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US International Tax Alert

Trump Administration and Congressional Republicans consider tax and withholding increases in response to Pillar Two and DSTs

Overview

The Trump Administration and House Republican tax writers are separately considering US tax increases on investors from countries that impose undertaxed profits rules (UTPRs), digital services taxes (DST), or other "discriminatory or extraterritorial taxes" on US citizens or corporations.

- On January 20, 2025, President Trump issued two memoranda to his Cabinet and staff relating to Pillar Two of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting, or as the memorandum calls it, the "OECD Global Tax Deal." One memorandum nullifies any former US commitments to the deal. The other orders the Treasury Department to investigate and report by April 1, 2025 whether any foreign countries are imposing discriminatory or extraterritorial taxes on US citizens or corporations within the meaning in section 891 of the Internal Revenue Code (which gives the President the power to double US income tax rates on citizens and corporations of any such country).[1]
- On January 21, 2025, Chairman Jason Smith, with the support of all Republican members of the House Ways & Means Committee, introduced H.R. 591. The bill, titled the "Defending American Jobs and Investment Act," would add section 899 to the Code: "Enforcement of Remedies Against Extraterritorial Taxes and Discriminatory Taxes." Section 899 would mandate increased tax rates on citizens and corporations of countries imposing extraterritorial or discriminatory taxes. It would also increase US withholding tax rates on payments to such persons.

While both efforts appear focused on deterring UTPRs and DSTs by threatening to impose tax burdens on inbound foreign investment, the details of the two provisions differ significantly, as described in this alert.

Section 891

- This is a long-standing Code section providing that upon a determination by the President that citizens or corporations of the US are being subjected to discriminatory or extraterritorial taxes, and upon his proclamation to this effect, rates of taxes imposed by sections 1, 3, 11, 801, 831, 852, 871, and 881 are doubled in the case of each citizen and corporation of such foreign country.

[1] "America First Trade Policy," 90 Fed. Reg. 8471 (January 20, 2025)

- Any increase of tax imposed on a taxpayer is limited to at most 80% of taxable income (not counting certain deductions).

Observations

- Section 891 was enacted in 1934 and has never been invoked by a President.
- Section 891 does not mention increases in withholding tax rates, such as those in sections 1441, 1442, 1445, or 1446.
- Section 891 appears to be limited in application to income directly earned by a non-resident alien (NRA) or foreign corporation; therefore, the earnings of a US subsidiary of a foreign person do not appear to be affected.
- However, section 891 does not exclude controlled foreign corporations (CFCs) from the doubling of US tax rates.
- Sections 871(b)(2) and 882(a)(2) provide that taxable income generally includes only effectively connected income (ECI). As a result, the 80%-of-taxable-income limitation on US taxes in section 891 may mean that a foreign corporation or an NRA with fixed, determinable, annual or period (FDAP) income but no effectively connected income (ECI) cannot be taxed under sections 871(a) or 881 at a rate higher than 30%.
- Section 891 does not mention section 894 (income affected by treaty) or section 7852(d) (treaty obligations).
- Section 891 predates every US income tax treaty now in force, and possibly every US income tax treaty that ever was in force. It does not appear to give the President any instruction on existing or future treaties or treaty overrides, or otherwise address the interaction between the rate increases and subsequently negotiated tax treaties, nor does it seem to derogate from the President’s inherent power to terminate a tax treaty.

H.R. 591 – Proposed section 899

- H.R. 591 requires the Treasury Secretary to submit a report, with a list of foreign countries that impose one or more extraterritorial or discriminatory taxes (defined below), to the appropriate committees of Congress within 90 days of the enactment of section 899.
- Subsequent reports are to follow every 180 days thereafter.

Extraterritorial tax is tax imposed by a foreign country on a corporation that is determined by reference to any income or profits received by any persons by reason of such person being connected to such corporation through any chain of ownership, determined without regard to the ownership interests of any individual, and other than by reason of such corporation having a direct or indirect ownership interest in such person.

