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House Advances Reconciliation Package That Would Impose Retaliatory Taxes on Certain Non-U.S. Investors and Lenders

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June 30, 2025 Update: *On June 26, 2025, Treasury Secretary Scott Bessent asked House and Senate leaders to remove Proposed Section 899 from the Bill after an agreement-in-principle was reached with fellow G7 members under which U.S.-parented groups would be exempt from those countries' income inclusion rules (IIRs) and/or UTPRs. Consistent with this request, on June 28, 2025, the Senate released updated text for the Bill that does not include Proposed Section 899.*

June 17, 2025 Update: *On June 16, 2025, the Senate Finance Committee released its proposed changes to the tax portions of the Bill, retaining Proposed Section 899 with several notable modifications –*

- *Retaliatory rate increases would begin from the applicable person's existing rate (taking into account zero or reduced treaty rates) and be capped at 15% above that rate — a significant scaling back of the House's proposed 20% cap over the baseline statutory rate. These increases expressly would not apply to enumerated scenarios where income is statutorily excluded from a specified tax (most notably, portfolio interest), but expressly would apply to other exemptions (e.g., under a treaty) and would override Section 892.*
- *Retaliatory rate increases would apply only to applicable persons of "offending foreign countries" that impose "extraterritorial taxes" (i.e., UTPRs and similar taxes), and not of "offending foreign countries" that impose only "discriminatory taxes" (i.e., DSTs and certain other taxes designated by the Treasury Secretary). This distinction could benefit*

investors from potential "offending foreign countries," like Canada, that have not yet adopted UTPRs.

- *Super BEAT would apply — at a proposed general 14% rate — to U.S. corporations majority-owned (directly or indirectly) by applicable persons from "offending foreign countries" imposing either type of tax.*
- *Proposed Section 899's effective date would be delayed one year (i.e., to January 1, 2027, for calendar-year taxpayers).*

The proposal remains subject to ongoing negotiation.

On May 22, 2025, the U.S. House of Representatives passed a budget reconciliation package, titled the "One, Big, Beautiful Bill Act" (the Bill), that includes Proposed Section 899.[1] This provision would impose escalating U.S. tax rates on residents and governmental entities of non-U.S. countries that impose certain "unfair foreign taxes." Among other taxes, "unfair foreign taxes" would include certain taxes enacted in accordance with the OECD Pillar 2 regime as implemented by many OECD-member countries and "digital service tax" regimes.

If enacted in its current form, Proposed Section 899 could have a dramatic effect on the cost of non-U.S. investment in the U.S., with U.S. tax rates imposed on certain non-U.S. investors (whether through withholding or otherwise) increasing to up to 50% (and even higher in the case of certain U.S. branches of non-U.S. persons). These increased rates could apply to, among other things, certain investments in debt instruments issued by U.S. borrowers, investments in credit funds that invest in debt instruments issued by U.S. borrowers, U.S. real estate gains and "effectively connected income."

The Bill is now under consideration by the Senate, which could make material changes as the legislative process unfolds. Even if Proposed Section 899 is enacted in its current form, its scope may change significantly over time if foreign governments respond by repealing or modifying their purportedly "unfair" tax regimes and/or the Treasury Secretary designates additional foreign taxes as "unfair."

Below is a high-level summary of Proposed Section 899, together with some key potential implications, including for lending arrangements and bond offerings and for investment funds and their non-U.S. investors.

Overview

Proposed Section 899 would create a complicated retaliatory tax regime targeting "applicable persons" (including both individuals and entities) associated with "discriminatory foreign countries." For these purposes, any country that imposes an "unfair foreign tax" would be treated as a "discriminatory foreign country."

"Unfair foreign taxes" would include certain OECD Pillar 2 measures (including undertaxed profits rules (UTPRs)), digital services taxes (DSTs) and diverted profits taxes (DPTs).[2] The Treasury Secretary would have discretion to designate other types of taxes, including "extraterritorial" or "discriminatory" taxes, as unfair foreign taxes. A general exception would apply for any tax that does not apply to any U.S. person (including a trade or business of a U.S. person) or to any controlled foreign corporation majority-owned (directly or indirectly) by U.S. persons. This carve-out would allow countries to avoid discriminatory foreign country status by exempting U.S. persons and their foreign operations from applicable unfair foreign taxes. Proposed Section 899 would require the Treasury Secretary to publish and update a list of all discriminatory foreign countries on a quarterly basis.

Some examples of key jurisdictions and regions that have adopted UTPRs include most European Union member states, the UK, Australia, South Korea and Japan. Countries that have DSTs and/or DPTs include Austria, Australia, Canada, France, Italy, Spain, Turkey and the UK.[3]

The retaliatory measures outlined in the following subsection would apply to all "applicable persons," including:

- governments of discriminatory foreign countries, including sovereign wealth funds and foreign government pension plans;
- individuals (other than U.S. citizens and residents) who are discriminatory foreign country tax residents;
- foreign corporations that are discriminatory foreign country tax residents, unless majority-owned (directly or indirectly) by U.S. persons;
- non-publicly held foreign corporations that are majority-owned (directly or indirectly) by applicable persons; and
- foreign partnerships, branches and other entities identified with respect to a discriminatory foreign country by the Treasury Secretary.

