

Interaction Of OECD Pillar Two Rules with The U.S. GILTI And FDII Regimes (Pre-G7/ US Deal): “A Comparative and Policy Analysis”

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Abstract:

This paper explores the interaction between the OECD's Pillar Two Global Anti-Base Erosion (GloBE) rules and the U.S. international tax provisions introduced by the Tax Cuts and Jobs Act (TCJA) of 2017, namely the Global Intangible Low-Taxed Income (GILTI) and Foreign-Derived Intangible Income (FDII) regimes. As multinational enterprises (MNEs) face increasing tax transparency and coordination demands, the convergence and friction between Pillar Two and U.S. law raises questions of neutrality, competitiveness, and compliance. The analysis reveals that while GILTI and Pillar Two share similar aims, structural differences in tax base, rates, and jurisdictional application create fundamental differences thereby causing tension. Considering the UTPR rules, FDII may become a casualty of incompatibility under the GloBE model. The paper concludes with policy considerations for aligning U.S. law with global norms.

Keywords: GILTI, FDII, Pillar Two, GloBE, UTPR, QDMTT, Global Minimum Tax, BEPS, International Taxation, Tax Cuts and Jobs Act, Anti-Base-Erosion, Multinational Enterprises, Competitiveness, Compliance

1. Introduction

In December 2021, the OECD and G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) finalized the two-pillar solution to address the tax challenges arising from the digitalization of the economy. Pillar Two introduces a global minimum tax of 15% on the profits of large multinational enterprises (MNEs), enforced via a set of coordinated rules: the Income Inclusion Rule (IIR) and Undertaxed Profits Rule (UTPR).¹ Concurrently, the United States' Global Intangible Low-Taxed Income (GILTI) and Foreign-Derived Intangible Income (FDII) provisions, enacted in 2017 under the Tax Cuts and Jobs Act, operate as a unilateral attempt to address base erosion and profit shifting. While superficially aligned in objective, the technical and conceptual differences between GILTI/FDII and the OECD's GloBE rules create potential for double taxation, compliance complexity, and policy misalignment.

2. GILTI

GILTI (IRC §951A) requires U.S. shareholders of Controlled Foreign Corporations (CFCs) to include in gross income a deemed return on intangible assets. The calculation uses a formulaic excess-return approach, taxing CFC income above a 10% return on Qualified Business Asset Investment (QBAI). A 50% deduction (§250) yields a 10.5% effective U.S. rate ($21\% \times 50\%$) on GILTI through 2025 (Joint Committee on Taxation, 2018).

GILTI is applied on an aggregate basis across the global CFCs, allowing for cross-crediting of high and low taxed income, which differs sharply from the jurisdictional blending required under Pillar Two. Under the Pillar Two rules, effective tax rates (ETRs) are calculated on a jurisdiction-by-jurisdiction basis, rather than globally or entity-by-entity. This means all entities of a multinational group that are located in the same country are blended together for the ETR calculation.²

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3. FDII

FDII incentivizes U.S. corporations to earn income from exports of goods and services. Income derived from serving foreign markets in excess of a 10% return on U.S. tangible assets receives a 37.5% deduction (§250), resulting in a 13.125% effective tax rate. (subject to scheduled increases). FDII is seen as a “carrot” complement to the “stick” of GILTI.³

4. The OECD Pillar Two Framework

Pillar Two imposes a 15% minimum effective tax rate (ETR) on income earned by MNEs with consolidated revenue over €750 million. The primary mechanism, the IIR, requires a parent entity to top up tax on low-taxed income of foreign subsidiaries. The UTPR, a secondary rule, denies deductions or imposes equivalent adjustments when income is not subject to minimum tax.

Unlike GILTI, Pillar Two applies on a jurisdiction-by-jurisdiction basis and allows only qualified taxes in calculating ETR. Moreover, the GloBE rules require deferred tax accounting conformity and a separate calculation from financial statements under OECD prescribed adjustments.⁴

5. Key Points of Interaction and Tension

GILTI's Compatibility as a “Qualified IIR”

GILTI does not currently qualify as an IIR under GloBE because of:

- Blending methodology: GILTI aggregates income across jurisdictions.
- Rate mismatch: GILTI's effective rate (10.5% or 13.125% post-2025) is below the 15% Pillar Two minimum.
- Tax base differences: QBAI exemption and lack of deferred tax treatment differ from GloBE mechanics.

