



The Intersection of Pillar Two and U.S. Worldwide Taxation: FTC Implications

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Solve for Complexity

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Pillar Two overview

Refresher

Policy objective: Pillar Two is designed to ensure that large internationally operating businesses pay a 15% minimum level of tax in every jurisdiction (described interchangeably by OECD Inclusive Framework members as “ending the race to the bottom in CIT rates” and “addressing remaining BEPS risks”)

Three shots at achieving the policy objective (in order):



Qualified domestic minimum top-up tax (QDMTT)

Allows the local jurisdiction to collect any top-up tax that would otherwise be paid to another jurisdiction under Pillar Two

Tax paid under a QDMTT reduces top-up tax payable under IIR/UTPR

“Local” country measure



Income inclusion rule (IIR)

Triggers top-up tax at the level of the Parent where the income of a constituent entity (aggregated at the jurisdictional level) is taxed at a rate less than 15%

“Parent” country measure



Undertaxed profits rule (UTPR)

UTPR is a backstop; it only applies where Group income is not already subject to an IIR

It operates by denying deductions (or an “equivalent adjustment”)

Applies to ultimate parent jurisdiction, including the U.S., with equal force

Backstop measure

Pillar Two has arrived

Europe:

EU Directive approved in December 2022 requires EU Member States to bring the IIR and UTPR into their domestic legislation and apply those rules in respect of the fiscal years beginning from 31 December 2023 (IIR) and 31 December 2024 (UTPR). In addition, the U.K. is adopting an IIR and QDMTT from 31 December 2023 and expected to adopt UTPR in 2024 (draft legislation published).

Important because: (1) direct impact i.e., most MNEs have operations in Europe and (2) indirect impact of Europe serving as a “first mover” to stimulate implementation in other jurisdictions

South Korea:

In late December, the Korean National Assembly passed the 2022 Tax Revision Bill which includes the IIR and UTPR both of which will take effect for fiscal years starting on or after January 1, 2024

Important because: (1) questions re financial statement impact and (2) brings U.S. profits within reach of UTPR from 2024

Investment Hubs:

Singapore announced that its QDMTT, IIR, and UTPR will apply from 2025. Hong Kong QDMTT to apply from 2025 as well.

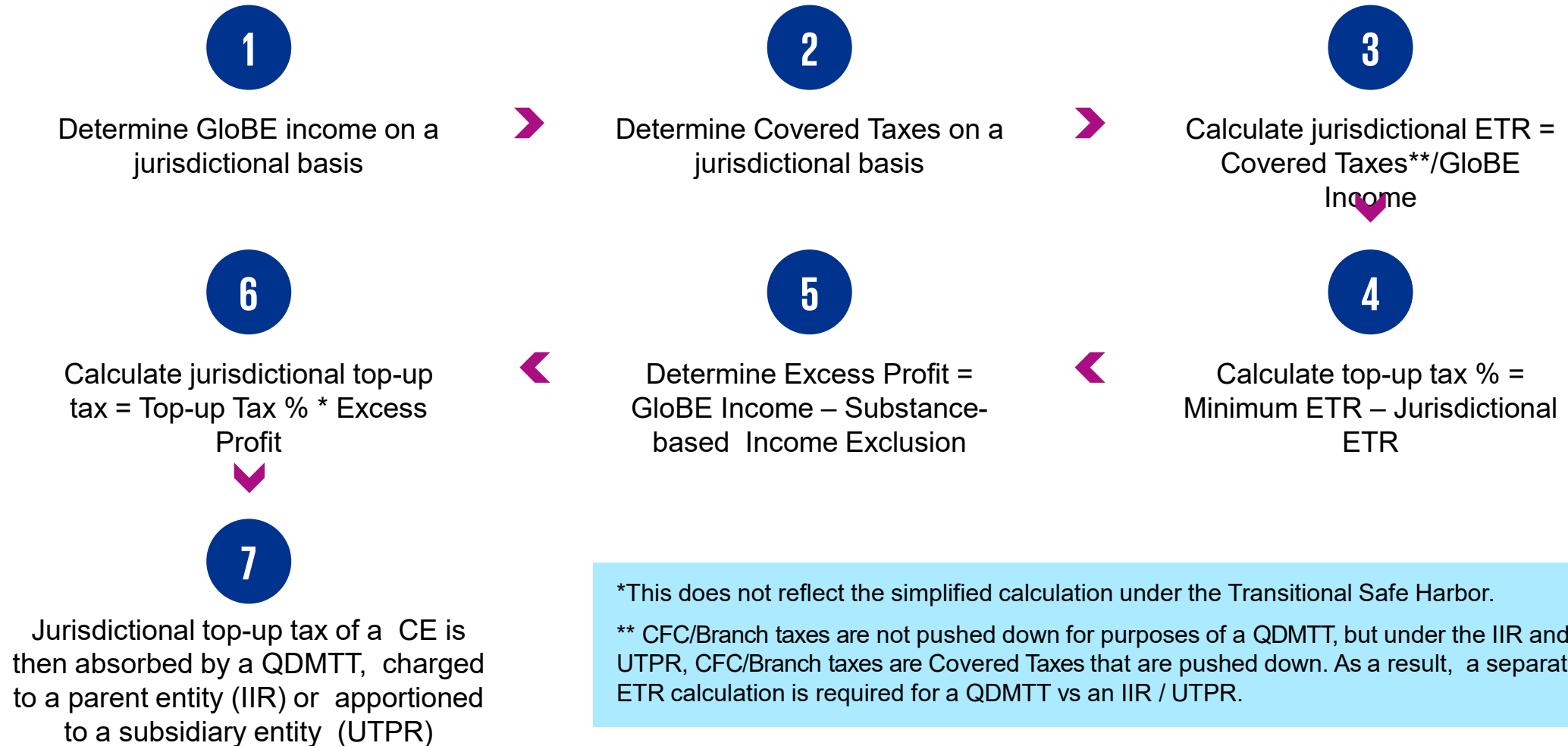
Important because: (1) impact on other “investment hubs”? (2) what about the “no or nominal CIT jurisdictions,” such as Bermuda, Bahamas and Cayman?

Recent Bermuda budget notes: *“Bermuda is regarded by some as an offshore jurisdiction, but as the Global Minimum Tax sets standard tax rates throughout the world, we must adapt and become a mid-shore jurisdiction”*

Other:

Japan recently enacted an IIR effective for fiscal years beginning on or after 1 April 2024. A number of other G20 nations have expressed an intent to implement Pillar Two, including, for example, Australia and Canada.

How does the calculation generally work?*



*This does not reflect the simplified calculation under the Transitional Safe Harbor.

** CFC/Branch taxes are not pushed down for purposes of a QDMTT, but under the IIR and UTPR, CFC/Branch taxes are Covered Taxes that are pushed down. As a result, a separate ETR calculation is required for a QDMTT vs an IIR / UTPR.

