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The Proposed DCL and DPL Rules: A Tale of Dreams and Nightmares

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The proposed DCL and DPL regulations have drawn the ire of many taxpayers and are bad tax policy, say Baker McKenzie practitioners.

Last week, Treasury issued proposed regulations (REG-105128-23) under §1503(d) and §7701 (the "Proposed Regulations") that address many issues that have been top of mind for taxpayers as foreign countries have begun enacting Pillar Two rules. These Proposed Regulations address how several U.S. tax rules apply in a Pillar Two world. In some situations, the Proposed Regulations provide a welcome relief to taxpayers. In many other situations, the Proposed Regulations create complex and punitive rules that may give taxpayers nightmares.

This article considers three aspects of the Proposed Regulations. First, it focuses on the new disregarded payment loss rules ("DPL Rules") that have caught many taxpayers off guard. These DPL Rules will justifiably draw the ire of many taxpayers and will keep legions of tax advisers busy over the next year as they seek to advise clients on ways to avoid punitive tax results.

In addition, this article addresses Treasury's decision to treat the Transitional CbCR Safe Harbor in the Pillar Two rules as potentially giving rise to foreign use under the dual consolidated loss ("DCL") rules. While Treasury had foreshadowed its conclusion over the last several months, many taxpayers believe that this decision is contrary to the mechanical application of the Transitional CbCR Safe Harbor rules. Finally, this article discusses the proposed rules that address the interaction of the DCL rules and the intercompany transaction rules in Treas. Reg. §1.1502-13. These rules had been anticipated by taxpayers, and many taxpayers will find these rules to be a helpful clarification of current law.

I. The New Tax Bogeyman: The DPL Rules

The DPL Rules are Treasury's attempt to prevent a U.S. corporate taxpayer from having its foreign disregarded entity ("DRE") make a disregarded interest or royalty payment to its U.S. owner (or to another of its DREs resident in a third jurisdiction) if the corresponding interest or royalty expense reduces the foreign taxable income of a regarded foreign affiliate of the foreign DRE.

If the DPL Rules are "triggered," then the U.S. taxpayer is required to recognize taxable income potentially up to the entire amount of the disregarded payment from the foreign DRE to its U.S. owner ("DPL Inclusion Income"). Thus, the DPL Rules can cause a disregarded payment to be treated as giving rise to U.S. taxable income.

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While the DPL Rules are targeted at situations in which a foreign DRE's expense reduces foreign taxable income of an affiliate without a corresponding income inclusion by a U.S. taxpayer, the current DPL Rules are so broadly drafted that the DPL Rules will apply far beyond those situations that appear to be the target of Treasury's ire.

Given the potentially draconian results of DPL Inclusion Income, taxpayers are now assessing their structures to determine:

1. Whether the taxpayer has "disregarded payment entities" (each a "DPE," as defined below) that are subject to the DPL Rules;

2. Whether each DPE has a DPL (as defined below);

3. Whether the taxpayer can make a certification for its DPL to avoid DPL Inclusion Income from the DPL; and

4. Whether there has been or will be a "foreign use" of the DPL that would prevent the taxpayer from making a certification.

Each of these issues is discussed below.

A. DPEs and Deemed Consent Under the DPL Rules

The DPL Rules apply when a domestic corporation owns a "specified eligible entity," which generally is a business entity that (1) is a foreign tax resident and (2) is not a *de facto* corporation under the check-the-box regulations (i.e., an entity that can elect to be treated as either a flow-through or a corporation, such as an LLC, Ltd., GmbH, etc.) (*See* Prop. Reg. §301.7701-3(c)(4)(i)).

The Proposed Regulations provide that a domestic corporation is treated as consenting, or is deemed to consent, to the application of the DPL Rules, when its specified eligible entity elects to be treated as a DRE or defaults to DRE status, or if the domestic corporation holds or acquires a DRE (*See* Prop. Reg. §301.7701-3(c)(4)(i), (iii)). In other words, having a DRE is sufficient to constitute consent by the DRE's U.S. owner to be subject to the DPL Rules. This deemed consent arises as the result of a domestic corporation's ownership of any single DRE that is a foreign tax resident and grants broad consent to the full application of the DPL Rules, which also apply to unincorporated foreign branches. That is, as a result of the deemed consent, the domestic corporation's foreign tax resident DREs and foreign branches all become "disregarded payment entities" ("DPEs") (*See* Prop. Reg. §1.1503(d)-1(d)(1)(i)).

