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How the OBBBA's International Provisions Interact with Pillar Two

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Baker McKenzie practitioners explain what the OBBBA's international tax changes mean for taxpayers subject to Pillar Two and Inclusive Framework members that seek to deliver on the G7 statement.

The One Big Beautiful Bill Act (OBBBA) made significant changes to US international tax laws, and those changes have potential Pillar Two ramifications. On June 28, 2025, the G7 issued a "statement on global minimum taxes" that expressed a "shared understanding" that a "side-by-side system" in which "U.S. parented groups [are] exempt from the Income Inclusion Rule (IIR) and Undertaxed Profits Rule (UTPR)" could "preserve important gains made by jurisdictions in the Inclusive Framework in tackling base erosion and profit shifting and provide greater stability and certainty in the international tax system moving forward." The statement indicated that "recently proposed changes to the U.S. international tax system based on the Senate amendment of H.R. 1 (introduced June 16, 2025), the One Big Beautiful Bill Act (OBBBA), the removal of section 899 in the Senate version of the OBBBA, and consideration of the success of Qualified Domestic Minimum Top-up Tax (QDMTT) implementation and its impact" allowed the G7 to reach this understanding. The OECD acknowledged the G7 statement in the July 2025 OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors.

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The OBBBA became law on July 4, 2025. By contrast, in its statement, the G7 noted that its members "look forward to discussing and developing this [shared] understanding, and the principles upon which it is based, within the Inclusive Framework with a view to expeditiously reaching a solution that is acceptable and implementable to all." Among the "principles" that the G7 statement referenced were (i) "a commitment to ensure any substantial risks that may be identified with respect to the level playing field, or risk of base erosion and profit shifting, are addressed to preserve the common policy objectives of the side-by-side system" and (ii) "considering changes to the Pillar 2 treatment of substance-based non-refundable tax credits that would ensure greater alignment with the treatment of refundable tax credits."

The Pillar Two "solution" that the G7 statement promises is therefore unclear. Will the Inclusive Framework (IF) actually agree to exempt US-parented groups from both the UTPR and intermediate IIRs? Will the US R&D tax credit be granted equal treatment to qualified refundable tax credits (QRTCs)? The statement is silent on QDMTTs—do they remain? And what does the statement mean for US-parented subgroups within foreign-parented structures? It is impossible to say at present.

Against this backdrop, we address the interaction of the OBBBA's US international tax changes with Pillar Two in both its current form and some possible, future incarnations.

GILTI and FDII

1. Overview

No provision in the House version of the OBBBA would have been more consequential from a Pillar Two standpoint than proposed §899, which sought to punish jurisdictions that enacted UTPRs and other measures the United States viewed as "discriminatory" or "extraterritorial." With proposed §899 absent from the version of the OBBBA that is now law, the OBBBA's changes to the GILTI and FDII regimes are likely the most significant in relation to Pillar Two.

Before the OBBBA, under §250(a) and §951A, US shareholders of CFCs included "net CFC tested income" less their "net deemed tangible income return" in income as GILTI and were allowed a 50% deduction with respect to that GILTI. The concept of "net CFC tested income" meant that a US shareholder blended "tested income" and "tested loss" of its CFCs to arrive at a net amount that served as the basis for the GILTI inclusion. The concept of a "net deemed tangible income return" reflected a deemed 10% return on certain CFC tangible property (referred to as "qualified business asset investment" or "QBAI") that was subtracted from "net CFC tested income" to support the contention that GILTI represented "intangible" income.

US shareholders of CFCs were allowed a credit for 80% of the foreign taxes that were attributable to tested income under §960(d), but could not carry those taxes back or forward under §904(c) as they could foreign taxes in the general, passive, or branch category. The idea behind the 50% GILTI deduction and the 20% haircut on tested income foreign taxes was that US shareholders would not pay US federal income tax on tested income that was subject to a foreign tax rate of at least 13.125%, given the 21% US federal corporate income tax rate. The GILTI foreign tax credit limitation was subject to the general §861 expense allocation and apportionment rules, however, even though GILTI was already calculated net of the CFCs' expenses. That meant that US shareholders could find themselves unable to use foreign taxes on tested income in the year in which they included that income in GILTI, or in subsequent years, with the result that foreign income that was subject to foreign tax at a rate in excess of 13.125% was also subject to US federal income tax.

