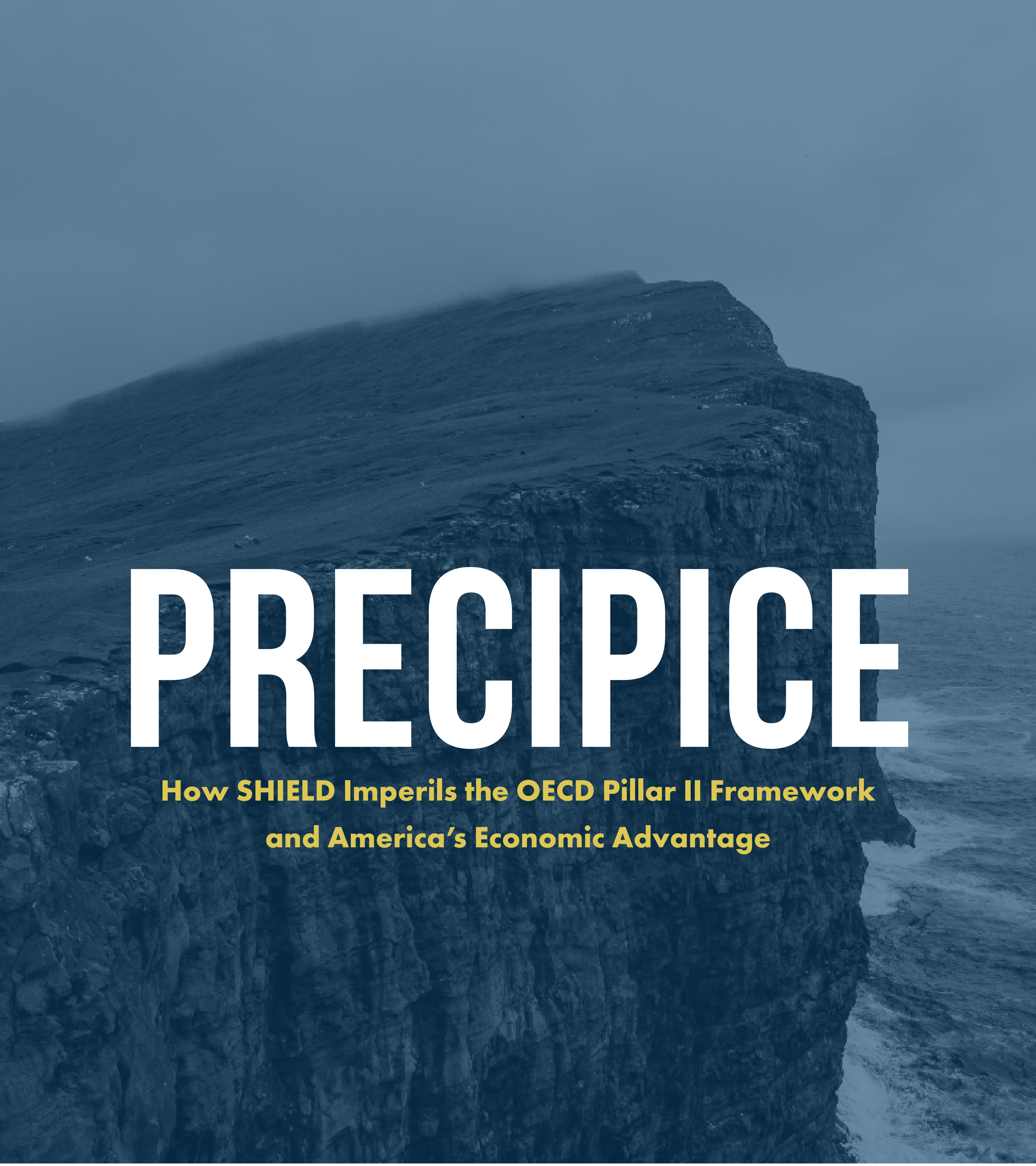

PRECIPICE

How SHIELD Imperils the OECD Pillar II Framework and America's Economic Advantage

GLOBAL BUSINESS ALLIANCE

“No one should ever be taxed twice on the same income.
It’s not fair and it’s not just.”

-- Rep. Jerry Nadler (D-NY-10)

“We believe that our country – and our world – are safer, more resilient, and more prosperous because of the investment of foreign-owned companies in the United States.”

-- President Joe Biden

Introduction

The SHIELD (Stopping Harmful Inversions and Ending Low-tax Developments), whether a stand-alone provision or incorporated into the BEAT, creates policies discouraging U.S. investment, gets too far ahead of the OECD including the necessity for a definition of an effective tax rate that the OECD is currently undertaking and results in U.S. tax results not aligned with Pillar II or global low-taxed amounts. Below is more detail illustrating these points.