This consent is vital to the operation of the DPL Rules because, as we will see, the DPL Rules invent items of gross taxable income that do not exist under any provision of the Code. Thus, by owning a foreign tax resident DRE, Treasury is proposing that a domestic corporation be deemed to consent to recognize and be subject to tax on income that does not exist for U.S. federal income tax purposes. The Proposed Regulations extend the DPL Rules to dual resident corporations as well and can cause dual resident corporations to recognize income inclusions in respect of disregarded payments to their DREs (*See* Prop. Reg. §1.1503(d)-1(d)(1)(ii)).

A domestic corporation that directly or indirectly owns a DPE is referred to as a "specified domestic owner" (a "Domestic Owner") (*See* Prop. Reg. §1.1503(d)-1(d)(1)(i)). When a DPE has a DPL, and a

triggering event occurs with respect to the DPL at a time during the certification period (described below), the Domestic Owner is required to recognize the DPL Inclusion Income (with certain adjustments discussed below).

B. How to Calculate a DPL

A DPE's DPL is the amount by which its "Items of Deduction" exceed its "Items of Income" (*See* Prop. Reg. §1.1503(d)-1(d)(6)(ii)(B)). Taxpayers need to carefully parse these definitions because these definitions cause taxpayers to have DPLs in many surprising situations.

A DPE's Items of Deduction generally are items: (i) allowed as a deduction to the DPE under the relevant foreign tax law; (ii) that are disregarded for U.S. federal income tax purposes; and (iii) that if regarded for U.S. federal income tax purposes would be treated as a payment of interest, a royalty payment, or a structured payment (*See* Prop. Reg. §1.1503(d)-1(d)(6)(ii)(C)). Additionally, Items of Deduction include deductions that, under the relevant foreign tax law, arise: (i) with respect to equity or deemed equity, or (ii) as the result of interest imputed on a debt instrument.

Similarly, a DPE's Items of Income are items: (i) the DPE includes as income under the relevant foreign tax law; (ii) that are disregarded for U.S. federal income tax purposes; and (iii) that, if regarded for U.S. federal income tax purposes, would constitute the receipt of interest, a royalty, or a structured payment (*See* Prop. Reg. §1.1503(d)-1(d)(6)(ii)(D)). A structured payment is similar to an interest payment (*See* Treas. Reg. §1.267A-5(b)(5)(ii)). Because an Item of Income must be disregarded for U.S. federal income tax purposes, the utility of this reduction will often be limited.

It is also important to note that the DPL Rules contain a "combined separate unit" rule that is similar to the rule in the DCL regulations. Under this rule, DPEs that are subject to tax in the same foreign jurisdiction and that have the same foreign tax year are generally treated as a single DPE (a "DPE Combined Unit") (*See* Prop. Reg. §1.1503(d)-1(d)(7)(i)). Therefore, Items of Income of the DPE Combined Unit can offset Items of Deduction of the DPE Combined Unit.

Based on these definitions, profitable DPEs often will have DPLs because the relevant Items of Income are limited to disregarded interest and royalty income. The punitive nature of these rules can be illustrated by the following three examples.

First, assume a profitable distributor DPE borrows funds from its parent in order to finance its inventory purchases that are then sold to customers. In this situation, the DPE has Items of Deduction from disregarded interest payments, but the DPE's income is from sales. As a result, the DPE does not have any Items of Income to reduce its Items of Deduction from its disregarded interest expense, even though its Domestic Owner is fully taxed on all of the DPE's sales income. Thus, the Domestic Owner of the DPE will have a DPL for its entire interest expense.

Similarly, assume a profitable DPE licenses in certain IP from its Domestic Owner and licenses out IP to third parties or regarded affiliates of its owner. In this case, the DPE often will have a DPL because its royalty expense is disregarded, and is thus an Item of Deduction, while its income is regarded income, and thus is not an Item of Income. This is the case even though the Domestic Owner is fully taxed on all of the DPE's third-party royalty income. Thus, the Domestic Owner of the DPE will have a DPL for its entire royalty expense.

Finally, assume a profitable DPE pays a disregarded royalty to its Domestic Owner so that it can manufacture inventory that it sells to another DPE that the Domestic Owner owns. The sales income that it derives will not prevent a DPL from arising because sales income is not an enumerated Item of Income that can be netted against a DPE's Items of Deduction. This result follows even though, on a net basis, the DPE may not have a loss.

These three examples show that the DPL rules can often create DPLs where a foreign DRE generates net positive income, and where, in many cases, all of that income is subject to tax in the United States. It is also not clear why Treasury would want a Domestic Owner to forgo charging arm's-length royalties and interest to these foreign DREs. These arm's-length expenses reduce foreign taxable income so that fewer foreign tax credits can be claimed in the United States against the U.S. taxable income produced by the foreign DRE. Treasury needs to understand that these DPL Rules are arguably inconsistent with transfer pricing principles and are likely to result in a larger amount of foreign tax credits being claimed by U.S. taxpayers.

