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Legislative Update

Section 899 of the One Big Beautiful Bill — Focus on Tax and Private Funds

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On May 22, the House of Representatives voted to approve the One Big Beautiful Bill (OB3), which contains a new addition to the U.S. Internal Revenue Code — Section 899. OB3 is now under consideration by the Senate, which could make substantial changes to its tax provisions. Pending those changes, the following is a high-level summary analysis of the potential implications of proposed Section 899, in particular for non-U.S. investors in U.S. private investment funds.

Key Tax Provisions

Section 899 Generally

Proposed Section 899 would increase the net income and withholding tax rates on U.S.-source income for non-U.S. persons who are classified as "applicable persons." Applicable persons include individuals, corporations, governments and sovereign wealth funds, and non-U.S. partnerships resident in a "discriminatory" country (i.e., a country that imposes an "unfair foreign tax"). Applicable persons also include private corporations not resident in a "discriminatory" jurisdiction, but the majority of whose owners *are* applicable persons. Some examples of unfair foreign taxes include certain OECD Pillar 2 measures, "digital services taxes," "diverted profits taxes" as well as certain other taxes designated by the Treasury. Section 899 requires the Treasury to publish a quarterly list of all jurisdictions that it designates as discriminatory. It is currently expected that most European Union member states, the United Kingdom, Australia, Canada, Japan and certain other countries will be considered to be discriminatory foreign countries for purposes of proposed Section 899.

The section would impose an annual increase on the applicable tax rates of certain specified U.S. taxes, including applicable withholding taxes. The increase in applicable tax rates is 5% each year, up to a maximum tax rate of 20% higher than the baseline statutory rate (e.g., income normally taxed at 30% could, over four years, become taxed at 50%). Such specified U.S. taxes subject to increase include: (i) U.S. withholding tax on what is referred to as FDAP (e.g., interest, dividends, rents, royalties); (ii) with respect to applicable persons that are corporations, "effectively connected income" (ECI) of a U.S. trade or business, including branch profits taxes and FIRPTA withholding on dispositions of U.S. real property interests; and (iii) with respect to applicable persons that are individuals, only ECI taxed under the FIRPTA regime. However, House guidance provides that these rate increases are not intended to apply to income that is excluded by a statutory exemption to a specified tax (e.g., the "portfolio interest" exemption).

Because, as noted above, foreign governmental entities that are organized in a discriminatory jurisdiction are included in the definition of applicable persons, the section would also operate to override the so-called Section 892 exemption for foreign governments. For example, an affected foreign government would effectively go from (i) no U.S. withholding tax on FDAP to 35% (subject to further 5% increases or 5% above the applicable treaty rate, if any) and (ii) no U.S. tax on FIRPTA stock gains to 26% U.S. tax (subject to further 5% increases). Importantly, it does not appear that the exemption from FIRPTA for qualified foreign pension funds (QFPFs) is affected by OB3. Consequently, it is expected that the increased U.S. tax on FIRPTA stock gains noted immediately above will apply only to non-QFPF 892 investors.

These provisions, if passed in their current form, would be applicable starting January 1, 2026.[1]

"Super" BEAT

Proposed Section 899 would apply a modified Base Erosion and Anti-Abuse Tax (BEAT). The BEAT is a tax passed during the first Trump administration designed as an alternative minimum tax for certain large corporations that were perceived as making payments eroding the U.S. tax base. Very generally, it currently only applies to corporations that meet a $500 million gross receipts test and a 3% "base erosion percentage" threshold. Section 899 would expand the BEAT to cover any nonpublic U.S. or non-U.S. corporation that is more than 50% owned (by vote or value) by applicable persons, without regard to the $500 million or 3% thresholds. Additionally, the BEAT rate would be increased for such corporations to 12.5%, instead of the baseline BEAT rate of 10% under current law.

Potential Impact on Private Investment Funds and Their Non-US Investors

Increased Withholding

Proposed Section 899 as currently contemplated could have a significant impact on investment funds that generate a material amount of U.S.-source income (e.g., interest or dividends). Non-U.S. investors in funds that generate mostly U.S.-source interest (including interest that would be ECI) and dividend income will be impacted to the extent such non-U.S. investor (i) is an "applicable person"[2] and (ii) relies on tax treaty benefits or the Section 892 exemption to eliminate or reduce the 30% U.S. withholding tax on FDAP income that otherwise applies.