02

Rule order & allocation of taxes under a blended CFC tax regime



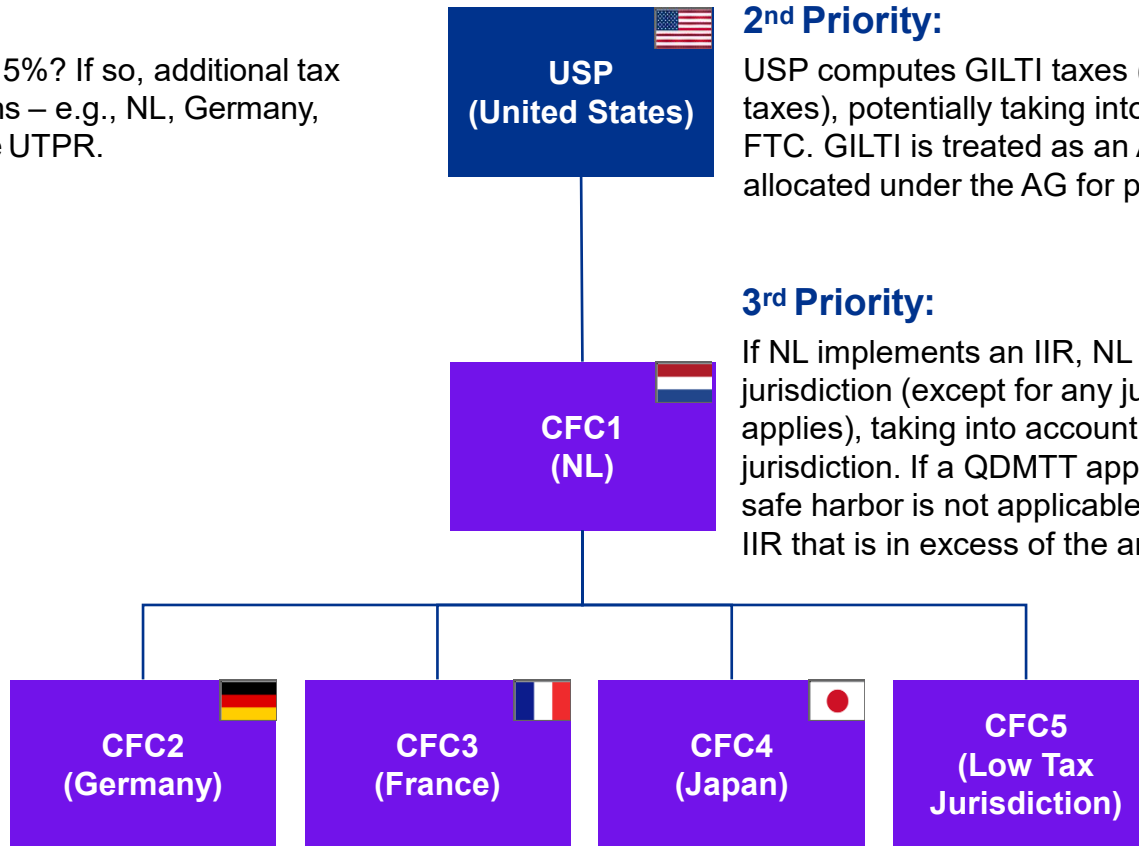
A revised rule order has emerged: QDMTT, CFC Taxes, IIR, UTPR

U.S. Parented Group:

Is the ETR in the U.S. below 15%? If so, additional tax will be paid in other jurisdictions – e.g., NL, Germany, France and Japan – under the UTPR.

4th Priority:

If NL does not implement an IIR, other jurisdictions will seek to collect any top-up tax via the UTPR, which is not expected to be creditable in the United States. The total amount paid under a UTPR is generally determined in the same manner as the IIR, but may be larger in the case of less than wholly-owned subsidiaries as the UTPR will be based on 100% of the subsidiary's income.



2nd Priority:

USP computes GILTI taxes (as well as Subpart F and branch taxes), potentially taking into account any QDMTTs paid as an FTC. GILTI is treated as an Allocable Blended CFC Tax and allocated under the AG for purposes of the IIR and UTPR.

3rd Priority:

If NL implements an IIR, NL computes the ETR of each subsidiary jurisdiction (except for any jurisdiction to which a QDMTT safe harbor applies), taking into account CFC taxes allocated to each such jurisdiction. If a QDMTT applies in a given jurisdiction and a QDMTT safe harbor is not applicable, NL collects any top-up tax owing under its IIR that is in excess of the amount determined under the QDMTT.

1st Priority:

If Low Tax Jurisdiction implements a QDMTT, it will apply before the IIR and UTPR and will not take into account GILTI, Subpart F, or branch taxes, but the QDMTT may be creditable in the U.S. The value of FTC depends on FTC capacity in the relevant basket.

***This does not reflect the simplified calculation under the Transitional Safe Harbor as U.S. taxes are not pushed down to foreign jurisdictions under the Simplified ETR Test.**

Creditability of the QDMTT

- Pursuant to Administrative Guidance issued in February 2023 (the “AG”), for purposes of determining the Jurisdictional ETR under a QDMTT, Adjusted Covered Taxes do not include taxes paid or incurred by a Constituent Entity (a “CE”) under a CFC regime or with respect to a PE
- Recognizing that double tax would arise if income is subject to both a QDMTT and a cross-border tax imposed on the CE Owner in respect of the same income, the AG notes that a jurisdiction may allow an FTC for taxes imposed under a QDMTT
- Future guidance may provide that a QDMTT satisfies the creditability requirements of Reg. § 1.901-2. As a book minimum tax imposed on domestic income of a resident, a QDMTT generally appears to satisfy the net gain requirement.

Allocation of taxes under blended CFC tax regimes (i.e., GILTI)

While guidance on the allocation of GILTI taxes was highly anticipated, its relevance could be limited in practice if QDMTTs proliferate. However, the allocation would still be relevant in the context of determining top-up tax under an IIR and UTPR.

Blended CFC Tax Regime definition



Blended CFC tax regime

A Blended CFC Tax Regime is a CFC tax regime that aggregates income, losses, and creditable taxes of all the CFCs for the purposes of calculating the shareholder's tax liability under the regime and has an Applicable Rate of less than 15%.

Impact to U.S. tax rules



GILTI and CAMT considerations

Explicitly includes U.S. tax on GILTI Income. Implicitly excludes the new U.S. Corporate Alternative Minimum Tax (CAMT) as a Blended CFC Tax Regime.

Relevant timing



Simplified allocation method

Applies for fiscal years beginning on or before 31 Dec 2025, but not including a fiscal year that ends after 30 June 2027. The Inclusive Framework may alter simplified allocation for future periods. [\(see next slide for calculation mechanics\)](#)

Allocation considerations



GILTI tax allocation rules

GILTI tax generally is allocated to lower-taxed jurisdictions (i.e., below 13.125% as computed under Pillar Two rules), which will exclude those that have adopted a QDMTT, thereby reducing any liability that could arise under an IIR or UTPR for the jurisdiction.

Simplified formula to allocate taxes - blended CFC tax regime

Blended CFC Allocation Key = *Attributable Income of Entity* × (*Applicable Rate* – *GloBE Jurisdictional ETR*)

Blended CFC Tax Allocated to an Entity = *Allocable Blended CFC Tax* × $\frac{\text{Blended CFC Allocation Key}}{\text{Sum of all Blended CFC Allocation Keys}}$

Attributable Income of Entity:

- Shareholder's proportionate share of the income of the CFC (or relevant part thereof if CFC is comprised of more than one CE) as determined under the Blended CFC Tax Regime
- For GILTI, "the U.S. shareholder's share of the tested income (without reduction for foreign income taxes) of the CE (which may be a CFC or a tested unit of the CFC)."