To avoid a DPL Inclusion in such circumstances, the taxpayer generally must make a certification and ensure that the DPL is not subject to foreign use during the current year, the subsequent five years, and any prior taxable years (*See* Prop. Reg. §1.1503(d)-1(d)(6)(iii)). The regulations refer to this period as the "DPL certification period." We discuss this certification process below.

C. DPL Certification to Avoid a DPL Inclusion

As explained above, DPLs are going to arise in numerous non-abusive situations. For a taxpayer to avoid recognizing punitive DPL Inclusion Income, the taxpayer will need to vigilantly comply with the certification requirements in the DPL Rules.

For the owner of a DPE to not have a DPL Income Inclusion, the owner must file a DPL certification with its timely filed tax return (as well as for the next five years). If a taxpayer fails to timely file a DPL certification, then the taxpayer may have inadvertently created DPL Inclusion Income up to the entire amount of the disregarded payment. Thus, DPL certifications will become critical compliance items for U.S. taxpayers.

The first DPL certification must be filed with the taxpayer's return for the U.S. taxable year in which the foreign taxable year in which the DPL was incurred ends (*See* Prop. Reg. §1.1503(d)-1(d)(4)(i)). This "Initial Disregarded Payment Loss Certification" certification must include:

1. Identification of the DPE, including the name under which it conducts business, its principal activity, and the country in which its principal place of business is located (for a DPE Combined Unit, this information must be provided for each individual DPE that is treated as part of the DPE Combined Unit);

2. A statement of the amount of the DPL; and

3. A statement that there has been no foreign use of the DPL during the certification period (*See* Prop. Reg. §1.1503(d)-1(d)(4)(i)).

Then, for each subsequent year in the certification period and in which the DPE's foreign tax year ends, the Domestic Owner must file "Annual Disregarded Payment Loss Certifications" in which the Domestic Owner: (i) sets forth the amount of the DPL and the year it was incurred; (ii) certifies no foreign use of

the DPL; and (iii) warrants that arrangements have been made to ensure that there will be no foreign use of the DPL and that the Domestic Owner will be informed if there is a foreign use (*See* Prop. Reg. §1.1503(d)-1(d)(4)(ii)). A "termination of DPL certification period exception" applies with respect to the DPL of a DPE when the Domestic Owner, and parties related to the Domestic Owner, no longer hold any direct or indirect interest in the DPE. Specifically, when a Domestic Owner terminates its direct or indirect interest in a DPE, and the DPE is no longer owned by a person related to the Domestic Owner, the certification period terminates. When this termination occurs, the Domestic Owner is obligated to comply with the certification requirements (and will have income inclusions from triggering events) only with respect to the tax year in which its interest in the DPE was terminated, and prior years (*See* Prop. Reg. §1.1503(d)-1(d)(7)(iii)).

As those familiar with the DCL rules will see, the DPL rules broadly treat a DPL as a DCL with respect to which a Domestic Owner has made a domestic use election ("DUE"). In that sense, conceptually, the DPL rules treat the disregarding of a DPE's otherwise deductible payment in a similar manner to a domestic use of a DCL pursuant to a DUE, which results in an income inclusion if triggered. Thus, the DPL certification requirements closely resemble the requirements for making and certifying a DUE (*Compare* Prop. Reg. §1.1503(d)-1(d)(4) *with* Treas. Reg. §1.1503(d)-6(d), -6(g)). Importantly, however, unlike DUEs, there is no exception to the DPL certification requirements if the Domestic Owner shows no possibility of foreign use.

When filing these certification statements, the critical item will be determining whether there has been foreign use of the DPL during the year.

D. Foreign Use and Other Triggering Events That Require a DPL Inclusion

Similar to the DUE rules for DCLs, a DPL can be triggered if there is foreign use of the DPL or by a failure to comply with the DPL certification requirements (*See* Prop. Reg. §1.1503(d)-1(d)(3)).

1. Determining Whether There Is Foreign Use of a DPL

If there is no foreign use of the DPL, then there generally will be no DPL Inclusion Income, and the taxpayer can continue making its annual certifications for its DPLs. However, if there is foreign use, then that foreign use is a triggering event that will cause the Domestic Owner of the DPE to recognize DPL Inclusion Income.

Whether there is a foreign use of a DPL is determined "under the principles" that apply for determining whether there is a foreign use of a DCL of separate unit, except that there is a foreign use of a DPL only if the use is by a person related to the Domestic Owner (*See* Prop. Reg. §1.1503(d)-1(d)(3)(i)).

Even though the DCL rules for foreign use generally apply, the DPL Rules raise numerous complexities regarding the foreign use of a DPL. These complexities are not addressed in the current DCL regulations or the Proposed Regulations. We believe that Treasury is going to have to address these complexities in any final regulations because the current DPL Rules would otherwise become unduly punitive.

