

# Will Pillar Two Crumble Before It's Built?

February 21, 2025

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Over 135 jurisdictions signed up for a global Organisation for Economic Cooperation and Development (OECD) project in October 2021 aimed at reforming the international taxation system. A Two-Pillar approach was developed to combat base erosion and profit-shifting strategies, which large multinational enterprises (MNEs) employ to move their profits to low or no-tax jurisdictions or to lower their tax bases through deductible expenses. On the first day in office of his second term, President Donald Trump withdrew from this "Global Tax Deal." The threat of punitive measures now looms over countries that impose tax on US MNEs under their domestic Pillar Two legislation.

## Pillars One and Two

In summary, Pillar One reallocates the profits of MNEs from jurisdictions where they earn income to those where they have substantial engagement (i.e., where they sell goods and supply services). Pillar Two imposes a minimum effective tax rate of 15 percent on MNEs (with over €750 million in turnover) in every country in which they operate, regardless of local tax rates or available reliefs. Pillar Two comprises a set of Global Anti-Base Erosion (GloBe) rules that include two key tax collecting mechanisms (applicable where the effective tax rate in a jurisdiction is lower than 15 percent):

1. Income Inclusion Rule (IIR): a top-up tax is paid in the jurisdiction of the ultimate parent entity or of the intermediate parent entity.
2. Undertaxed Payment Rule (UTPR): if the IIR does not collect all the top-up tax in a certain jurisdiction, the UTPR assigns the liability to pay the top-up tax to the other constituent entities (in other jurisdictions) of that MNE group.

## Executive Orders

Among the numerous executive orders that President Trump has signed since his inauguration, two are particularly relevant here. First, as mentioned, President Trump withdrew all US commitments to the Global Tax Deal, stating that it "allows extraterritorial jurisdiction over American income," and ordered that the Secretary of the Treasury shall investigate whether any foreign countries have put in place or are likely to put in place any tax rules that are "extraterritorial or disproportionately affect American companies" and develop options for protective measures. Second, the Secretary of Commerce and the Office of the United States Trade Representative have been tasked with investigating if any foreign countries subject US citizens or corporations to "discriminatory or extraterritorial taxes pursuant to section 891 of title 26, United States Code." Section 891 allows for the doubling of US tax rates on foreign citizens and corporations without prior approval from Congress. Importantly, Section 891 has been on the statute book for approximately 90 years but has never been invoked.

## What Might Happen Now?

President Trump has been highly critical of Pillar Two for several years, and it has long been speculated that under a Trump administration, countries may be reluctant to apply the UTPR to US corporations for fear of retaliation, specifically in the form of tariffs on their exports to the United States. As such, the withdrawal from the Global Tax Deal comes as no real surprise. However, two important questions arise: (i) how does this affect the US income of foreign individuals and corporations, and (ii) where does this leave the future of the Global Tax Deal?

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As opposed to the retaliatory tariffs, doubling taxes under Section 891 would not only directly affect a significant number of corporations but also the income of individuals. The threat of invoking Section 891 is startling, given this is likely one of the most extreme options President Trump has at his disposal in this context. Several questions also remain unanswered. For example, how would these measures work in practice, what would their interactions be with Double Taxation Treaties (which generally take precedence over domestic rules) or how would this affect US dual citizens?

Section 891 measures seem so radical that they could be viewed as an exaggerated but unlikely threat. However, the US House Committee on Ways and Means has introduced a more realistic form of potential retaliatory measures in the form of the Defending American Jobs and Investment Act. This proposes the following: first, countries that impose “discriminatory taxes” on US businesses would be identified. The UTPR is given as an example of such “discriminatory taxes.” Then, the tax rates on the US income of individual investors and corporations from those countries would increase by 5 percent each year for four years, after which the tax rates would remain elevated by 20 percent while “the unfair taxes are in effect.” Though undoubtedly a lesser risk than the doubling of tax rates, this proposal would still result in a heavy financial and administrative burden on corporations (and individuals), affecting their profitability. Many corporations and individuals may also have to rethink or restructure planned business ventures, resulting in additional legal and advisory costs.

At the same time, numerous corporations have already incurred significant administrative costs in preparing for Pillar Two to come into effect — and around 50 countries have already implemented Pillar Two rules. However, with President Trump’s executive order withdrawing US support of the Global Tax Deal, Pillar Two’s future is now uncertain.

It is universally acknowledged that the success and future of Pillar Two rests on collective effort and cooperation between countries. The threat of the retaliatory measures as described above, including the potential for the imposition of tariffs by the United States (which is still highly pertinent), may give rise to two outcomes. On the one hand, many jurisdictions may be slower to adopt Pillar Two rules or avoid implementing them all together. This will likely depend on the severity of any retaliatory measures proposed rather than purely based on US withdrawal from the deal (given that House Republicans, who held a majority when Pillar Two came into being, were against its implementation — US implementation was never guaranteed).

On the other hand, US retaliation to Pillar Two implementation may escalate global economic tensions. Countries may recognize and use their existing leverage to fight such measures. For example, several countries have frozen their digital services taxes (which the United States has long opposed) due to the implementation of the Global Tax Deal, thereby benefitting US tech giants. As such, countries have the option of reinstating these taxes at their disposal.

Amongst so much uncertainty, one thing is clear: both corporations and individuals must monitor any updates in this area vigilantly. Developments, with respect to either the implementation (or lack thereof) of Pillar Two by countries or US retaliatory measures, may be highly consequential. Keeping on top of them will be key to proactively and effectively addressing resulting challenges as and when they arise.

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## CONTACTS

For more information, please contact your Katten lawyer or any of the following [Tax](#) lawyers.



**Charlotte Sallabank**  
+44 (0) 20 7776 7630  
charlotte.sallabank@katten.co.uk



**Daniel Lewin**  
+44 (0) 20 7770 5251  
daniel.lewin@katten.com



**Christy Wilson**  
+44 (0) 20 7770 5241  
christy.wilson@katten.co.uk

*\*Georgia Griesbaum, trainee in the Transactional Tax Planning practice, contributed to this article.*

# Katten

katten.com

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB

+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

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2/19/25