The SHIELD proposal was developed in connection with the OECD/G20 Inclusive Framework discussions of a comprehensive agreement on global minimum taxation under Pillar II of the BEPS 2.0 project. In an effort to ensure that income wherever earned is subject to an agreed minimum rate of taxation, the coordinated global effort includes an Income Inclusion Rule (IIR) that would give taxing rights over low-taxed foreign income of a multinational group to the headquarters jurisdiction as well an Under-Taxed Payments Rule (UTPR) that would apply to multinational groups that are not subject to an IIR in their headquarters jurisdictions. The UTPR would give taxing rights to jurisdictions that are home to members of a multinational group that make deductible payments to other low-taxed members of the group.

The SHIELD reflects concepts underlying the UTPR that is under development. However, the SHIELD as proposed would be a very blunt instrument that is not well targeted to the objective of ensuring that all income, wherever earned, is subject to a minimum rate of taxation. The additional tax that would be imposed on a multinational group under SHIELD is not based on the benefit the group may derive from its connection to a low-tax jurisdiction. As designed, SHIELD would be unbalanced in its application, imposing a relatively greater burden on groups with lower profit margins in low-tax jurisdictions and on groups whose low-tax income has an ETR that is closer to the agreed minimum tax rate. This would be exacerbated by the application of SHIELD to payments from U.S. affiliates made to high-tax foreign affiliates and to foreign affiliates that only appear to be low-taxed based on the measurement approach used. In addition, the burden of SHIELD on necessary payments for costs of goods sold could make it impossible for foreign-headquartered multinationals to continue to operate a business in the United States. The overreach of SHIELD would create a significant risk that foreign investment would be driven out of the United States, resulting in a loss of U.S. jobs and a reduction in the U.S. tax base. Moreover, contrary to the underlying objective of the SHIELD proposal, this would not advance the effort to ensure that all income is subject to a minimum rate of taxation.

The OECD/G20 Inclusive Framework discussions regarding global minimum taxation overall and the design specifics of the UTPR in particular are still ongoing. As work continues on development of a common set of global minimum tax rules, the United States should continue its active and constructive participation in the global effort. The SHIELD proposal then could be revisited and refined based on the global agreement that is reached so that it is aligned with the agreed minimum tax framework. Taking action now on a proposal that is significantly more burdensome than the minimum tax approach being developed in the global effort would be harmful to the foreign multinationals that have established business operations in the United States and would create a substantial barrier to further investment in the United States. The United States should not put itself at a disadvantage by getting ahead of the rest of the world on what is intended to be a coordinated approach to achieving a level playing field for business activity in today's global economy.

Operation of SHIELD is Not Aligned with Objective of Comprehensive Minimum Taxation

While the SHIELD is proposed in connection with global discussions of a common set of minimum tax rules, its operation is very different than the operation of the Pillar II UTPR that has been developed in the global discussions. SHIELD uses the agreed minimum tax rate only to determine the payments to low-tax affiliates that would be subject to tax under SHIELD. The tax that would be imposed under SHIELD bears no relationship to the tax that would be imposed on the affiliate at the minimum rate. In contrast, the UTPR uses the agreed minimum tax rate both to determine the payments that are subject to tax under the UTPR and also to determine the tax imposed under the UTPR. The tax under the UTPR would be the amount of additional tax necessary to bring the tax on the affiliate up to the agreed minimum rate.

The overreach of SHIELD and its uneven application yielding results that bear no relationship to the tax benefits a multinational group may derive from its low-tax affiliates can be seen from a comparison of the results under SHIELD and the UTPR in a series of simple illustrative examples.

Additional Tax Under SHIELD Far Exceeds Additional Tax Under the UTPR

Consider an agreed minimum tax rate of 15% and a foreign-headquartered group that includes a U.S. subsidiary, a low-tax foreign affiliate, and a high-tax foreign affiliate. The U.S. subsidiary earns income from third-party sales of the products it manufactures, and its costs include payments to both foreign affiliates for inputs to its manufacturing operation.

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
Jurisdictional Tax Rate	28%	5%	20%	
Third Party Sales	1000			1000
Related Party Income		250	100	
Payment from U.S. to low-tax foreign	-250			
Payment from U.S. to high-tax foreign	-100			
Other costs	-450	-150	-80	-680
Profit	200	100	20	320
Tax due	56	5	4	65
ETR	28%	5%	20%	20%

Under SHIELD, the deduction for the payment to the low-tax foreign affiliate would be disallowed in full. In addition, the deduction for the payment to the high-tax foreign affiliate would be partially disallowed, based on the profit of the low-tax foreign affiliate as a percentage of the group's total profits (in this example, the low-tax foreign affiliate's profit of 100 represents 31% of the group's total profits of 320). This additional partial disallowance is completely duplicative as the disallowance of the direct payment to the low-tax foreign affiliate alone far exceeds the total low-tax profit of the group, so that there is no policy rationale for any disallowance with respect to the payment to the high-tax foreign affiliate.

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
SHIELD disallowance - low-tax foreign SHIELD disallowance - high-tax foreign	250 31			250 31
Additional tax under SHIELD	79			79
ETR with SHIELD	67%	5%	20%	45%

In this example, SHIELD would result in substantial additional U.S. tax, more than doubling both the U.S. effective tax rate and the overall global effective tax rate of the group.