For instance, when determining whether there is foreign use of a DPL, we suspect that taxpayers will rely heavily on Treas. Reg. §1.1503(d)-3(c)(3) to show that there is no foreign use. Generally, Treas. Reg. §1.1503(d)-3(c)(3) provides that a DCL is treated as offsetting gross income in a manner that does not give rise to a foreign use before it is treated as offsetting income in a manner that gives rise to a foreign use. Applying the principle of this regulation, a taxpayer should generally be allowed to treat its

DPL as first offsetting the DPE's own net income (regardless of whether that income is comprised of Items of Income, specifically, disregarded interest and royalty income). Similarly, if the DPE is a member of a DPE Combined Unit, then we would expect that the DPE Combined Unit's DPL would be offset by the DPE Combined Unit's income before it is treated as offsetting the income of an affiliated foreign corporation.

It is our hope that Treasury will clarify that applying DCL principles to determine foreign use means that the items forming a DPL are first to be applied to offset all of the DPE's regarded income (and not just its disregarded interest and royalty income) before any foreign use can occur. We see no policy justification as to why Treas. Reg. §1.1503(d)-3(c)(3) would only apply to disregarded interest and royalty income. In fact, we think that Treasury would want to encourage taxpayers to marry as much income with expense as possible to minimize the amount of creditable foreign taxes that can reduce U.S. federal income tax.

If there can be bright spots in these DPL Rules, it would be that they only apply to a foreign use by a person related to the Domestic Owner and that triggering events appear not to include the further array of triggering events that trigger DUEs (e.g., transfer of assets, transfer of interest, etc.) (*Compare* Prop. Reg. §1.1503(d)-1(d)(3) *with* Treas. Reg. §1.1503(d)-6(e)). In addition, we note that taxpayers should be able to rely on the transition period for foreign use in the context of both Pillar Two and the Transitional CbCR Safe Harbor as set forth in Prop. Reg. §1.1503(d)-8(b)(12). Under this rule, generally speaking, for calendar year taxpayers, no foreign use should occur with respect to a DPL (or DCL, for that matter) that is incurred in 2024 to the extent a DPE's results are combined with those of a foreign corporation under an Income Inclusion Rule ("IIR"), a qualified domestic minimum top-up tax ("QDMTT"), or the Transitional CbCR Safe Harbor.

2. Reporting Failure

If a taxpayer fails to timely file a DPL certification with its tax return, presumably the Domestic Owner can cure this failed filing if the Domestic Owner follows the general procedures for reasonable cause relief for DCL-related filing errors (*See* Treas. Reg. §1.1503(d)-1(d); Prop. Reg. §1.1503(d)-1(e)).

Nevertheless, the compliance aspects of the DPL rules seem like a daunting and perilous innovation Treasury is imposing on taxpayers. Domestic corporations will need to monitor every foreign tax resident DRE and foreign branch for disregarded interest and royalty expense and income, including monitoring whether this income and expense would or would not appropriately be treated as interest/royalty income/expense for U.S. federal income tax purposes. This interest/royalty income/expense must be specially tracked and accounted for under the DPL rules, and, if there is any failure to comply with the DPL reporting and certification rules, the result is an income inclusion, unless the Domestic Owner undertakes and satisfies the requirements of the relevant reasonable cause procedures.

3. Amount of the DPL Inclusion from a Triggering Event

If a triggering event occurs, the DPE's Domestic Owner is required to include in gross taxable income an amount equal to the triggered DPL, as reduced by the cumulative register mechanism (*See* Prop. Reg. §1.1503(d)-1(d)(2)(i)).

A DPE's cumulative DPL register tracks a DPE's net disregarded payment income or loss for a given year, such that if there is ever a triggering event with respect to a DPL, the resulting income inclusion is generally limited to the negative amount reflected in the cumulative register (*See* Prop. Reg. §1.1503(d)-1(d)(5)(i)). For example, if a DPE has disregarded payment income of $100 in each of years 1 and 2, and

then, in year 3, the DPE has a DPL of $200 that is triggered, the DPE's Domestic Owner has no inclusion because the DPE's cumulative register reflects a zero amount. If the year 3 loss, instead, were $300, the DPL inclusion would be the $100 amount reflected in the DPE's cumulative register.

Again, it bears emphasizing that disregarded payment income is limited to disregarded interest and royalty income. Thus, most taxpayers will not be relying on the cumulative DPL register.

If a DPL is triggered, the DPL Inclusion Income is treated as ordinary interest or royalty income (depending on the composition of the DPL) paid by a foreign corporation (*See* Prop. Reg. §1.1503(d)-1(d)(2)(ii)). Thus, to the extent treated as interest income, the DPL inclusion income generally is foreign source, while sourcing for any portion treated as royalty income must be determined based on the place of use of the relevant intangible (*See* Code §861(a)(1), §861(a)(4), §862(a)(1), §862(a)(4)).