Thus, if no reform is enacted, GILTI will not shield U.S. parented MNEs from UTPR exposure in other jurisdictions applying Pillar Two. This could result in double taxation, once under GILTI and again through top-up tax abroad.⁵

FDII's Exposure to UTPR

FDII, designed to lower the U.S. tax rate on foreign-derived income, may be treated as a harmful tax incentive under Pillar Two. Since FDII creates a low-tax preference within the U.S. tax base, it can trigger UTPR adjustments by other countries. As such, FDII may be increasingly difficult to defend in a Pillar Two-aligned world unless it is repealed or restructured.⁶ The U.S. Treasury has acknowledged incompatibilities, and while it supports Pillar Two, it has not yet restructured GILTI to meet IIR requirements.

Efforts at Reconciling GILTI to Pillar 2 (the Build Back Better Act of 2021- Proposals)

The Build Back Better Act (BBBA) proposed a range of tax reforms aimed at increasing revenue to fund social, climate, and infrastructure programs, while promoting tax equity. Though the bill was never passed in full, its tax reform provisions significantly shaped the eventual Inflation Reduction Act (IRA) of 2022 and broader policy debates.

6. Key Tax Reform Proposals in the BBBA

Corporate Tax Provisions

15% Corporate Minimum Tax

- Imposed on corporations with more than \$1 billion in financial statements (book) income. This aimed to address “book-tax gaps” where highly profitable corporations paid little or no federal income tax.⁷

1% Excise Tax on Stock Buybacks (adopted later in the IRA)

- Intended to curb excessive buybacks and encourage reinvestment of dividends.⁸

BEAT to SHIELD (not implemented)

- The BBBA proposed replacing the Base Erosion and Anti-Abuse Tax (BEAT) with a more robust Undertaxed Profits Rule (UTPR), aligned with OECD Pillar Two.⁹

7. International Tax Reforms

GILTI Reform

- Application of GILTI on a country-by-country basis (instead of an aggregate global approach), aligning with OECD's Pillar Two framework and reduction of the Section 250 deduction, increasing the effective GILTI tax rate.¹⁰

FDII Deduction Reduction

- Decrease of the deduction for Foreign Derived Intangible Income (FDII), while maintaining a focus on domestic innovation incentives.¹¹

BEPS Alignment

- Enhancing consistency with OECD Pillar Two rules, including better integration of controlled foreign corporation (CFC) rules and the proposed global minimum tax.¹²

Several key tax measures, like the corporate minimum tax, stock buyback excise tax, and clean energy incentives, were eventually passed in the Inflation Reduction Act of 2022. However, international tax reforms like the GILTI country-by-country rule and full BEPS Pillar Two alignment were not enacted but remain under consideration in ongoing Treasury and congressional discussions.¹³

8. Transitional Relief

OECD Transitional CbCR Safe Harbors

The OECD offered safe harbors (for 2024–2026) allowing MNEs with low top-up risk to defer certain top-up payments based on consolidated financial data, reducing early compliance burdens.¹⁴

The U.S. Treasury and IRS have issued transitional reliefs.

The U.S. Treasury and IRS have issued transitional relief through Notice 2023-80 and proposed regulations REG-105128-23) to address the interaction between U.S. tax rules and the OECD's Pillar Two Global Anti-Base Erosion (GloBE) rules. However, the transitional relief and proposed regulations focus primarily on avoiding unintended interaction with legacy loss regimes, but not the broader GILTI/Pillar Two misalignment.¹⁵

Notice 2023-80: (Initial Transitional Relief)

Released in December 2023, Notice 2023-80 provided guidance on how U.S. tax provisions, including the foreign tax credit (FTC) and dual consolidated loss (DCL) rules, interact with taxes imposed under the GloBE framework, such as the Income Inclusion Rule (IIR) and Qualified Domestic Minimum Top-up Tax (QDMTT).¹⁶

Key Provisions:

- Foreign Tax Credit Eligibility: The notice clarified that certain foreign taxes aligned with GloBE rules could be creditable under §§ 901 and 903, provided they meet specific criteria.¹⁷
- Legacy DCLs: For DCLs incurred in tax years ending on or before December 31, 2023, or in tax years beginning before January 1, 2024, and ending after December 31, 2023, the notice provided that the mere inclusion of such losses in GloBE calculations would not constitute a "foreign use" under § 1503(d), thereby avoiding immediate recapture concerns.¹⁸
- Extension of Relief: The temporary relief measures initially outlined in Notice 2023- 55 were extended, allowing taxpayers additional time to adapt to the evolving international tax landscape.¹⁹

REG-105128-23: (Proposed Regulations Expanding Relief)

In August 2024, the Treasury and IRS issued proposed regulations (REG-105128-23) that expanded upon the relief provided in Notice 2023-80, offering more comprehensive guidance on the application of DCL rules in the context of GloBE.²⁰