Applicable Rate:

"[T]hreshold for low taxation under the Blended CFC Tax Regime," currently 13.125% for GILTI

GloBE Jurisdictional ETR:

As determined under Article 5.1, but ignoring Covered Taxes allocated under a CFC Tax Regime; QDMTT is taken into account if the QDMTT is creditable under the Blended CFC Tax Regime

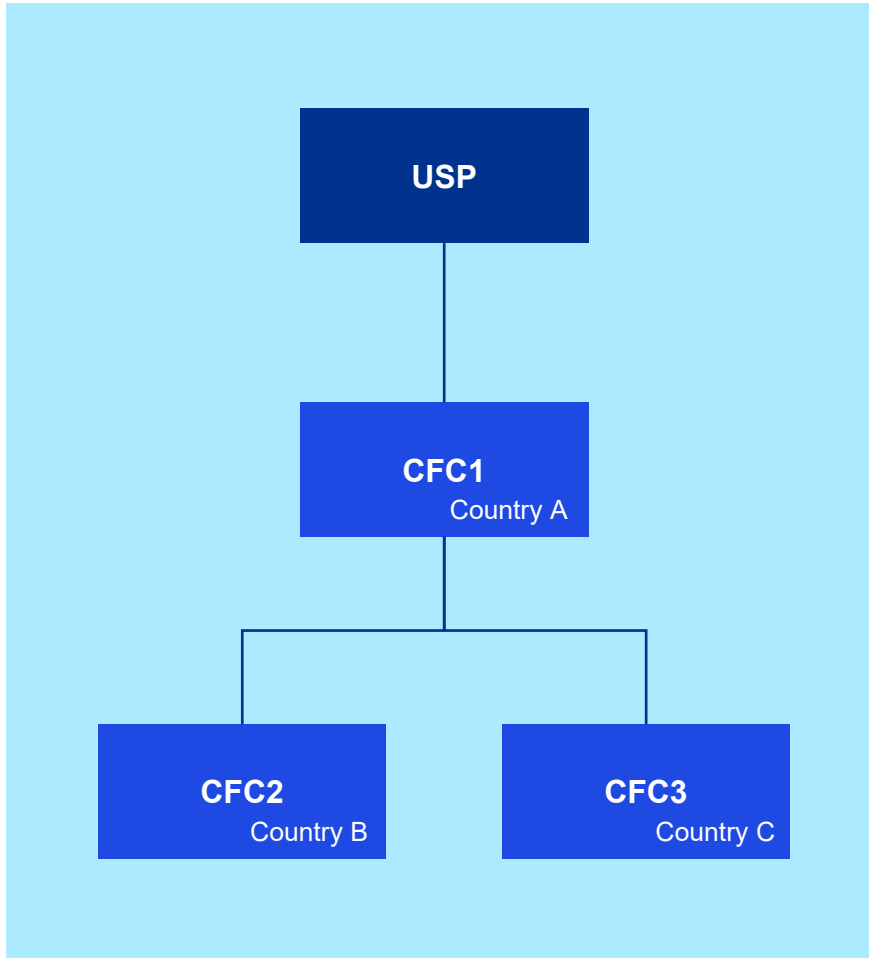
Allocable Blended CFC Tax:

For GILTI, in the absence of a domestic loss, the GILTI inclusion (reduced by the GILTI deduction) multiplied by 21%, less the foreign tax credit allowed in the GILTI basket

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Potential for increased tax burden under a QDMTT

Example 1 – CFC Holdco IIR & no QDMTT



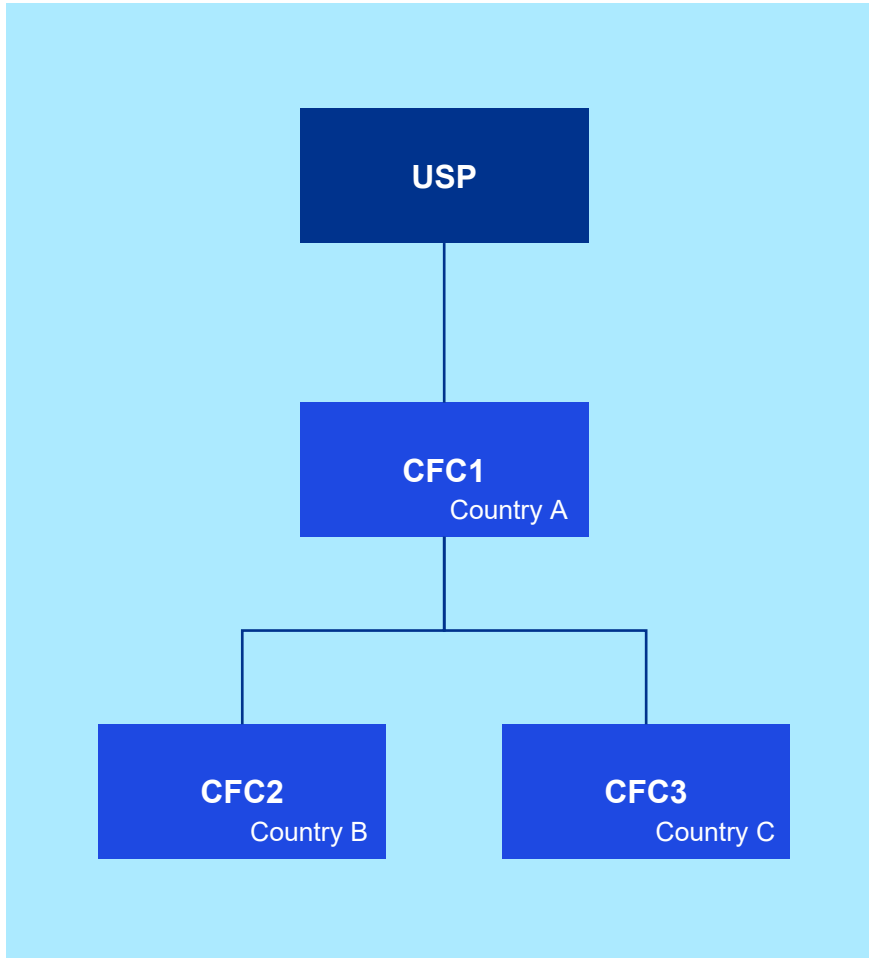
Key Facts:

| | USP | CFC1 | CFC2 | CFC3 |
|---------------------------|-----|------|------|------|
| USP's Attributable Income | | 0 | 100 | 100 |
| GloBE Jurisdictional ETR | | - | 10% | 5% |

- USP, CFC1, CFC2 and CFC3 constitute an in-scope MNE Group for purposes of Pillar 2
- Attributable Income (Tested Income) = GloBE Income
- Assume zero Substance Based Income Exclusion (“SBIE”)
- Country A introduces IIR
- No QDMTT in any jurisdiction
- Available FTCs = 12 (80% *(10 +5))
- FTC limitation in GILTI basket = 10 (due to USP interest expense apportionment)

→ **Allocable Blended CFC Tax = 21% * (200 tested income, less 100 section 250 deduction) – 10 FTCs = 11**

Example 1 – CFC Holdco IIR & no QDMTT

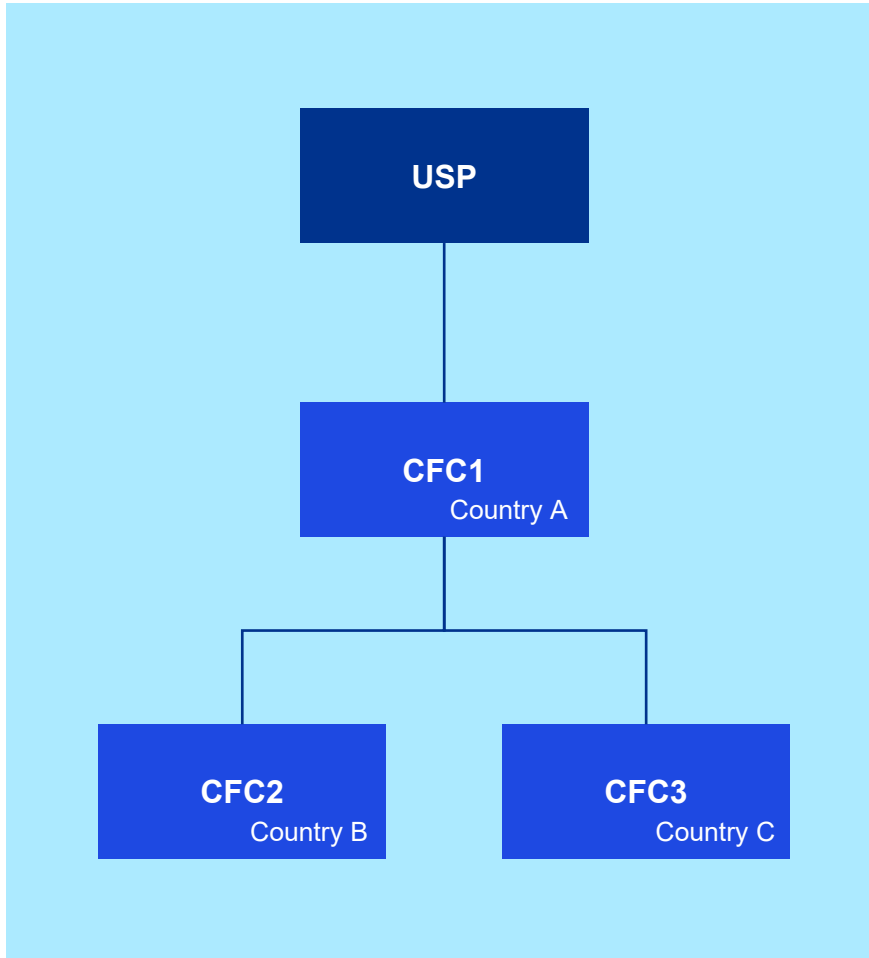


Analysis:

- Prior to the imposition of top-up tax under the Country A IIR, total tax paid by the MNE Group is 26 (15 Country B and C CIT and 11 residual GILTI)
- Application of Blended CFC Allocation Key* results in 3 of Allocable Blended CFC Tax (“ABCT”) allocated to CFC2 and 8 allocated to CFC3
- For purposes of the Country A IIR:
 - Country B ETR = $(10 \text{ CIT} + 3 \text{ ABCT})/100 = 13\%$
 - Country C ETR = $(5 \text{ CIT} + 8 \text{ ABCT})/100 = 13\%$
 - 2 of Top-up Tax is collected by Country A in respect of each of CFC2 and CFC3
- Upon imposition of the Country A IIR, total tax paid by the MNE Group becomes 30, rendering an ETR of 15%

*See Appendix for detailed calculations

Example 2 - CFC Holdco IIR & Country C QDMTT



Key Facts:

- Facts are the same as Example 1, except that Country C introduces a QDMTT

Analysis:

- 10 of QDMTT paid by CFC3
- Available FTCs increase by the 10 of QDMTT, but none are utilized due to FTC limitation
- Allocable Blended CFC Tax (“ABCT”) remains 11
- ABCT entirely allocated to CFC2 because Country C GloBE Jurisdictional ETR exceeds 13.125% due to QDMTT
- Country B ETR = $(10 \text{ CIT} + 11 \text{ ABCT})/100 = 21\%$, resulting in no top-up tax due under the Country A IIR
- Upon imposition of the Country C QDMTT, total tax paid by the MNE Group becomes 36, rendering an ETR of 18%
 - Country C top-up tax: +8 from Example 1 (from 2 under Country A IIR to 10 Country C QDMTT)
 - Country A top-up tax: -2 from Example 1 (from 2 under Country A IIR to 0)
- The net additional top-up tax of 6 is an overall increase in worldwide tax of the MNE Group as USP does not have FTC capacity to credit any of the Country C QDMTT.

Takeaway: Impact of U.S. Multinational's (U.S. MNE's) FTC limitation on the potential for increased tax burden under a QDMTT

If a jurisdiction introduces a QDMTT, top-up tax will increase in respect of such jurisdiction to the extent the relevant entities are low-taxed and would have been allocated a share of CFC or branch taxes if top-up tax were instead determined in respect of such jurisdiction under an IIR or UTPR

- There are at least two potential mechanisms that can mitigate the effect of the QDMTT increase in top-up tax:
 - 1) Because CFC or branch taxes are not allocated to QDMTT jurisdictions, QDMTTs can free up (and concentrate) CFC or branch taxes to be allocated to IIR and UTPR jurisdictions.
 - 2) US excess limitation in a relevant basket can allow the QDMTT to offset US taxes (but can be challenging in the GILTI and branch baskets)
- Crediting the full amount of QDMTT paid by a MNE Group may not result in a dollar-for-dollar reduction of worldwide tax burden because at some point it may reduce USFIT that would have been allocated to IIR and UTPR jurisdictions (including the U.S.) to the point that additional top-up tax becomes due under an IIR or UTPR

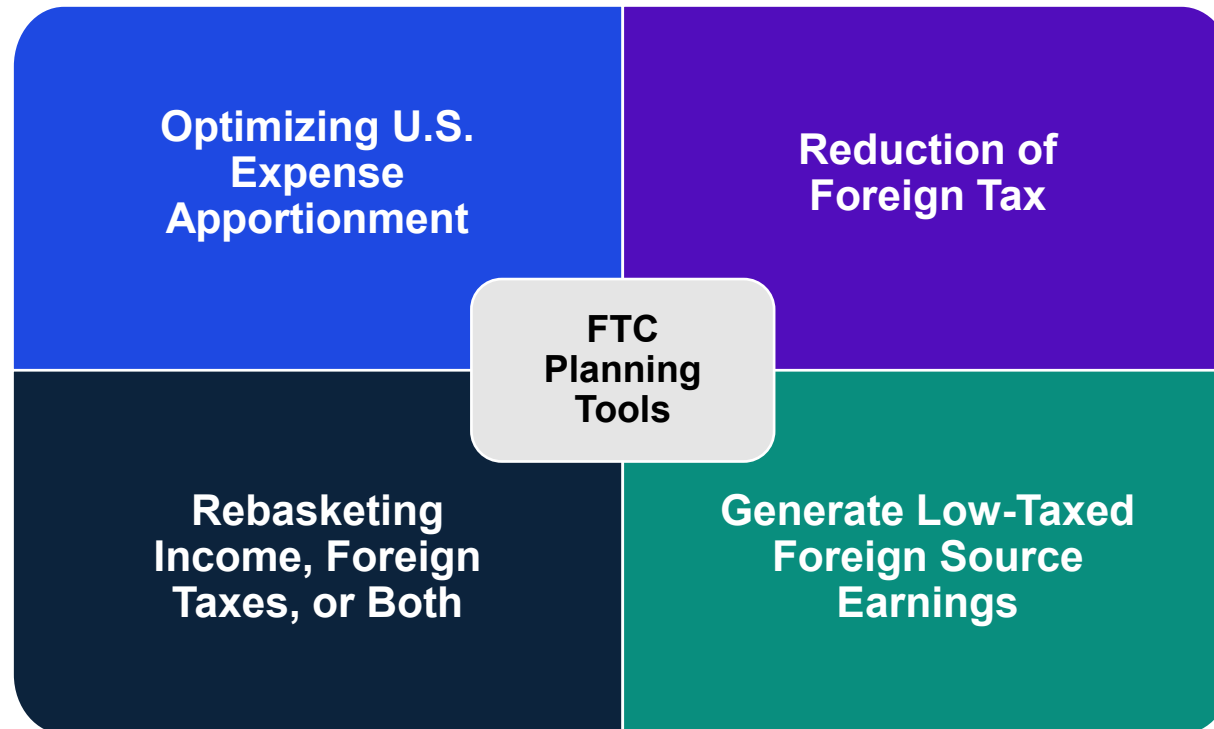
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Optimizing foreign tax credit capacity



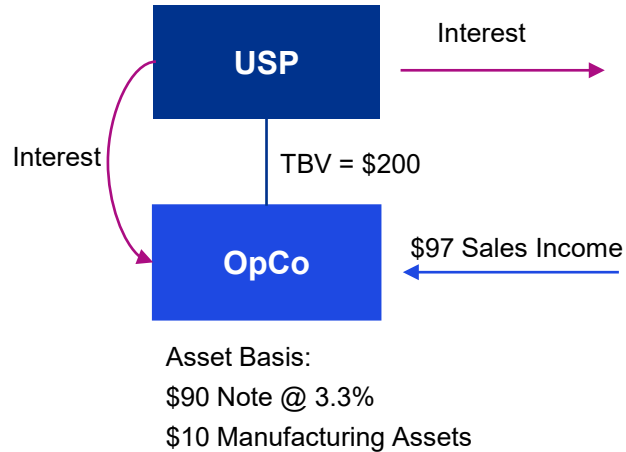
Optimizing foreign tax credit capacity

It is expected that a QDMTT would be a foreign income tax and therefore eligible to be claimed as a FTC. The premium on FTC planning will likely increase as a result because most taxpayers will likely be subject to a QDMTT apportioned to one or more separate limitation categories (“baskets”) in which they are excess credit.