It's also important to note that, unlike DCL recapture, the DPL Rules result in an irreversible, deemed income inclusion. This can be contrasted with the DCL rules in which, even though there may be recapture, the DCL is effectively deferred and can be used in later years (*See* Treas. Reg. §1.1503(d)-6(h)(6)).

E. Effective Date of the DPL Rules

The draconian consequences of the DPL Rules already have taxpayers scrambling to ensure that they do not have DPLs with respect to existing DREs and foreign branches that could result in DPL Inclusion Income. However, it is not entirely clear when the DPL Rules begin to apply.

The DPL Rules apply to a Domestic Owner for its tax years ending after August 6, 2024 (*See* Prop. Reg. §1.1503(d)-8(b)(11)). However, Prop. Reg. §301.7701-3(c)(vi)(B) provides that Domestic Owners are only deemed to consent to the regulations for existing DREs after August 6, 2025. The question arises as to what happens to disregarded interest and royalty expenses for existing DREs that accrue between now and August 6, 2025.

A DPL is defined as a DPE's Items of Deduction and Income, and these two items are determined by reference to the DPE's foreign tax year. Thus, it is not clear how much of a DPE's Items of Deduction and Income are taken into account during the DPE's first foreign tax year that ends after August 6, 2025.

We hope that Treasury will clarify that the DPL Rules do not apply retroactively and that a DPL for a deemed consenting DPE only includes foreign deductions that accrue after August 6, 2025. This grace period would allow taxpayers to restructure their operations to avoid draconian DPL Inclusion Income. If the DPL Rules apply to foreign deductions that accrue before August 6, 2025, then companies are going to need to begin the process immediately of restructuring their actual business operations that involve disregarded royalty and interest payments. However, it will be hard to restructure distribution and manufacturing operations (like those discussed above) so quickly. As a result, if, for instance, the DPL Rules were to apply to all foreign deductions that accrue in a foreign tax year that ends after August 6, 2025 (e.g., a foreign tax year that begins January 1, 2025), then the taxpayer in the three examples above will begin accruing foreign deductions sooner and will likely have some DPL Inclusion Income (if it is unable to prove no foreign use over the next five years).

F. Authority for the DPL Rules

After reading the DPL rules, many taxpayers will no doubt be left wondering what authority Treasury is

relying on to propose to issue these rules. The DPL rules are generally in line with the anti-hybrid rules in BEPS Action 2, but Congress has not enacted all of the anti-hybrid rules from that BEPS report. Instead, Congress has only enacted §267A and §1503(d).

The preamble to the Proposed Regulations cites §1503(d) and §7701 as the basis for the DPL rules. However, §1503(d)(2)(A) defines a DCL by reference to a "net operating loss." Moreover, the Treasury regulations under §1503(d) confirm that Treasury believes that the statute is referring to a net operating loss under §172, and that the DCL rules therefore apply to losses that are regarded for U.S. federal income tax purposes (*See* Treas. Reg. §1.1503(d)-1(b)(5), -5(c)). Thus, one has to wonder whether §1503(d) provides Treasury with the authority to issue regulations that require taxpayers to create gross income based on disregarded transactions that do not give rise to a "net operating loss" as used in §1503(d).

Perhaps Treasury believes it is entitled under §7701 to condition an entity classification election on the entity agreeing to whatever Treasury believes to be appropriate under Title 26, regardless of whether such agreement has any bearing on a matter that is within §7701(a)'s scope — here, whether an entity is appropriately classified as a corporation, a partnership, or a DRE. That, too, would allow Treasury to create seemingly unbounded rules whenever an entity makes an entity classification election. Moreover, Treasury is applying the DPL Rules to entities that default to DRE status, and it is hard to understand why §7701 gives Treasury the authority to apply the DPL Rules to entities that default to disregarded status. Ultimately, the DPL Rules do not seem to be the best interpretation of the statute.

Instead, the materials that provide the best support for the current DPL rules are the anti-hybrid rules in BEPS Action 2. Treasury makes this point clear in the preamble to the Proposed Regulations, when it says that "the OECD/G20 recommends defensive rules that require income inclusions to neutralize D/NI outcomes. See, for example, Hybrid Mismatch Report Recommendations 1.1(b) and 3.1(b)." The DPL rules are not the first instance in which Treasury cited BEPS Action 2 as support for a regulatory approach — it appears in Treas. Reg. §1.1503(d)-7(c), Example 41, for instance, and in Treasury Decision 9896 (Apr. 8, 2020), which introduced the domestic consenting corporation rules along with regulations under §245A(e) and §267A. Here, however, between §1503(d), §7701, and BEPS Action 2, it seems like the primary, and perhaps only, support for the DPL rules is in the final BEPS Action 2 report, a document issued by the OECD, not by Congress.