Notable Expansions:

- Extended Transition Relief: The proposed regulations extended the transition relief to DCLs incurred in tax years beginning before August 6, 2024. This means that such losses, when included in GloBE calculations, would not automatically trigger a foreign use under § 1503(d).²¹

- Anti-Avoidance Measures: To prevent potential abuse, the regulations included provisions stating that the relief would not apply to losses incurred or increased with a principal purpose of reducing QDMTT or IIR liabilities or qualifying for transitional safe harbors.²²
- Clarification on Foreign Taxes: The regulations clarified that taxes imposed under IIR and QDMTT could be considered income taxes for U.S. tax purposes, affecting the application of DCL rules.²³

Comparison Table: BBBA vs. OECD Pillar Two (GloBE Rules)

Feature	BBBA Proposal	OECD Pillar Two (GloBE)	Alignment/Conflict
Minimum Tax Rate	15% book minimum ²⁴	15% jurisdictional ETR ²⁵	Aligned in rate; different base
Scope	\$1B+ U.S. income ²⁶	€750M+ global revenue ²⁷	Similar thresholds
GILTI Reform	Jurisdictional + rate increase ²⁸	UTPR applies if ETR <15% ²⁹	Aligned if enacted
FDII Deduction	Reduced to 24.8% ³⁰	No equivalent, discouraged ³¹	Conflict
BEAT Reform	Replaced by SHIELD ³²	UTPR-like denial rules ³³	Conceptual alignment
Deferred Tax	U.S. GAAP; uncapped ³⁴	Capped at 15%, with recapture ³⁵	Partially aligned
Timing	Initially 2023 ³⁶	2024 (IIR), 2025 (UTPR) ³⁷	BBBA was earlier

9. Political Feasibility of BBBA Reforms

Despite conceptual alignment with global norms, the BBBA's international tax proposals stalled in Congress due to the following challenges:

1. Competitiveness Concerns: Business lobbies and moderate lawmakers argued that a 15% GILTI rate and FDII repeal could disadvantage U.S. MNEs globally.³⁸
2. Complex Interactions with State Tax Law: Many states corporate tax regimes conform to U.S. definitions of taxable income. Changes to GILTI or SHIELD could have cascading effects, complicating state-level compliance.³⁹

10. Strategic Implications for U.S. MNEs

- Due to Global Minimum Tax Pressure, even though the BBBA did not pass, future reforms may still push GILTI and other U.S. tax regimes closer to GloBE norms.⁴⁰
- Because of Compliance Complexity, companies operating in both GloBE jurisdictions and under evolving U.S. rules must reconcile the two different minimum tax systems.⁴¹
- Tax Planning Adjustments, including jurisdictional profit shifting, legacy loss utilization, and deferred tax strategies, must now consider global rules and not just IRS regulations.⁴²

11. Policy Options for Reconciliation

11.1 Jurisdictional GILTI

Amending GILTI to apply jurisdiction-by-jurisdiction, thereby aligning with GloBE's ETR calculation method. This is part of the Build Back Better Act but has stalled in Congress.⁴³

11.2 Rate Adjustment

Raising the GILTI effective rate to 15% through deduction reduction would align with Pillar Two. However, this may face opposition due to competitiveness concerns for U.S. MNEs.⁴⁴

11.3 FDII Repeal or Reform

Treasury has previously proposed repealing FDII and reallocating incentives to onshore RCD.⁴⁵

11.4 QDMTT Implementation

Allowing U.S. states or the federal government to implement a Qualified Domestic Minimum Top-Up Tax (QDMTT) could help shield U.S. profits from foreign UTPR enforcement.⁴⁶

5. Conclusion

The OECD Pillar Two framework and the U.S. GILTI regime share a common policy goal i.e., limiting base erosion and low-tax income shifting. However, technical divergences, particularly GILTI's blending, rate, and tax base create substantial risks of double taxation and compliance complexity.

Without reform, U.S. headquartered MNEs may suffer competitive disadvantage under foreign IIR/UTPR regimes. To ensure tax certainty, preserve competitiveness, and fulfil international commitments, the U.S. must seriously consider aligning GILTI with GloBE standards or negotiating special treatment under the Inclusive Framework.

Taxpayers should assess their existing Dual Consolidated Losses (DCLs) to determine eligibility for the extended relief and ensure compliance with the anti-avoidance provisions. Given the evolving nature of international tax regulations, staying informed about further guidance and final regulations is also crucial for taxpayers. Nonetheless, engaging with tax professionals can help navigate the complexities of these transitional rules and optimize tax positions accordingly.

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