The FDII regime operated similarly. Under §250(b), a US corporation subtracted 10% of its QBAI from certain "deduction eligible income" to arrive at its "deemed intangible income," determined how much of that "deduction eligible income" was "foreign-derived," and then multiplied the ratio of "foreign-derived deduction eligible income" over "deduction eligible income" by "deemed intangible income" to arrive at its FDII. The corporation was then allowed a 37.5% deduction with respect to FDII. In contrast to the GILTI regime, the FDII regime did not impose a 20% haircut on FDII foreign taxes. The FDII regime therefore also sought to achieve a 13.125% effective rate on foreign intangible income that a US corporation derived, with a view to establishing parity between foreign intangible income that US corporations derived directly or through CFCs and disincentivizing the movement of intangibles-related returns offshore.

2. OBBBA Changes

The OBBBA:

- Eliminated the deemed return on QBAI that was previously subtracted from net CFC tested income under GILTI and deduction eligible income under FDII;
- Renamed GILTI as net CFC tested income (NCTI) and FDII as foreign-derived deduction eligible income (FDDEI);
- Reduced the GILTI deduction from 50% to 40% and the FDII deduction from 37.5% to 33.34%;
- Increased the percentage of creditable foreign taxes with respect to tested income to 90%; and
- Provided that interest and R&D expense are not allocable to NCTI or FDDEI and otherwise greatly restricted the expenses that are allocable to NCTI.

Eliminating QBAI means that more offshore income is subject to current US tax under the NCTI regime and more domestic income benefits from the FDDEI rate, incentivizing investment in US manufacturing operations instead of providing a benefit for manufacturing through a CFC. Moreover, in contrast to the GILTI and FDII rates that the TCJA established in 2017, which were scheduled to increase after 2025, the OBBBA's NCTI and FDDEI rates are permanent. These features of the OBBBA suggest that Congress is seeking to establish a stable and predictable regime in which the target rate on foreign income that US MNE groups derive is 14%.

Specifically, if a US shareholder recognizes $100 of NCTI that is subject to $14 of foreign income tax (ignoring the §78 dividend for simplicity), the shareholder has a notional $12.6 US federal income tax liability (21% x 60% x $100) and can offset that liability with $12.6 of allowable foreign tax credits (90% x $14). Thus, at a high level, NCTI that is subject to foreign tax at a rate of 14% or greater ought not to result in incremental US federal income tax, assuming no additional US expenses are allocated or apportioned to the NCTI. If a US corporation recognizes $100 of FDDEI, that income is subject to $14 of US federal income tax (21% x 66.66% x $100), but if the US corporation pays $14 of foreign income tax on that $100 (and the income is foreign source income), the US corporation can offset its $14 US federal income tax liability dollar for dollar with foreign tax credits in the amount of $14. There, too, at a high level, FDDEI that is subject to foreign tax at a rate of 14% or greater ought not to result in incremental US federal income tax.

3. Pillar Two Implications

a. Rate

The first observation here is an obvious one. While a 14% NCTI rate does not equal 15% (the Pillar Two minimum tax rate), it is still closer than where the GILTI regime was prior to these changes. In addition, in contrast to the GILTI regime, the NCTI rate is permanent. Moreover, a 14% rate assumes that foreign taxes on the relevant income are available to offset US federal income tax (subject to the 10% haircut), and the OBBBA's restrictions on allocating and apportioning expenses to NCTI are intended to do just that. Nevertheless, as other commentators will no doubt discuss in detail, there will be cases in which expense allocation and apportionment nonetheless result in an effective rate of tax on NCTI that exceeds 14%, which is therefore the taxation floor, and not the ceiling, for NCTI. Anyone tasked with selling the "side-by-side system" to skeptical countries should find these changes at least optically helpful, and, in politics, optics are always helpful.