Thus, the DPL rules seem to be another instance in which Treasury is seeking to align U.S. tax law with international guidance — just like Treasury sought to do with the foreign tax credit rules for IIR taxes in Notice 2023-80. While this article is not the proper place to address in detail Treasury's authority to issue the DPL rules, we believe it is the proper place to raise the question, as we have done.

II. Foreign Use and Pillar Two: The Nightmare Continues

The Proposed Regulations address a number of ways in which there can be foreign use under the DCL rules. A full treatment of this aspect of the Proposed Regulations is beyond the scope of this article. Instead, this article focuses on the narrow issue of whether foreign use occurs under the Transitional CbCR Safe Harbor. However, before examining this specific issue, it is helpful to analyze why foreign use could arise under the "regular" Pillar Two QDMTT and IIR regimes.

A. In General

Under Treas. Reg. §1.1503(d)-3(a)(1), foreign use occurs when any portion of a DCL is made available under the income tax laws of a foreign country to offset or reduce an item of a foreign corporation that is recognized as income or gain under those laws.

For purposes of determining whether a jurisdiction meets the 15% Pillar Two minimum tax rate, the Pillar Two Global Anti-Base Erosion ("GloBE") Model Rules compute the effective tax rate of a multinational group for that jurisdiction in part by determining the "Net GloBE Income" of that jurisdiction (*See* GloBE Model Rules, Art. 5.1.1). Net GloBE Income equals the sum of the "GloBE Income" of all the group's Constituent Entities in that jurisdiction minus the sum of the "GloBE Losses" all the group's Constituent Entities located in that jurisdiction (*See* GloBE Model Rules, Art. 5.1.2). Generally speaking, a Constituent Entity is a body corporate, a partnership, a trust, or a PE that is a member of a multinational group, and the starting point for the GloBE Income or Loss of that entity is the entity's net income or loss as determined for purposes of the group parent's consolidated financial statements (*See* GloBE Model Rules, Arts. 1.3.1, 3.1.1–3.1.2, 10.1.1).

Assume that a U.S. parent corporation owns a DRE in jurisdiction X ("DREX") and a CFC in jurisdiction X ("CFCX"). To determine the jurisdiction X effective tax rate for purposes of Pillar Two, the GloBE Income or Loss of each of DREX and CFCX is aggregated to arrive at the Net GloBE Income of jurisdiction X that will serve as the denominator in the Pillar Two effective tax rate computation. If DREX has a GloBE Loss that also is a DCL, does the Pillar Two effective tax rate computation constitute a foreign use of that DCL? In Notice 2023-80, the IRS observed that they were "studying the extent to which the DCL rules should apply with respect to the GloBE Model Rules, including the extent to which aggregation should result in a foreign use of a DCL" (*See* Notice 2023-80, §3.02).

Treasury and the IRS appear to have concluded their study of this topic. The preamble to the Proposed Regulations addresses a similar DREX and CFCX illustration and states: "[A]n IIR or QDMTT may be an income tax for purposes of the DCL rules and a foreign use may occur under such tax by reason of a loss being used in the calculation of Net GloBE Income or to qualify for a Transitional CbCR Safe Harbour."

This conclusion is consistent with Treasury's conclusion in Notice 2023-80 that taxes under QDMTT and IIR regimes could be foreign income taxes for purposes of the foreign tax credit provisions. One question that remains unaddressed is whether the DCL rules could apply to a QDMTT or IIR tax that does not qualify as an income tax for purposes of the §901 foreign tax credit rules.

B. Use of a Loss to Qualify for a Transitional CbCR Safe Harbor Should Not Represent a Foreign Use of a DCL

The Proposed Regulations also address the interaction of the DCL rules with the Pillar Two Transitional CbCR Safe Harbor. Much to the chagrin of many taxpayers—yet in line with previous comments by Treasury officials—the Proposed Regulations provide that foreign use can occur in the context of the Transitional CbCR Safe Harbor.

As background, the Transitional CbCR Safe Harbor was first introduced in December 2022 in the document entitled, "Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)" (the "Safe Harbors Document"). The Safe Harbors Document announced transitional relief for multinational groups in the initial years of Pillar Two (*See* Safe Harbors Document, Ch. 1, para. 9). This transitional relief took the form of simplified computations that determine whether a multinational group is exempt from the more onerous GloBE Model Rules (as incorporated into local law) (*See* Safe Harbors Document,

Ch. 1, para. 9). These simplified computations deviate materially from the computations in the GloBE Model Rules.