Discriminatory tax is tax imposed by a foreign country if such tax either:

- Applies to items of income that would not be considered from sources within the foreign country (applying Code source-rule principles);
- Is imposed on a base other than net income and is not computed by permitting recovery of costs and expenses;

- Is exclusively or predominantly applicable, in practice or by its terms, to individuals not resident in the country and corporations or partnerships organized outside the country; or
- Is not treated as an income tax under the laws of such foreign country or is otherwise treated by such foreign country as outside the scope of any double tax agreements that are in force between such foreign country and one or more jurisdictions.

Exceptions apply for "generally applicable" taxes on transactions on a per-unit or per-transaction (not ad valorem) basis; withholding taxes on FDAP income; consumption taxes; and property taxes.

Effect of a country's appearance on a list: Starting 181 days after the list is submitted (and ending when a subsequent list is submitted *without* the country), the tax rates specified in

- Code sections 1 and 871(a) that apply to *citizens of the country*, and
- Code sections 11, 881, and 884 that apply to *corporations created or organized in the country (other than a specified 10%-owned corporation)*

(collectively, "applicable persons") would increase.

- The specific rate increase depends on how many years the country remains on the list.
- Generally, the rates increase in five-percentage-point increments for each year a country remains on the list, for up to four years.

Observations

- Withholding agents of payments to applicable persons must withhold at 35 to 50% under sections 1441 and 1442 and may not withhold at lower treaty rates.
- In the case of an NRA who is an applicable person and has ECI, the higher section 1 rates apply only to gains under the Foreign Investment and Real Property Tax Act (FIRPTA).
- Transferees of US real property interests (USRPIs) must withhold at 20 to 35% under section 1445(a) on proceeds of a USRPI disposition by an applicable person, and the 5%-to-20% percentage-point rate increases also apply to the section 1445(e) withholding rates when the person against whom amounts are withheld is an applicable person.
- The President is authorized to prohibit Federal procurement of goods or services from applicable persons.
- Proposed section 899 does not appear to deprive applicable persons of the right to claim treaty benefits. Moreover, it expressly addresses the interaction of treaties with sections 1441 and 1442 by effectively "turning off" Treas. Reg. § 1.1441-6 (Claim of reduced withholding under an income tax treaty) on payments to applicable persons.[2] Thus, the possible absence of a treaty override by section 899 does not appear to be the result of inattention to treaty questions.
- It does not appear that a typical Business Profits treaty article will save an applicable person from owing US tax of up to 41% (in the case of a

[2] Treas. Reg. § 1.1441-6 permits a withholding agent to take the beneficial owner's treaty entitlement into account if appropriate documentation is received.

corporation) or up to 57% (in the case of an NRA) on ECI attributable to a permanent establishment in the United States under proposed section 899. However, it may be that a typical Nondiscrimination treaty article would have the effect of entitling the person to a rate no higher than 21% (in the case of a corporation) or 37% (in the case of an individual).

- Proposed section 899 might possibly have its largest impact on citizens of and corporations organized in countries that enact a UTPR or a DST, but do not have a US income tax treaty.
- Theoretically, a Presidential proclamation pursuant to section 891 and a Treasury Secretary finding that a country imposes a discriminatory or extraterritorial tax under section 899, if enacted, could conceivably cause a tax in excess of 100% of a taxpayer's taxable income.
- If the introduced bill progresses (perhaps as part of the planned reconciliation bill), it will be important to watch to see if the proposal, which now increases rates for withholding agents *notwithstanding the treaty claims of their payees who are applicable persons*, is later modified to add a matching statutory override of applicable persons' *entitlements* to benefits (if any) under existing treaties.
- H.R. 591 is a modified version of a similar bill, by the same name, that Chairman Smith introduced in the 118th Congress (H.R. 3665, introduced May 2023).

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