Mitigating interest expense apportionment to FSI

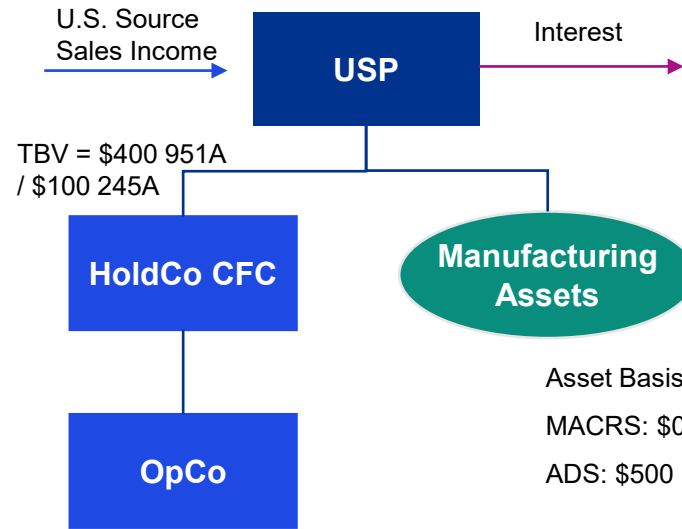
Electing asset method



Characterization of OpCo Stock:

- Asset Method: 90% U.S. source
- MGI Method: 3% U.S. source

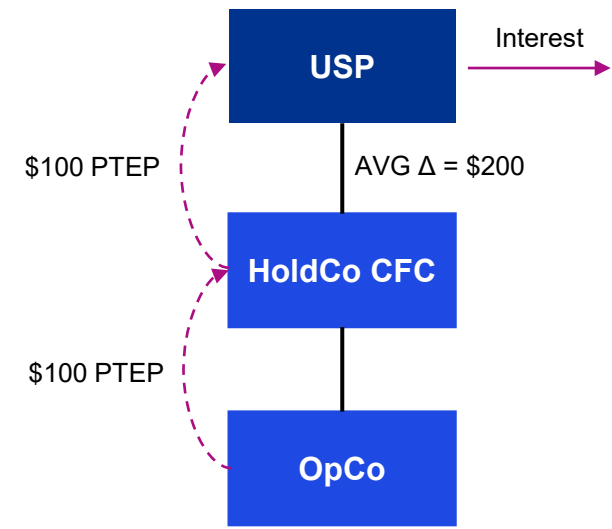
Tax book value vs. Alternative tax book value



TBV v. ATBV

- TBV: 0% U.S. source
- ATBV: 50% U.S. source

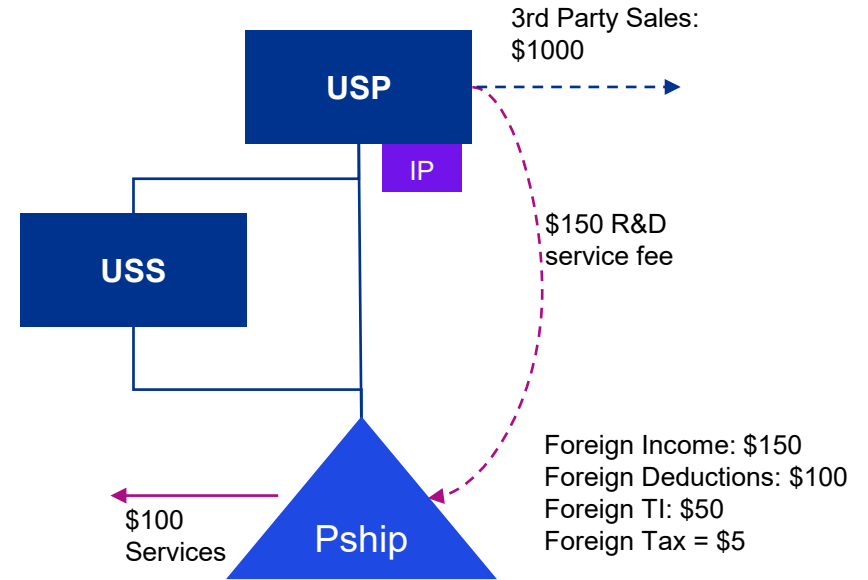
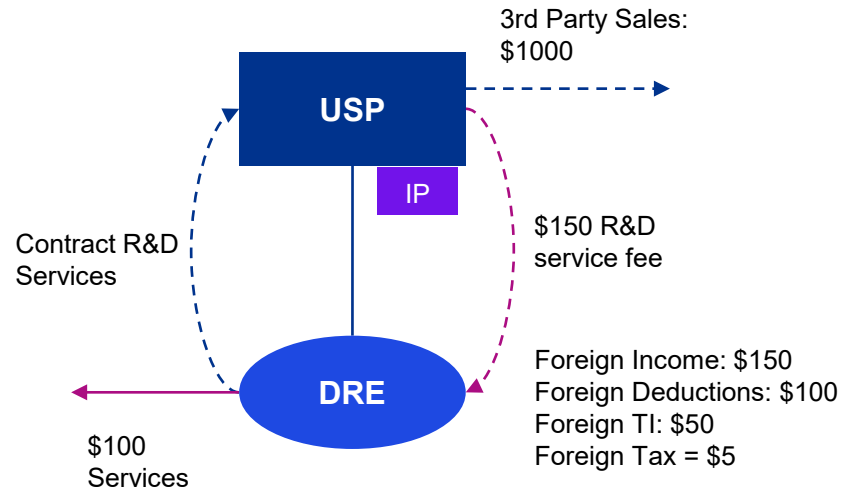
PTEP distribution



Asset Character Shift

- CFC stock value reduced by \$100
- \$100 PTEP received becomes a U.S. asset if deposited in interest bearing account with a U.S. bank.

R&E branch services

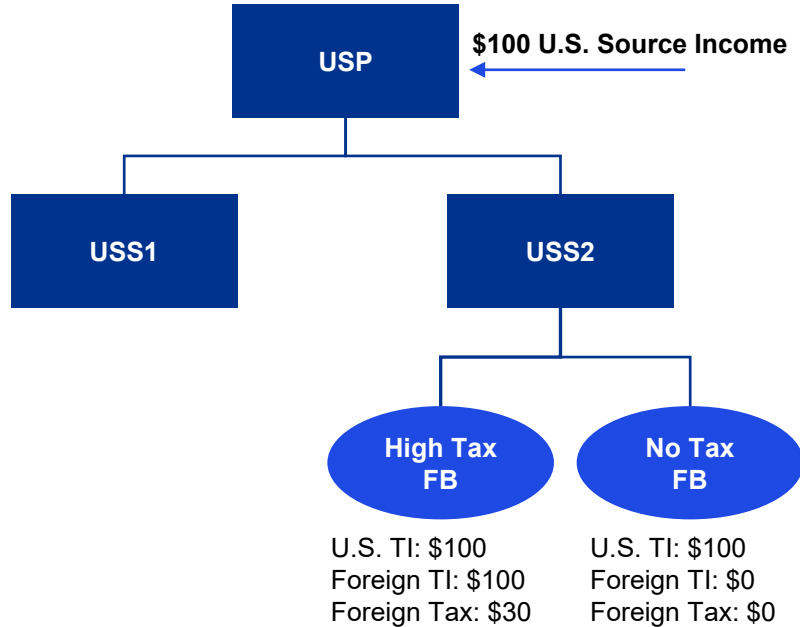


- QDMTT is imposed on DRE's income and is apportioned to the branch basket.
- USP is excess credit in the foreign branch basket for the following reasons:
 - Mandatory section 174 capitalization reduces the disregarded reattribution payment (DRP) to \$10 (instead of \$150). (The third party services deduction is also reduced to \$6.67.)
 - The portion of the DRP that is treated as foreign source branch basket income depends on a hypothetical application of Reg. § 1.861-17 and could be substantially US source.