For instance, under the "Simplified ETR Safe Harbor," if a multinational group's "Simplified ETR" in a given jurisdiction is at least 15% for a fiscal year starting in 2024, then the Pillar Two top-up tax for that jurisdiction for that year "is deemed to be zero" (*See* Safe Harbors Document, Ch. 1, description of Transitional CbCR Safe Harbor). A group generally computes a Simplified ETR by dividing the jurisdiction's Simplified Covered Taxes by its Profit (Loss) before Income Tax as reported on the group's country-by-country report (*See* Safe Harbors Document, Ch. 1, description of Transitional CbCR Safe Harbor). Simplified Covered Taxes represent a jurisdiction's income tax expense as reported on the group's financial statement, without regard to uncertain tax positions and taxes that are not Covered Taxes under the GloBE Model Rules (*See* Safe Harbors Document, Ch. 1, description of Transitional CbCR Safe Harbour).

The Simplified ETR Safe Harbor computations therefore differ materially from the computations under the GloBE Model Rules. Simplified Covered Taxes take into account valuation allowances; Covered Taxes under the GloBE Model Rules do not (*See* GloBE Model Rules, Art. 4.4.1(c)). Profit (Loss) before Income Tax does not take into account the many adjustments that the GloBE Model Rules make to financial statement results to arrive at GloBE Income (*See, e.g.*, GloBE Model Rules, Art. 3.2.1). Most importantly, in contrast to the GloBE Model Rules, under the Simplified ETR Safe Harbor, multinational groups can deviate from the group parent's accounting standard in determining Profit (Loss) before Income Tax irrespective of the differences that may exist between the relevant GAAPs; thus, groups can use U.S. GAAP for the United States, jurisdiction X GAAP for jurisdiction X, and jurisdiction Y GAAP for jurisdiction (*Compare* GloBE Model Rules, Art. 3.1.2 *with* Qualified Financial Statements definition, Safe Harbors Document, Ch. 1; and Tax Challenges Arising from the Digitalisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), December 2023, §2.3.2).

Revisiting the DREX and CFCX example above, assume that, for a fiscal year beginning in 2024, DREX has a loss of $100 that is also a DCL, and CFCX has a profit of $200, all as determined under jurisdiction X GAAP. Assume further that CFCX has Simplified Covered Taxes of $20. In addition, assume that jurisdiction X has enacted a QDMTT that uses parent, and not jurisdiction X, GAAP, and that, but for this QDMTT, jurisdiction X would not consolidate the results of DREX and CFCX or determine taxable income based on GAAP. Jurisdiction X satisfies the Simplified ETR Safe Harbor because country-by-country reporting looks at the aggregate results of entities in a given jurisdiction, and the jurisdiction X Simplified ETR based on jurisdiction X GAAP is 20% (20 / (200 – 100)) (*See, e.g.*, Treas. Reg. §1.6038-4(d)). CFCX's $100 profit is not income under jurisdiction X income tax law because jurisdiction X cannot and will not impose tax on that profit (including under the QDMTT regime), and the concept of income or gain under an income tax law presupposes the possibility that the taxing jurisdiction could impose tax on that income or gain. While a jurisdiction X QDMTT could theoretically apply to CFCX income as computed under the GloBE Model Rules, as noted above, this income item would be computed under rules that differ materially from the rules under which the CFCX profit is computed. If jurisdiction X satisfies the Simplified ETR Safe Harbor for a given year, CFCX never computes its income under the QDMTT for that year because the QDMTT does not apply to CFCX in that year (*See* Safe Harbors Documents, Ch. 1 para. 33 (acknowledging that the transitional safe harbor rules defer the date on which a jurisdiction becomes subject to the GloBE rules)). As a result, DREX's $100 loss is not made available to offset an item of income or gain under the jurisdiction X income tax laws, and there is no foreign use of the DREX DCL within the meaning of Treas. Reg. §1.1503(d)-3(a)(1).

Treasury is aware of the reasoning above. Specifically, in the preamble to the Proposed Regulations, Treasury acknowledges that comments noted that the Transitional CbCR Safe Harbour "is not a collection mechanism" and "claimed that the calculation of income and expenses under the Transitional CbCR Safe Harbour is substantially different from such calculations under the general GloBE Model Rules and generally accepted accounting principles."

Without addressing these points, Treasury explained that they generally declined to include an exception to the foreign use rule for the Transitional CbCR Safe Harbor because the Transitional CbCR Safe Harbor could allow a group to "avoid tax" that would otherwise be imposed under the GloBE Model Rules.

