 2.

Let us assume countries can design incentives—likely, grants or QRTCs—that do not reduce "Covered Taxes" (which form the numerator of the jurisdictional GloBE effective tax rate ("ETR")) and thereby result in offsetting GloBE top-up tax. For many U.S.-parented companies, disallowance of a U.S. foreign tax credit under various provisions of the Code Sec. 901 regulations as a result of the incentive could still render the incentive effectively worthless. This would be the case for foreign taxes on global intangible low-taxed income ("GILTI") "tested income" where the U.S. shareholder's taxes in the

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GILTI "basket"[3] do not exceed its Code Sec. 904 limitation (*i.e.*, an "excess GILTI limitation" position), or foreign taxes on other categories of income (*e.g.*, foreign branch income or general basket income) that give rise to credits that may be carried forward or back even in the absence of available current-year Code Sec. 904 limitation.[4]

Although there are a variety of foreign tax credit disallowance provisions under Code Sec. 901 and the regulations thereunder, the most relevant for purposes of analyzing the impact of new foreign incentives are the rules regarding refundable tax credits under Reg. §1.901-2(e)(2) and those under Code Sec. 901(i) regarding certain tax-linked subsidies.[5] This column considers both of these sets of rules and the interaction with QRTCs and grants that may be offered by jurisdictions in the future.

Qualified Refundable Tax Credits

A QRTC is a tax credit that is treated as income for purposes of the GloBE rules and not as reducing covered taxes. Accordingly, the QRTC increases the denominator of the ETR fraction (*i.e.*, GloBE income) but does not reduce the numerator (*i.e.*, Covered Taxes). Computationally, this treatment means that the ETR fraction is reduced by less than if the credit reduced taxes but was not taken into account in GloBE income. For instance, for a taxpayer with $20 of jurisdictional taxes with respect to $100 of income, a $10 QRTC would only result in a reduction of the GloBE ETR from 20% (=$20/$100) to 18.2% (=$20/$110). In contrast, a refundable credit that does not qualify as a QRTC would result in an ETR of 10% (=$10/$100), exposing the taxpayer to jurisdictional Top-Up Tax.

In order to qualify as a QRTC, the tax credit regime must be designed such that a credit becomes refundable within four years from when the conditions for granting the credit are met.[6] For this purpose, refundable means that the amount of the credit that has not been applied to reduce Covered Taxes is either payable as cash or cash equivalents. Notably, the definition of refundable does not preclude the granting jurisdiction from requiring that the credit first be applied against any tax liability (over a period of up to four years) of the taxpayer, with only the remaining credit after reducing tax liability being paid to the taxpayer in cash. Such a credit would be treated as a QRTC in full, even though only a portion of the credit could be received by the taxpayer as a cash payment.

Fully Refundable Credits Under Reg. §1.901-2(e)(2)

In general, a credit allowed under foreign law is treated as reducing the amount of foreign tax paid for purposes of determining the amount of U.S. foreign tax credit allowed.[7] For a taxpayer that otherwise would be able to use the foreign tax credit that is reduced by the credit, the result of the credit is an increase in U.S. tax. For example, if a foreign tax is imposed on the tested income of a taxpayer, a credit that reduces foreign taxes by a dollar would also reduce a GILTI basket foreign tax credit by 80 cents (taking into account the "haircut" on GILTI deemed paid foreign tax credits under Code Sec. 960(d)(2)), such that the incentive has only provided a 20-cent benefit. In the case of a foreign tax imposed on income other than tested income, a credit that reduces foreign tax by a dollar could also reduce the available U.S. foreign tax credit by a dollar, such that the credit is effectively meaningless.

Notwithstanding the general rule that credits against foreign tax reduce foreign taxes paid for U.S. foreign tax credit purposes, Reg. §1.901-2(e)(2)(iii) provides as an exception that a "fully refundable credit" ("Fully Refundable Credit") is treated as income rather than a reduction of foreign tax liability resulting in a reduction of foreign tax credits. In order to qualify as a Fully Refundable Credit, the *full* amount of the tax credit must be payable in cash at the taxpayer's option. The preamble to the final Code Sec. 901 regulations issued in 2021 clarifies that a credit is only a fully refundable credit if the taxpayer "has the option to receive in cash the full amount of the credit, rather than just the portion that exceeds the taxpayer's foreign income tax liability."[8] As long as a credit meets this condition, it will be treated as a Fully Refundable Credit even if the taxpayer does choose to apply part or all of the credit against foreign tax liability rather than receiving a cash payment. In the case the taxpayer applies the tax credit against foreign tax, the taxpayer is treated as receiving a constructive payment of cash that it uses to satisfy foreign tax liability (rather than the credit reducing foreign tax liability).