- Payment to Pship is not a disregarded reattribution payment and results in \$150 of gross foreign source branch basket income (hypothetical application of Reg. § 1.86-17 does not apply to source a regarded payment). The \$100 third party services deduction may reduce net branch basket FSI to \$50.
- The \$150 R&D service fee deduction of USP, along with other section 174 expenses of USP, will be subject to mandatory capitalization and the deductible amounts could be apportioned to branch basket income under Reg. § 1.861-17.
- Any increased amount of foreign source branch basket income may create FTC limitation that enables USP to take an FTC for the QDMTT.

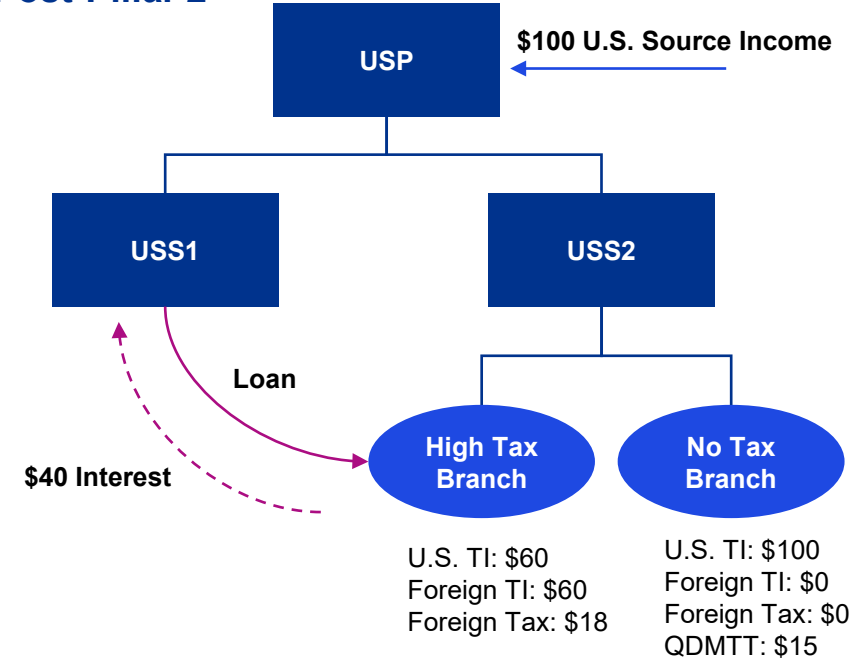
Branch loan

Pre-Pillar 2



- The USP consolidated group is not excess credit in the foreign branch basket, assuming no expense apportionment.

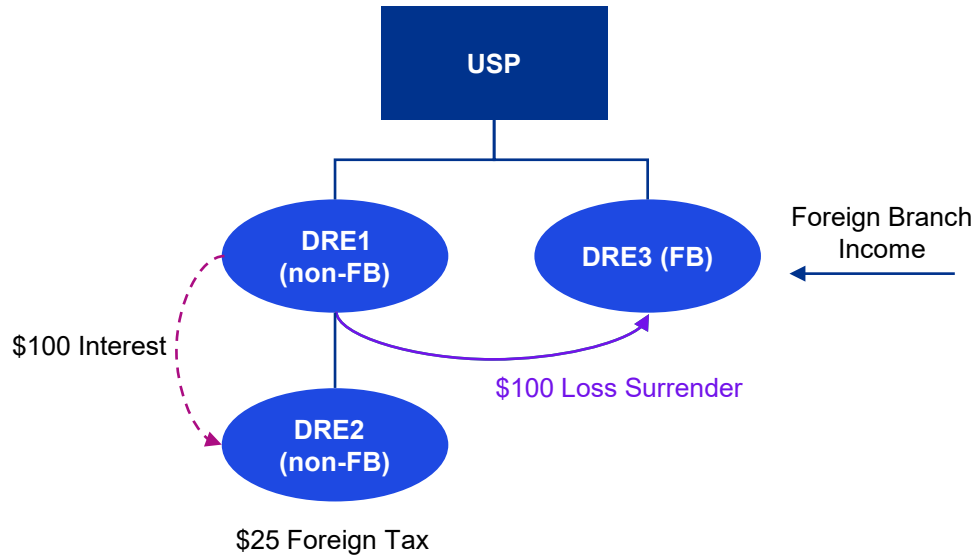
Post-Pillar 2



- The USP consolidated group is excess credit in the foreign branch basket, even without expense apportionment, prior to introduction of the loan as a result of the \$15 QDMTT.
- Interest payment does not result in the reassignment of foreign branch basket income to general basket income for USFIT purposes, which may result in additional foreign branch basket FTC limitation that can be used to credit the QDMTT.
- Note: The U.S. GloBE Income will increase by \$40 so modeling is needed to determine whether the loan triggers top-up tax in respect of the U.S.
- Consider application of BEPS Action 2 / ATAD 2 rules.

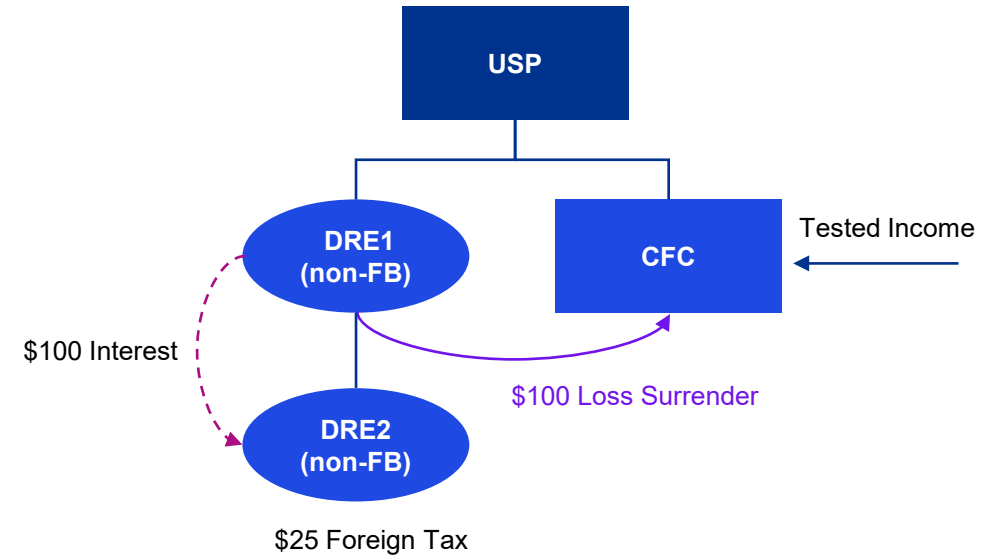
Rebasketing foreign taxes

Foreign Branch → General



- The USP Group is subject to a QDMTT with respect to foreign branch income, has \$25 excess credits in the foreign branch basket, and is excess limitation in the general basket.
- Interest payment is a “contribution” and the \$25 of foreign tax is assigned to the general basket.
- Loss surrender to DRE3 reduces foreign branch basket taxes by \$25, enabling the USP to credit the QDMTT.
- Note: consider whether the utilization of the \$25 general basket FTC causes top-up tax in respect of any entity with general basket income (or the U.S.) as it reduces U.S. Covered Taxes paid on general basket income.