As relates to FDDEI, the argument is similar. The US corporate income tax rate is 21%, such that the 14% FDDEI rate is a taxation floor, and not a ceiling. It would be atypical for a US corporation to derive only

FDDEI, and we would expect most, if not all, US corporations to be subject to a blended rate well in excess of 15% on their US taxable income.

b. QBAI vs. SBIE

The removal of QBAI also moves the rate on NCTI closer to, if not above, the Pillar Two minimum rate. The equivalent provision in Pillar Two is the Substance-Based Income Exclusion (SBIE) return, which reduces the profits that are subject to top-up tax. Even prior to QBAI being removed, the SBIE was more generous than its US counterpart. SBIE is based on tangible assets as well as employee costs, and, in the transition period (which runs to 2032), the applicable percentages start at 10% (payroll) and 8% (assets) before they settle at 5% for both. So while 15% is nominally greater than 14%, in many instances 15% will be applied to a much lower base, because of the deduction that is granted for SBIE (assuming a side-by-side comparison of, say, an IIR or UTPR to NCTI).For example, groups operating manufacturing facilities in a country in which they enjoy a reduced rate via, say, a tax holiday, would be worse off under the NCTI regime than under an IIR or a UTPR because it does not include the same generous substance-related deductions as the other two regimes.

c. Blending

The OBBBA did not change the global blending feature of GILTI (now NCTI). Stakeholders seeking to undermine the notion that the two regimes can co-exist may continue to latch onto this feature of NCTI—because Pillar Two tax is required to be determined on a jurisdictional basis. But increasing the NCTI rate and removing the deduction for QBAI ought to go some way toward weakening the argument that global blending is too much of a hurdle to be overcome. Moreover, in light of the G7 statement, the question is no longer whether the NCTI regime and the IIR are comparable; it is whether NCTI is sufficiently robust to ensure that there is a level playing field as between US-parented groups and groups that are subject to Pillar Two, and whether NCTI and FDDEI, along with the other features of the US international tax system (for example, taxation on a worldwide basis and subpart F), effectively counter the risks of base erosion.

d. Allocation of NCTI Tax

As we note above, there are concerns that the foreign tax credit limitation rules may still result in taxpayers paying US federal income tax on NCTI that already was subject to foreign tax at a rate that is greater than 14%. That said, the expense allocation/apportionment changes that the OBBBA introduced are a significant improvement to the status quo, and we expect there to be less residual US federal income tax on high-taxed NCTI than there was under the current GILTI regime.

Under the Consolidated Commentary on Article 4.3.2 of the Pillar Two Model Rules, at least for now, US federal income tax on NCTI, less a foreign tax credit, should be allocated to CFCs as Covered Taxes for IIR and UTPR purposes. If the expense allocation/apportionment rules work as we think they are intended to, there will likely be less tax on NCTI to allocate because foreign tax credits will reduce US federal income tax on NCTI. The question is whether this consequence matters. If US-parented groups are outside the scope of the IIR and the UTPR, the NCTI allocation rules will generally be irrelevant for those groups. The rules may nevertheless be relevant to US-parented subgroups within a foreign structure if those subgroups are not considered US-parented groups for purposes of an eventual deal.

Even within a US-parented group, the allocation of NCTI may be relevant to the application of QDMTTs. As we note at the outset, the G7 statement addresses the application of the IIR and the UTPR to US-parented groups but suggests that QDMTTs may continue to apply to CFCs. Allocating NCTI taxes to US CFCs may therefore remain relevant where a CFC in a QDMTT jurisdiction makes a payment to a CFC in a non-QDMTT jurisdiction, and the payor CFC needs to understand whether that non-QDMTT CFC is in a low tax jurisdiction for purposes of Article 3.2.7 (the intragroup financing arrangement rule).

More generally, under the Consolidated Commentary on Article 10 of the Pillar Two Model Rules at paragraph 118.30, the QDMTT rules compute top-up tax before accounting for any allocable tax under CFC regimes, such as the NCTI regime. Observers have questioned whether QDMTT jurisdictions should be allowed to modify their rules to afford CFC regime taxes priority, as under the IIR and the UTPR. Some jurisdictions had already decided to shun the QDMTT path in favor of a domestic minimum top-up tax (DMTT) regime that allows for such an allocation, or for the application of CFC taxes to provide for a local DMTT exemption. With the changes that the OBBBA introduced, the question for certain countries will be whether these policy decisions still make sense.

