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U.S.-Based Multinationals Face a Double Tax Whammy

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In 2021, the U.S. Treasury Department led a global tax policy process that resulted in 137 countries agreeing to new corporate income tax rules despite dim prospects of congressional action to implement the rules in U.S. law. In January 2022, Treasury finalized new foreign tax credit regulations that could deny the credit for foreign income taxes paid under the globally agreed rules. Jeff VanderWolk of Squire Patton Boggs looks at the web of new rules facing U.S.-based multinational businesses.

The interaction of three current developments in international corporate income taxation—the global adoption of Pillars One and Two, the issuance of final U.S. foreign tax credit regulations, and the failure to date of Democrats in Congress to pass the Build Back Better Act—could result in significant unrelieved double taxation for U.S.-based multinationals. How has this state of affairs come about?

First, regarding the adoption of Pillars One and Two, early in 2021, the Biden administration took the lead in multilateral negotiations at the OECD, with a view to changing the global taxation of large multinational enterprises in a way that would support the administration's plan to increase the U.S. corporate tax rate on foreign earnings to 21% under global intangible low-taxed income, or GILTI, rules. The hope was that the 137-member Inclusive Framework on base erosion and profit shifting, or BEPS, would agree to a global minimum rate of at least 20%, creating a level playing field globally and minimizing any incentive for U.S.-based multinationals to avoid U.S. taxation. As the year wore on, negotiations resulted in both the Pillar Two minimum rate, and the proposed U.S. GILTI rate, settling at around 15%.

The Treasury Department negotiators at the OECD ensured that the Pillar One profit reallocation proposal would move forward alongside Pillar Two by offering a simplified version of Pillar One aimed squarely at the largest and most profitable global companies, most of which are U.S.-based. When tax writers in Congress asked Treasury for data on the expected effect of the two-pillar plan on the U.S. tax base, they received only vague assurances that the U.S. economy would benefit despite Pillar One's enlargement of the taxing rights of other countries with respect to certain profits under the Amount A regime. The Amount A rules use a formula to allocate part of a group's profits to market countries for tax purposes regardless of whether the group has a taxable presence in those countries.

The globally agreed Model Rules regarding Pillar Two's global minimum tax were issued in late December 2021, followed immediately by a draft EU directive based on the Model Rules, adapted to conform to EU legal requirements for non-discrimination. The Model Rules provide for top-up taxation with respect to the income of any group member taxed at an effective rate of less than 15% under the normally applicable income tax rules. The primary method for achieving this top-up taxation is the so-called income inclusion rule, which requires the ultimate parent entity of the multinational group to pay all of the deficiency for the entire global group. If no qualifying income inclusion rule is applicable, a backstop rule comes into play—misleadingly called the undertaxed payment rule, or UTPR, in the Model Rules, and more accurately called the undertaxed profits rule in the U.K.'s consultation document on the implementation of Pillar Two. This UTPR regime requires a country to deny deductions or otherwise adjust the tax liability of locally taxable group members to the extent necessary to increase their local tax liability to the amount of the total group top-up tax allocated to the country.

The second development mentioned at the start of this article was the issuance of final foreign tax credit regulations by the Treasury and the IRS in early January 2022. These regulations contain a so-called attribution requirement that effectively denies a credit if the foreign income tax is paid with respect to income that does not have its source in the taxing jurisdiction under U.S. sourcing principles. This requirement was intended to ensure that foreign digital services taxes would not be creditable and consequently ensure that U.S. taxpayers subject to such taxes would be incentivized to actively oppose them.

As it has turned out, the attribution requirement in the regulations is likely to result in the denial of credits for foreign income taxes paid on some, if not all, of the amounts reallocated to market countries under the Amount A rules of Pillar One, as well as amounts allocated to countries for top-up taxation under the backstop UTPR regime in Pillar Two.

The third development was Sen. Joe Manchin's (D-W.Va.) announcement in late December 2021 that he was not prepared to support the Build Back Better Act that was passed by the House of Representatives in November. That legislation includes international tax changes that would, among other things, allow the GILTI rules to be treated as a qualifying income inclusion rule for Pillar Two purposes. Without the support of all Democratic senators, the legislation will not pass. To date, no new version of the legislation has been proposed by Democratic leaders in Congress, and it is not clear whether the proposed GILTI changes will ultimately be made.

If the GILTI regime is not a qualified income inclusion rule, then any undertaxed profits in a U.S.-based group will be subjected to top-up taxation in other countries under the backstop UTPR regime. As noted, the attribution requirement in the foreign tax credit regulations will generally mean that no credit is available in the U.S. for top-up tax on income arising in a country other than the one imposing that tax.

As the saying goes, the road to hell is paved with good intentions, and the policy makers at Treasury undoubtedly felt that they had good reasons for leading the Inclusive Framework countries to adopt Pillars One and Two, and for adding the attribution requirement to the foreign tax credit regulations. One wonders, though, why they proceeded on the assumption that Congress would be able to pass tax legislation in the United States' current political environment.

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