Although not entirely clear, applicable persons that rely on statutory exemptions for certain types of income (such as the "portfolio interest" exemption) are anticipated to be able to continue to benefit from such exemptions without increased taxes imposed by proposed Section 899. This may include, for example, offshore lending funds that acquire loans pursuant to "season and sell" or similar strategies.

On the other hand, certain structures, particularly in the credit space, such as "treaty funds" or "bring your own treaty" funds that rely on the independent agent provisions of a tax treaty of the vehicle (or, in the latter case, of its owners) may be compromised by proposed Section 899 if such funds or their non-U.S. investors are deemed applicable persons. Consequently, such structures could face withholding taxes of up to 50%.[3] Importantly, nontransparent (for U.S. purposes) structures where the vehicle itself is subject to the tax would also appear to result in an indirect increased tax burden for beneficial owners that are not themselves applicable persons, including any U.S. persons such as U.S. tax-exempts.

Furthermore, any non-U.S. investors in private equity funds that engage in "leveraged recap" or dividend generating transactions with respect to their U.S. portfolio companies could also be subject to increased withholding.

Potential Impact on Blockers and Certain Other Corporate Entities

Many investment funds desiring to engage in a U.S. trade or business establish a leveraged blocker — a feeder structure for non-U.S. investors that (i) blocks ECI attribution and U.S. federal and state income tax filing obligations, (ii) generates interest deductions at the blocker level to mitigate the blocker-level income tax burden and (iii) generates U.S.-source interest income returns for non-U.S. investors that have access to the portfolio interest exemption, tax treaty benefits and/or the benefits of Section 892. Such structures are commonly established to hold interests in U.S. operating businesses (private equity), to engage in U.S. direct lending (private credit) or to hold interests in U.S. real estate assets and REITs.

As discussed above, absent access to the portfolio interest exemption, applicable persons who earn nonportfolio interest and dividends from a blocker would, under proposed Section 899, generally be subjected to higher withholding tax rates.

Importantly, however, leveraged blockers may now also be subject to the “super” BEAT tax (to the extent the interest payment is deemed made to a related party) — potentially reducing the benefit of any interest payments in addition to subjecting such payments to potential withholding with respect to the blocker investors.

Furthermore, investment funds that use non-U.S. entities taxed as corporations for U.S. federal income tax purposes would also be impacted by proposed Section 899 if such entities are (i) (A) resident of a discriminatory foreign country and (B) not majority owned by U.S. persons or (ii) more than 50% owned (by vote or value) by applicable persons. Proposed Section 899 taxes would be imposed on such non-U.S. corporations (seemingly without regard to whether such entities are “reverse foreign hybrids,” i.e. respected as fiscally transparent in their home jurisdiction), further impacting non-U.S. investors that commonly claim tax treaty benefits on income generated through such entities. Furthermore, under the “super” BEAT provisions described above, there is an increased risk that many non-U.S. corporations otherwise excluded under current law could become subject to the BEAT. This group may include, among others, offshore hedge funds structured as corporations or certain offshore (e.g., FIRPTA) filing blockers.

Uncertain Impact for Non-US Partnerships

Finally, proposed Section 899 leaves open the opportunity for further clarifying guidance to be provided in the context of partnerships and partners through future Treasury regulations. As it currently stands, it is unclear how and to what extent the new rules would impact non-U.S. partnerships (or similar flow-through entities, including disregarded entities).

Legislative Outlook

It is currently unclear whether and to what extent proposed Section 899 as included in the OB3 will pass in the Senate. There are a number of procedural and technical hurdles that could lead to all or a portion of the proposal being struck down or significantly modified. There has also been a concerted effort in the media and among interest groups (including, for example, foreign banks that generally cannot rely on the portfolio interest exemption) to lobby against the provision based on unfavorable budgetary projections and economic impact on foreign investment into the United States.

We will keep readers posted on any developments as this legislation moves through the Senate, in case there are further implications.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] It is unclear to what extent similar provisions would be adopted (automatically or otherwise) by U.S. states. Certain income of non-U.S. persons, such as, for example, ECI, is subject to both U.S. federal and state taxation.

[2] As noted above, a function of its country of residence or organization or of the residence or organization of its owners or beneficiaries.

[3] Those funds that would be applicable persons but rely on U.S. persons to meet the treaty vehicle's "limitation on benefits" provision may be able to avoid the reach of Section 899.