The objective of the Transitional CbCR Safe Harbor is not to avoid tax, however; it is to defer the administrative and compliance burden associated with Pillar Two during the initial years of the regime in jurisdictions where the risk of an effective tax rate well below the Pillar Two minimum rate is lower (*See* Safe Harbors Document, Introduction para. 1). Rather than ask, as Treasury does, whether the use of the Transitional CbCR Safe Harbor could avoid Pillar Two tax, the Inclusive Framework stops the inquiry if the Transitional CBCR Safe Harbor is satisfied. It is not known to the tax authorities, and may not be known to the taxpayer, what the Pillar Two liability is — that is how the safe harbor defers the administrative and compliance burden.

In sum, it is clear, as a technical matter, that there is no income in a Transitional CbCR Safe Harbor computation that a DCL could offset. Nevertheless, Treasury has made a policy decision to treat this gating calculation as an income tax, which seemingly contradicts the operation of the Transitional CbCR Safe Harbor.

III. Special Status for DCLs: A Pleasant Relief for Some Taxpayers

Not everything in the Proposed Regulations is taxpayer unfavorable. In particular, the proposed "special status" regulations in the intercompany transaction rules should be a welcome clarification for many taxpayers (*See* Prop. Reg. §1.1502-13(j)(10)(iii)).

Before explaining the proposed special status rule in the Proposed Regulations, it is first helpful to give some background on the intercompany transaction rules and the issue that some taxpayers believed arose under the current, unmodified DCL and intercompany transaction rules. The intercompany transaction rules in Treas. Reg. §1.1502-13 set forth the general principle that transactions between members of a U.S. consolidated group (i.e., intercompany transactions) should be determined as if the group members were a single corporation and that such intercompany transactions generally should not affect the consolidated group's taxable income (*See* Treas. Reg. §1.1502-13(a)). To accomplish this goal, the matching rule in Treas. Reg. §1.1502-13(c) can alter the tax "attributes" (e.g., source, character, inclusion within the DCL calculations, etc.) of income and expense from intercompany transactions. Specifically, Treas. Reg. §1.1502-13(c)(1) provides that the attributes of the income and expense from an intercompany transaction are "redetermined" to the extent necessary to produce the same effect on consolidated taxable income as if the two parties to the intercompany transaction were members of a single corporation (the "Attribute Redetermination Rule").

Some taxpayers were concerned that, if the Attribute Redetermination Rule were applied to intercompany transactions between a foreign DRE and another group member, then the Attribute

Redetermination Rule would require taxpayers to effectively treat the foreign DRE and other group member as a single corporation for purposes of that intercompany transaction. However, if the foreign DRE and other group member were treated as members of a single corporation, then that would mean that the intercompany transaction would be effectively disregarded. The consequences of treating an intercompany transaction as disregarded for purposes of the DCL rules leads to dramatic results because the DCL rules treat regarded and disregarded transactions very differently. In particular, a separate unit has to remove items of income and expense that arise from disregarded transactions from the separate unit's books and records for purposes of determining whether the separate unit has a DCL (*See, e.g.,* Treas. Reg. §1.1503(d)-5(c)(1)(ii); *see also* Barlow and Blanchard, *Dual Consolidated Loss Rules vs. Single Entity Principles*, 2024 TNTI 63-9 (Apr. 1, 2024), for a detailed explanation of the issues and policies surrounding the DCL and intercompany transaction rules).

The Attribute Redetermination Rule, however, contains an important exception. Specifically, the Attribute Redetermination Rule does not apply to the extent one party to the intercompany transaction has "special status" (*See* Treas. Reg. §1.1502-13(c)(5)). As a result, if the Domestic Owner of a separate unit has special status for purposes of the DCL rules, then the Attribute Redetermination Rule could not redetermine income or expense from the intercompany transaction to be excluded from the separate unit's DCL calculations.

Many taxpayers and advisers believed that a Domestic Owner had special status under the current rules. Nevertheless, Prop. Reg. §1.1502-13(j)(10)(iii) clarifies that it is definitely the case that a Domestic Owner of a separate unit has "special status" for purposes of the DCL rules. As a result, income from intercompany transactions must be taken into account for purposes of the DCL rules.

Presumably, these special status rules also apply for purposes of the DPL Rules to prevent regarded intercompany transactions from impacting the DPL calculations. However, this is not entirely clear from the proposed regulations.

IV. Conclusion

The comment period for the Proposed Regulations closes on October 7, 2024. Taxpayers that are grappling with the novel burden of the DPL Rules, or are frustrated by Treasury's position on foreign use under the Transitional CbCR Safe Harbor, should not be shy about making their views known to Treasury. We believe that this article makes some useful points on both fronts, but an even more persuasive case can and must be made to Treasury in the weeks that follow. The DPL and Transitional CbCR Safe Harbor aspects of the Proposed Regulations are not just a nightmare for taxpayers, they're also bad policy and bad law.

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