Other Key Provisions

Most of the headlines in response to the G7 statement focus on the impact of the deal for US-parented groups. Nothing in the statement expressly addresses the treatment of US-parented subgroups within foreign structures. As we note above, one possible outcome is that these subgroups remain within the scope of IIRs and UTPRs.

As we discuss above, a 14% rate on FDDEI is a floor, and the combination for most, if not all, US taxpayers of income that is treated as FDDEI and other US taxable income should result in a baseline rate in excess of 15%. That said, the absence of the QBAI deduction and the allocation of interest and R&D expense away from FDDEI should cause more US taxable income to be subject to a sub-21% rate than before. Thus, we would expect the FDDEI changes to decrease a US group's Pillar Two ETR.

Immediate expensing of both US R&D under §174A and “qualified production property” under §168 would appear to have a similar impact. Here, however, understanding the deferred tax implications of these provisions will be essential. Any timing difference between how an item is treated for tax versus book will have an impact on a group’s Pillar Two ETR. In this instance, the relief will be given at the statutory tax rate whereas the deferred tax implications of the difference will be booked at 15% for the purposes of Pillar Two. This difference will have a Pillar Two ETR impact both at the time the deferred tax position is established as well as when it unwinds.

At the same time, the changes to §163(j) may impact a US group’s Pillar Two ETR. While the OBBBA restored the ability to add back depreciation and amortization to earnings (i.e., EBITDA) in determining taxable income for the purposes of the US interest limitation rules, the OBBBA excluded subpart F and NCTI inclusions and income from §78 dividends from taxable income for this purpose. US groups that counted on significant amounts of offshore income boosting their §163(j) limitation will likely feel a need to respond if the impact of this change is material. Whether the response is to onshore foreign income or offshore debt, there will likely be an impact to the US Pillar Two ETR.

The Pillar Two impact of these changes is not limited to US-parented subgroups in foreign structures. On the theory that the G7 intends for QDMTTs to stay, payments from CFCs in QDMTT jurisdictions to their US parents are potentially subject to the intragroup financing arrangement rule in Article 3.2.7. The application of this rule turns in part on whether a recipient is or is not in a low-tax jurisdiction. In the example above, if the US Pillar Two ETR is below 15%, Article 3.2.7 does not apply. If the US Pillar Two ETR is above 15%, Article 3.2.7 conditions an expense in the CFC payor jurisdiction on a taxable income inclusion in the United States. Where, for instance, §163(j) causes a US group to push debt down to a CFC in a QDMTT jurisdiction, it will be critical to navigate Article 3.2.7 to make sure that the arrangement results in a QDMTT expense.

One key component of the US Pillar Two ETR is of course the US R&D tax credit (and, albeit to a lesser extent, certain other nonrefundable credits, such as the Work Opportunity Tax Credit). As we note above, the G7 appears open to “considering” changes to the treatment of this credit and other nonrefundable credits. The reference to “considering” is notable, however, and is perhaps a nod to the fact that changes in this area may be hard to achieve consensus on after previously hard-fought incentive-related negotiations in the past. That said, we understand that the previous Administration had commenced discussions targeted at expanding the scope of QRTCs to include certain nonrefundable credits that incentivized activity in the local jurisdiction (such as the US R&D tax credit) while protecting against incentives that are solely designed to attract income and, in the mind of certain negotiators, undermine the Pillar Two system.

If the US R&D tax credit continues not to qualify as a QRTC and, thus, remains treated as a reduction to Covered Taxes, it will continue to depress Pillar Two ETRs of US-parented subgroups. If US-parented subgroups in foreign structures are not exempt from the IIR and the UTPR, the unfavorable treatment of the US R&D tax credit means that US profits continue to be at risk of top-up tax under an IIR or a UTPR, notwithstanding other changes in the OBBBA that raise the ETR of US-parented subgroups under the Pillar Two rules.

Conclusion

It is in the nature of a global minimum tax regime like Pillar Two that any national, state, or local income tax changes also likely have global minimum tax implications, and the US international tax aspects of the OBBBA are no exception. While we cannot predict what a Pillar Two deal will look like, or when it will be reached, we suspect that the intersection of Pillar Two and the OBBBA—and the US international tax regime as a whole—will remain relevant for some time.