This proposed definition creates significant uncertainty regarding Proposed Section 899's application both to foreign partnerships and other pass-through entities, and to hybrid entities treated as tax resident in a discriminatory foreign country for non-U.S. tax purposes but as partnerships or disregarded entities for U.S. tax purposes.

Key Retaliatory Tax Measures

Escalating Increases in Specified Tax Rates

Proposed Section 899 would increase the "specified rate of tax (or any rate of tax applicable in lieu of such statutory rate)" imposed on applicable persons by 5% each year, up to a maximum of 20% above the baseline "statutory rate." For applicable persons claiming zero or reduced treaty rates, it appears these escalating rate increases would begin at zero or the reduced treaty rate and top out at 20% above the baseline statutory rate. For example, Proposed Section 899 would tax an applicable person's otherwise treaty-exempted interest income at 5% in year one, 10% in year two, and so on, before topping out at 50% (i.e., the 30% U.S. federal statutory rate plus 20%) in year 10.

These escalating rate increases would apply to the following key categories of specified taxes (including applicable withholding taxes):

- for all applicable persons, tax on "fixed, determinable, annual, or periodical" (FDAP) income (e.g., passive interest, dividends, rents and royalties);
- for applicable persons that are corporations, tax on income "effectively connected" with a U.S. trade or business (ECI), including branch profits taxes and FIRPTA withholding on dispositions of U.S. real property interests; and
- for applicable persons that are individuals, tax under FIRPTA.

House guidance indicates that these retaliatory rate increases are **not** intended to apply to income that is specifically excluded from a specified tax — for example, interest excluded from FDAP under the "portfolio interest" exemption.

Assuming Proposed Section 899 is enacted in its current form before October 3, 2025, applicable persons associated with discriminatory foreign countries imposing unfair foreign taxes at the time of enactment could be subject to these retaliatory rate increases starting January 1, 2026.

Suspension of the Section 892 Exemption

For governmental entities (including sovereign wealth funds) that are applicable persons, Proposed Section 899 would explicitly override Section 892's exemption for foreign governments and instrumentalities from tax on most U.S.-source investment income. Instead, such governmental entities would be subject to withholding at the escalating rates under Proposed Section 899 in the same manner as other applicable persons.

Super BEAT

Proposed Section 899 would apply a modified Base Erosion and Anti-Abuse Tax (BEAT) to non-publicly held U.S. corporations that are majority-owned (directly or indirectly) by applicable persons. This would include U.S. "blocker" corporations that are majority-owned by applicable persons. These corporations would be subject to a modified "Super" BEAT regime that applies regardless of whether they meet the otherwise applicable gross receipts and base-erosion percentage thresholds and with certain other unfavorable modifications, including an increased BEAT rate of 12.5% (as opposed to the baseline BEAT rate of 10% under current law).

Key Considerations for Lending Arrangements and Bond Offerings

Proposed Section 899 would tax interest on loans made to U.S. borrowers by applicable persons relying on treaty exemptions (e.g., banks, related-party lenders and treaty-qualified credit funds). This could dramatically raise the cost of non-U.S. capital to U.S. borrowers, including portfolio companies owned by private equity funds.

- *Considerations for Existing Loan Arrangements*: For existing lending arrangements, understanding Proposed Section 899's impact will require a review of each loan's documentation to determine how its increased taxes, if applicable, would be treated as a commercial matter — i.e., whether Proposed Section 899 taxes are subject to indemnification or gross-up obligations by borrowers/loan parties.
  - Since loan agreements typically provide that borrowers bear the cost of withholding taxes enacted after the closing of a financing facility, many borrowers may be required to gross up and indemnify lenders for any withholding taxes imposed under Proposed Section 899.
  - Loan agreements typically also provide that if a borrower is required to indemnify or gross up a lender for post-closing withholding taxes, the borrower can mitigate

    those indemnification and gross-up obligations only by either (x) requiring the lender, at the borrower's expense, to assign its interest to a lender not subject to withholding or (y) requesting that the lender designate a different lending office, so long as such designation is not disadvantageous to the lender and does not subject the lender to unreimbursed costs. In its current form, many lenders may not be able to avoid Proposed Section 899's application by designating a new lending office. In this case, a borrower may only be able to mitigate its indemnification or gross-up obligations through the assignment provisions and/or prepayment provisions, which may not be commercially feasible.