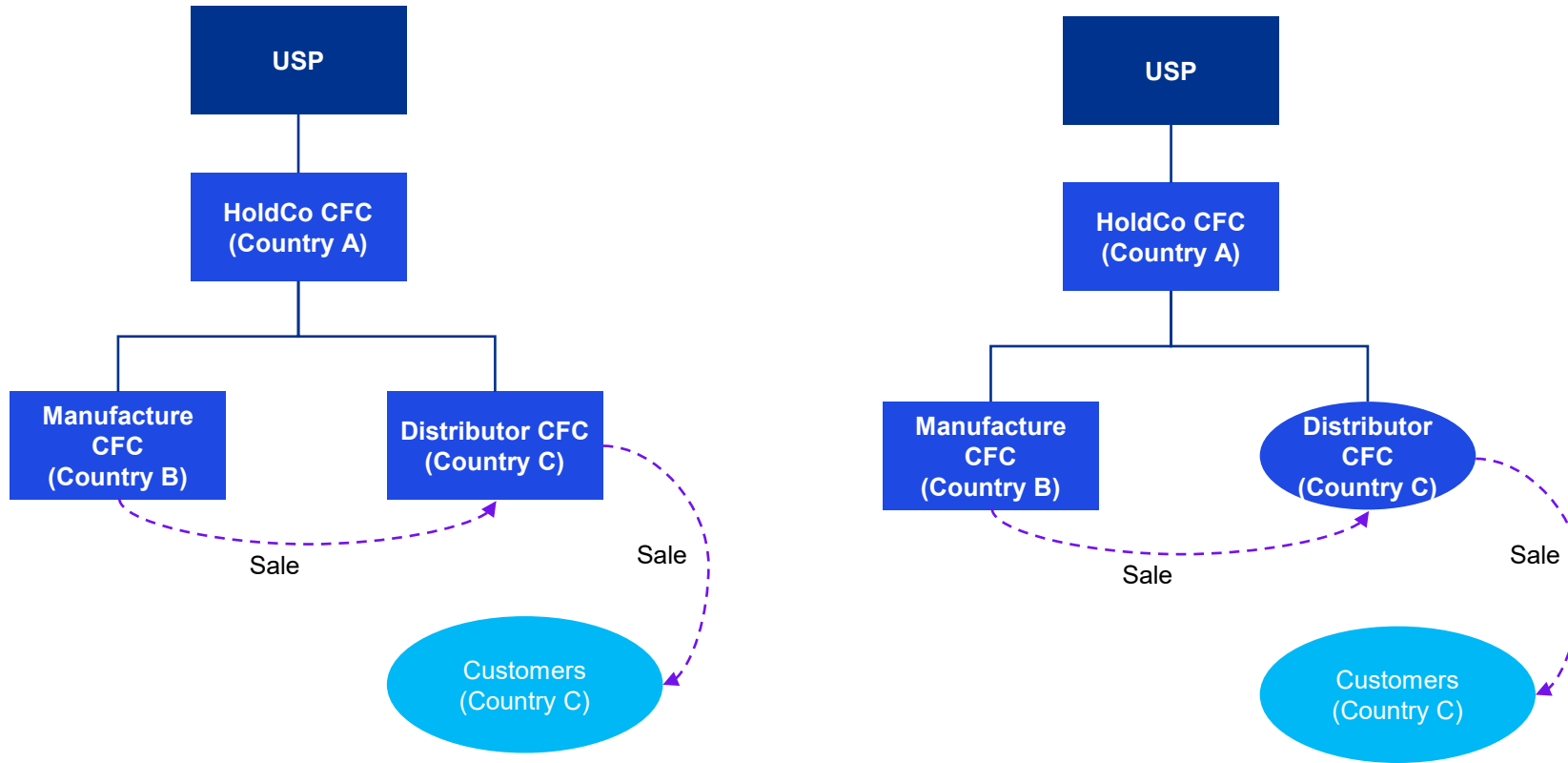
GILTI → General



- The USP Group is subject to a QDMTT with respect to tested income, has \$25 excess credits in the GILTI basket, and is excess limitation in the general basket.
- Interest payment is a “contribution” and the \$25 of foreign tax is assigned to the general basket.
- Loss surrender to CFC reduces foreign tax properly attributable to tested income by \$25, enabling USP to credit the QDMTT.
- \$25 of general basket foreign tax paid by DRE2 is a section 909 “split tax” that can be unsplit to the extent the CFC’s “related income” is “taken into account” by USP.
- Note: consider whether the utilization of the \$25 general basket FTC causes top-up tax in respect of any entity with general basket income (or the U.S.) as it reduces U.S. Covered Taxes paid on general basket income.

Rebasketing foreign income and taxes

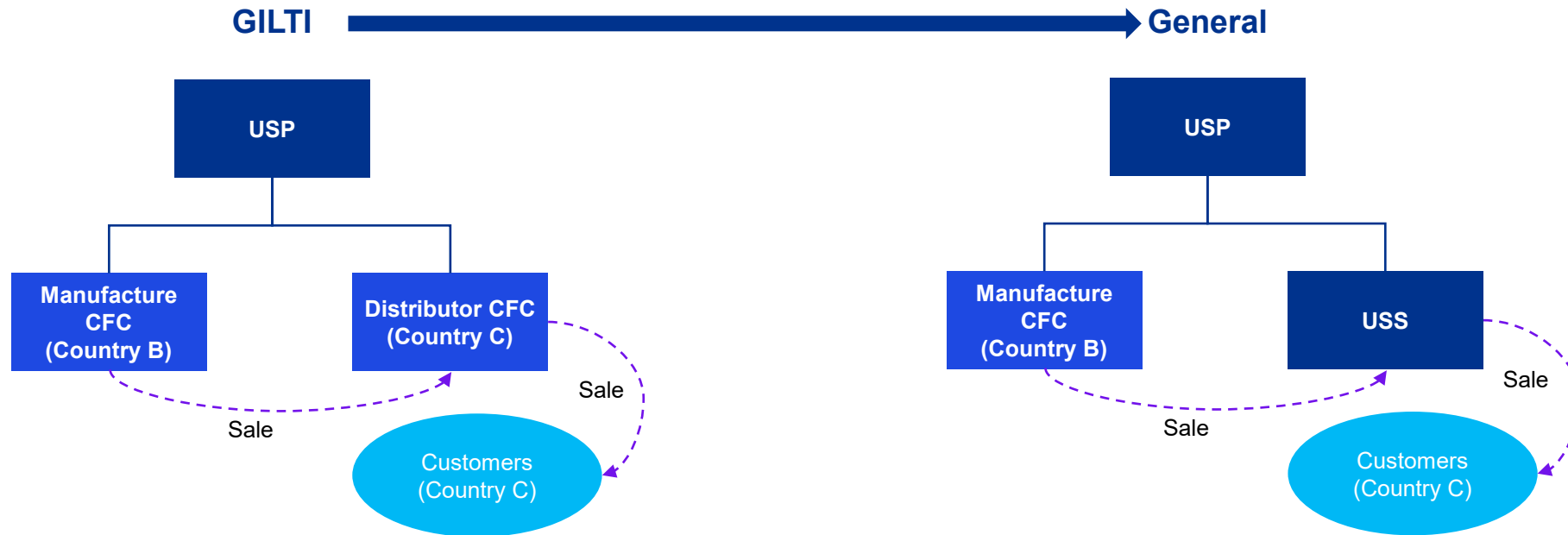
GILTI  General Subpart-F



When Beneficial?