The meaning of "refundable" is narrower for purposes of determining Fully Refundable Credit status than it is for determining QRTC status, such that a credit could be a QRTC but not a Fully Refundable Credit. In particular, a credit can be a QRTC even if the foreign country requires that it first be applied against four years of tax liability, even though such a credit would not be a Fully Refundable Credit for U.S. foreign tax credit purposes.

In that case, the foreign credit might reduce foreign tax while avoiding additional Top-Up Tax, but still amount to nothing because the credit reduces available U.S. foreign tax credits on a dollar-for-dollar (or 80 cents on the dollar) basis.

Countries seeking to use QRTCs to attract or retain investment, as well as the U.S. taxpayers that are the intended beneficiaries, should ensure that a QRTC also meets the definition of a Fully Refundable Credit. The most straightforward way to accomplish this would be for the QRTC to be eligible to be paid in full in cash to the taxpayer upon the conditions for obtaining the credit being satisfied. That said, Reg. §1.901-2(e)(2) does not specify a time period within which the credit must be payable in cash upon the taxpayer's election. Accordingly, a country seeking both QRTC and Fully Refundable Credit status for a credit but reluctant to commit to a full cash payment in the year the credit conditions are satisfied may be able to achieve Fully Refundable Credit status even if the taxpayer can only receive the cash payout over time or on a delayed basis (in any case, within four years, so that QRTC status is also maintained).

Tax-Linked Subsidies Under Code Sec. 901(i)

In designing a credit, grant, or other benefit that is also effective for U.S. taxpayers seeking to claim a foreign tax credit, a foreign jurisdiction should also be mindful of the rules under Code Sec. 901(i) with respect to certain subsidies provided by a foreign government. Code Sec. 901 provides that a foreign tax will not be treated as a tax for purposes of claiming a foreign tax credit to the extent that (1) the amount of the tax "is used (directly or indirectly) by the country imposing the tax to provide a subsidy by any means to the taxpayer" or a related party and (2) the subsidy "is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax." Reg. §1.901-2(e)(3)(ii) defines "subsidy" broadly to include "any benefit conferred, directly or indirectly, by a foreign country" to the taxpayer or a related party and indicates that "substance and not form" shall govern in determining the existence of a subsidy.

Because the term "subsidy" is broadly defined, any credit, grant, or other benefit provided by a foreign government could be considered a subsidy, such that the focus of inquiry will be on whether the subsidy is "(directly or indirectly) determined by reference to the amount" of tax or the tax base (a "Tax-Linked Subsidy"). The regulations provide little guidance on when a subsidy would or would not be considered a Tax-Linked Subsidy, but Internal Revenue Service ("IRS") field service advice issued in 1994 and 1997 provide examples of credits based on export revenue (in the case of a New Zealand export credit)[9] and R&D expenses (in the case of a French R&D credit) that were not considered to be determined by reference to the amount of tax or the tax base.[10] There may be a greater cause for concern where a subsidy is measured by reference to net income or a combination of revenue and expense or more directly references an element of the tax base or amount of tax.

Countries seeking to design a credit or grant that avoids the pitfall of being treated as a Tax-Linked Subsidy under Code Sec. 901(i) should consider credits based on revenue metrics alone, expense metrics alone, or other factors not taken into account in the tax base (*e.g.*, headcount).

Conclusion

As countries and U.S.-based taxpayers consider the design of credits and other incentives in a Pillar 2 world, it is critical to be mindful not just of the Pillar 2 consequences of such incentives but also of the consequences for the amount of U.S. foreign tax credits that may be claimed. In particular, a credit should be designed as a Fully Refundable Credit, and any incentive should avoid being considered a Tax-Linked Subsidy. An incentive that does not thread this needle risks providing the taxpayer little or no net benefit while still representing a revenue loss for the country providing it.

ENDNOTES

1. Commentary on Article 10.1, paragraphs 123–127.
2. *Id.*
3. That is, the "Code Sec. 951A category" described in Code Sec. 904(d)(1)(A)).
4. Code Sec. 904(c).
5. Where taxpayers have elections or other discretion under foreign law, the "compulsory payment" rules in Reg. §1.901-2(e)(5) may also be relevant.
6. Commentary on Article 10.1, paragraph 135.
7. Reg. §1.901-2(e)(2)(ii).
8. T.D. 9959, Jul. 27, 2022.
9. 1994 FSA LEXIS 473.
10. 1997 FSA 519.