- *Considerations for New Loan Arrangements*: Parties entering lending arrangements while Proposed Section 899 is still pending (and not enacted) should consider explicitly allocating the burden of any taxes resulting from Proposed Section 899 if enacted. Borrowers may seek to exclude from their gross-up obligations any taxes resulting from Proposed Section 899's enactment and lenders will seek the opposite.
    - Borrowers also should review assignment provisions to ensure they can require lenders that become subject to Proposed Section 899 to assign their interest to unaffected lenders without significant burden.
    - The traditional contractual provisions allocating the burdens of increased tax liability from changes in law should be reviewed and commercially considered by borrowers and lenders in the context of the legislation's complex terms. In its current form, Proposed Section 899 could cause a particular lender to become an applicable person subject to future withholding at escalating rates based on a determination by the Treasury Secretary or its own home country's tax laws (including a change in such home country's tax laws).

- *Considerations for Bonds*: The U.S. bond market does not typically require borrowers to indemnify or gross-up bondholders for withholding taxes. Bond issuers and agents may need to determine whether they are required to withhold Proposed Section 899 taxes in respect of certain bondholders.

Key Considerations for Funds and Their Non-U.S. Investors

- *Funds Not Anticipated to Give Rise to Material U.S.-Source Income*: For funds that are expected to generate primarily income that is not subject to specified taxes (e.g., non-ECI capital gains, portfolio interest and foreign-source income), Proposed Section 899's impact on the funds and on any investors or fund vehicles that are applicable persons would likely be limited to (x) the effect of Proposed Section 899 on such funds' borrowing arrangements (and the borrowing arrangements of their portfolio companies), as discussed above, and (y) the potential for increased withholding taxes applicable to dividends received from U.S. portfolio companies. This would include many private equity funds, venture capital funds and non-U.S. focused credit funds.

  - Proposed Section 899 could change the calculus with respect to funds making shareholder loans to U.S. “blocker” corporations or U.S. portfolio companies. Fund investors that are applicable persons could be subject to withholding tax under Proposed Section 899 with respect to income from such loans if not eligible for the portfolio interest exception.

- *Funds Anticipated to Give Rise to Material U.S.-Source Income*: For funds structured as partnerships for U.S. tax purposes and using strategies expected to give rise to significant U.S.-source income (e.g., interest and dividends), the practical impact of Proposed Section 899 would depend on whether such funds’ non-U.S. investors are applicable persons and, if so, the extent to which they rely on tax treaty benefits and/or Section 892 to enjoy zero or reduced rates of U.S. withholding tax.
  - Applicable persons that rely on a tax treaty or Section 892 would be subject to escalating withholding under Proposed Section 899, although applicable persons that rely on statutory exemptions from specified taxes (namely, the portfolio interest exemption) could continue doing so.

- *Corporate Structures and Reverse Hybrid Entities*: Fund vehicles treated as foreign corporations for U.S. tax purposes would be applicable persons if they are either (i) resident in a discriminatory foreign country and not majority-owned (directly or indirectly) by U.S. persons or (ii) more than 50% owned (directly or indirectly) by applicable persons.
  - In either case, Proposed Section 899’s retaliatory measures would apply at the entity level — presumably including for investors with respect to which such entities are “fiscally transparent” in their home country, overriding any relevant treaty benefits previously enjoyed by such investors (including even such investors that are not themselves applicable persons).[4]

- *Increased Compliance Obligations*: Proposed Section 899 would pose significant withholding compliance challenges.[5] Many funds would need to implement new systems — including collecting relevant information from existing investors and updating subscription materials with respect to new investors — to determine whether payments potentially subject to increased withholding rates are being made to applicable persons. This determination could be particularly challenging with respect to entities that are not readily identifiable as applicable persons, such as corporations that are not residents of discriminatory foreign countries but are majority-owned (directly or indirectly) by applicable persons.

If enacted in its current form, Proposed Section 899 could have other potentially significant consequences that are not addressed in this *Alert*. For questions regarding Proposed Section 899, please reach out to any member of the Kirkland tax team, including the authors below.

Information regarding other proposed tax law changes in the Bill can be found in our prior *Alerts*: "Ways and Means Committee Approves Tax Proposal Featuring Individual and Business Tax Breaks and Targeted Revenue Raisers – But No Changes to Carried Interest" and "House Proposes Scaling Back of Renewable Incentives – Next Stop, Senate."

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1. Section references are to the Internal Revenue Code of 1986, as amended. ↩

2. Although not defined in Proposed Section 899, presumably UTPRs are laws that subject multinational enterprises to a minimum level of tax globally, DSTs are laws intended to tax large technology companies on revenue derived from consumers within the taxing jurisdiction's borders, and DPTs are laws targeting arrangements that artificially shift profits out of a country to low- or no-tax jurisdictions. ↩

3. These lists are not intended to be exhaustive and even if Proposed Section 899 is enacted in its current form, countries could repeal, enhance or modify their existing tax regimes or the Treasury Secretary could exercise discretion to designate additional unfair foreign taxes. ↩

4. The practical significance of this will depend on the extent to which the fund vehicle is expected to generate significant U.S.-source income subject to specified taxes ↩

5. Proposed Section 899 offers some limited transitional relief for withholding agents that can demonstrate they made "best efforts" to timely comply with any increased withholding obligations, providing that such agents would not be subject to penalties or interest for failures to withhold Proposed Section 899 taxes before January 1, 2027. ↩

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