- USP Group is subject to a QDMTT in the GILTI basket. Country C is “high tax”, USP has excess limitation in the general limitation separate category, and USP is excess credit in the GILTI basket.
- USP Group is subject to a QDMTT in the general basket. Country C is “low tax,” USP is excess credit in the general basket, and USP is excess limitation in the GILTI basket.
- Note: Consider whether utilization of additional FTCs creates top-up tax under an IIR/UTPR since the FTC will reduce USFIT allocated to a jurisdiction with income in the relevant basket (or the U.S.).

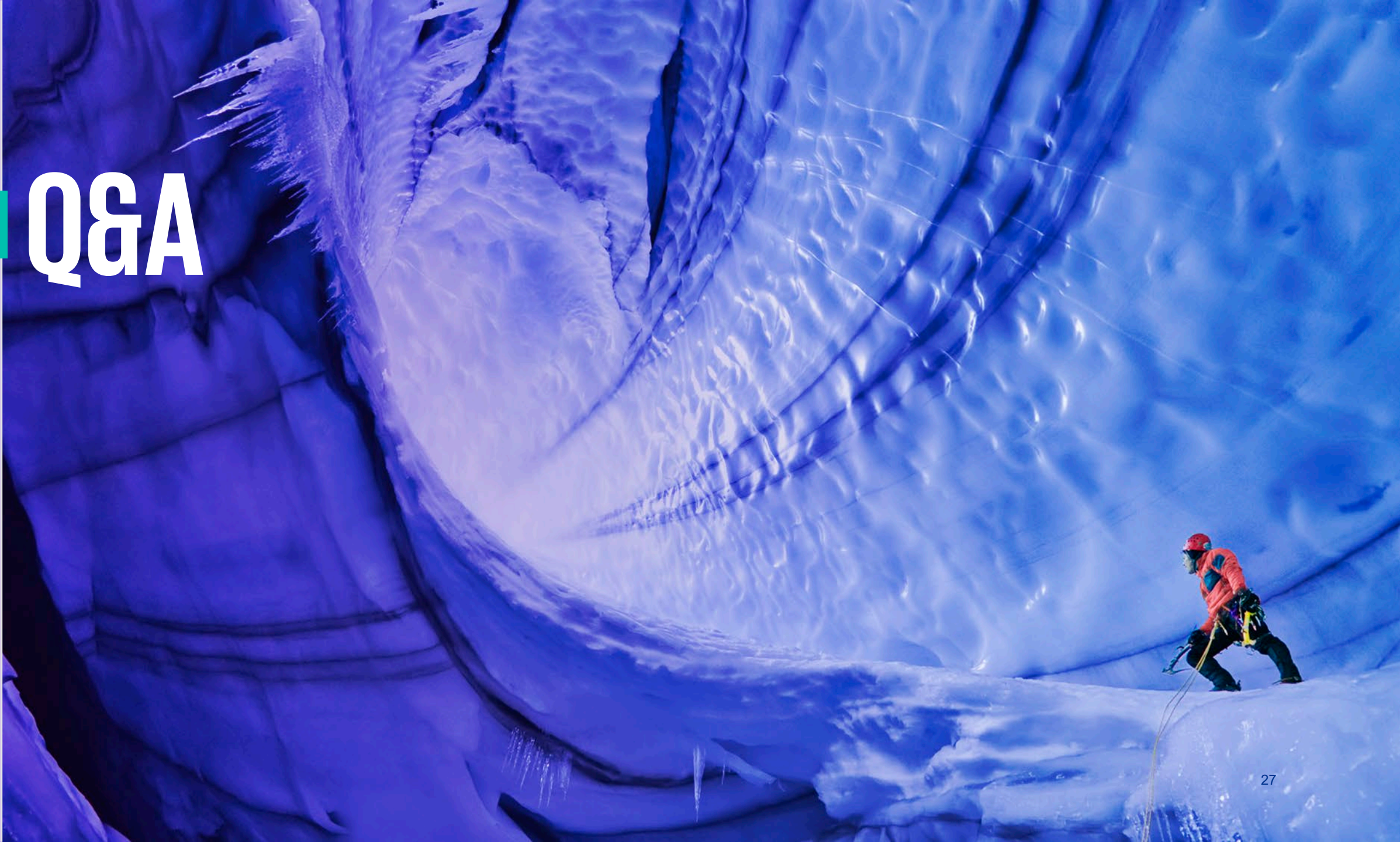
Generate low-tax foreign source earnings



Potential Benefits

- If Distributor CFC was “high tax”, potentially creates FTC limitation in the GILTI basket if USP group is subject to a QDMTT apportioned to the GILTI basket.
- In addition, title passage outside of the U.S. generates incremental foreign source general category income that can create FTC limitation if USP group is subject to a QDMTT apportioned to the general basket and was otherwise excess credit in the general basket.
- Note: Consider whether utilization of additional FTCs creates top-up tax under an IIR/UTPR as the FTC will reduce USFIT allocated to a jurisdiction with income in the relevant basket (or the U.S.).

Q&A



Appendix

Example 1 – Full Calculation

Calculate Blended CFC Allocation Key:

| Blended CFC Allocation Key | | |
|---|----------------------------------|----------------------|
| ➤ CFC1 | $0 \times (13.125\% - 0\%) =$ | No Allocation |
| CFC2 | $100 \times (13.125\% - 10\%) =$ | 3.125 |
| CFC3 | $100 \times (13.125\% - 5\%) =$ | <u>8.125</u> |
| Sum of Blended CFC Allocation Keys | | <u>11.25</u> |

11 of Allocable Blended CFC Tax allocated as follows:

| Blended CFC Tax allocated to each CFC | | |
|---------------------------------------|-------------------------------|----------------------|
| ➤ CFC1 | - | No Allocation |
| CFC2 | $11 \times (3.125 / 11.25) =$ | 3 |
| CFC3 | $11 \times (8.125 / 11.25) =$ | 8 |

Total Effect on Group Tax (WWFT):

| | CFC1 | CFC2 | CFC3 | Net ETR |
|--------------|-----------------|------------------|------------------|------------|
| CIT | 0 | 10 | 5 | |
| GILTI Tax | 0 | 3 | 8 | |
| IIR | <u>4*</u> | <u>n/a</u> | <u>n/a</u> | |
| Total | <u>4</u> | <u>13</u> | <u>13</u> | 15% |

*Represents 2 of Top-up Tax in respect of CFC2 and 2 of Top-up Tax in respect of CFC3

Example 2 – Full Calculation

Calculate blended CFC allocation Key:

| Blended CFC Allocation Key | | |
|---|----------------------------------|------------------------|
| CFC1 | $0 \times (13.125\% - 0\%) =$ | No Allocation |
| CFC2 | $100 \times (13.125\% - 10\%) =$ | 3.125 |
| CFC3 | $100 \times (13.125\% - 5\%) =$ | No Allocation** |
| Sum of Blended CFC Allocation Keys | | <u>3.125</u> |

**When a QDMTT exists and is creditable by US, Country C GloBE Jurisdictional ETR is assumed to exceed 13.125% and thus not be allocated any Allocable Blended CFC tax.

11 of blended CFC tax allocated as follows:

| Blended CFC Tax allocated to each CFC | | |
|---------------------------------------|-------------------------------|----------------------|
| CFC1 | - | No Allocation |
| CFC2 | $11 \times (3.125 / 3.125) =$ | 11 |
| CFC3 | - | No Allocation |

Total effect on group tax (WWFT):

| | CFC1 | CFC2 | CFC3 | Net ETR |
|------------------|-----------------|-------------------|-------------------|------------|
| CIT | 0 | 10 | 5 | |
| GILTI Tax | 0 | 11 | 0 | |
| QDMTT | n/a | n/a | 10 | |
| IIR | <u>0</u> | <u>n/a</u> | <u>n/a</u> | |
| Total | <u>0</u> | <u>21</u> | <u>15</u> | 18% |



Thank you!





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