In contrast, under the UTPR, the additional tax would be limited to the differential in the tax paid in the low-tax foreign affiliate and the tax that would be paid if the minimum tax rate were applicable to that affiliate. In this example, the tax differential would be 10 (15% minimum rate applied to the affiliate's 100 of profit minus local tax of 5). Moreover, under the UTPR, there would be no disallowance of deduction with respect to the payment to the high-tax foreign affiliate because the entire additional tax allowed would be captured through the partial disallowance applied to the payment to the low-tax foreign affiliate.

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
Additional tax under UTPR	10			10
ETR with UTPR	33%	5%	20%	23%

In this example, the additional tax under SHIELD (79) would be 7.9 times the additional tax under the UTPR (10). Moreover, the U.S. and overall global effective tax rates that would result under SHIELD, which are 67% and 45% respectively, would be close to double the effective tax rates that would result under the UTPR for the group, which are 33% and 23% respectively.

Disparity Between Additional Tax Under SHIELD and Under the UTPR Increases as the Tax Rate in Low-tax Affiliate Increases

The disparity between SHIELD and UTPR is more pronounced when the effective tax rate in the low-tax foreign affiliate is higher, up to the point where the effective tax rate equals the agreed minimum tax rate at which SHIELD would not be applicable. To illustrate this, consider the original example with the effective tax rate in the low-tax foreign affiliate increased from 5% to 14%.

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
Jurisdictional Tax Rate	28%	14%	20%	
Third Party Sales Related Party Income Payment from U.S. to low-tax foreign Payment from U.S. to high-tax foreign Other costs Profit	1000 -250 -100 -450 200	 250 -150 100	 100 -80 20	1000 -680 320
Tax due	56	14	4	74
ETR	28%	14%	20%	23%

Under SHIELD, which looks only to whether the payments are made to a foreign affiliate with an effective tax rate below the agreed minimum tax rate, the additional U.S. tax incurred and the post-SHIELD effective tax rate would be the same as in the original example.

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
Additional tax under SHIELD	79			79
ETR with SHIELD	67%	14%	20%	48%

In contrast, under the UTPR, the additional tax would be limited to the differential in the tax paid in the low-tax foreign affiliate and the tax that would be paid using the minimum tax rate. In this example, at a 14% effective tax rate in the low-tax affiliate, the tax differential would be 1 (15% minimum rate applied to the affiliate's 100 of profit minus local tax of 14).

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
Additional tax under UTPR	1			1
ETR with UTPR	29%	14%	20%	23%

In this example, the additional tax under SHIELD (79) would be 79 times the additional tax under the UTPR (1). Moreover, the U.S. and overall global effective tax rates that would result under SHIELD, which are 67% and 48% respectively, would be more than double the effective tax rates that would result under the UTPR, which are 29% and 23% respectively.

Taking this to the extreme, in this example, if the tax rate in the low-tax affiliate is increased to 14.9%, the additional tax under SHIELD (79) would be 790 times the additional tax under the UTPR (0.1). However, with a tax rate in the low-tax foreign affiliate of 15% (just one tenth of a percentage point higher than the foreign affiliate's effective tax rate), SHIELD would not be applicable (nor would the UTPR). The additional tax under the UTPR declines toward zero as the tax rate in the low-tax foreign affiliate increases toward the minimum rate. However, the additional tax under SHIELD is constant as the tax rate in the low-tax foreign affiliate increases toward the minimum rate until it drops to zero when the effective tax rate equals the minimum tax rate. This "cliff" effect of the SHIELD design would lead to results that are counter-intuitive, distortive, and punitive.

Disparity Between Additional Tax Under SHIELD and Under the UTPR Increases as the Profit Margin in Low-tax Affiliate Declines

SHIELD also creates counter-intuitive results in terms of its relative effects on low-tax foreign affiliates with different profit margins. Despite the common perception that a high profit margin in a low-tax jurisdiction could be more likely to indicate some element of base erosion or profit shifting than a low profit margin in a low-tax jurisdiction, the differential between the additional tax under SHIELD and under the UTPR is greater when the profit margin in the low-tax foreign affiliate is lower.

To illustrate this, consider the original example with the profit margin in the low-tax foreign affiliate reduced from 40% to 20% (which is the profit margin in the US sub and the high-tax foreign affiliate).

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
Jurisdictional Tax Rate	28%	5%	20%	
Third Party Sales Related Party Income Payment from U.S. to low-tax foreign Payment from U.S. to high-tax foreign Other costs Profit	1000 -250 -100 -450 200	 250 -200 50	 100 -80 20	1000 -730 270
Tax due	56	2.5	4	63
ETR	28%	5%	20%	23%

Again, under SHIELD, which looks only to whether the payments are made to a foreign affiliate with an effective tax rate below the agreed minimum tax rate, the additional U.S. tax incurred and the post-SHIELD effective tax rate would be very close to the original example (with a small difference attributable to the lower profit margin in the low-tax foreign affiliate reducing the low-tax percentage of the group's total profit and resulting in a smaller disallowance of deduction for the payment to the high-tax affiliate).

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
SHIELD disallowance-payment to low-tax foreign SHIELD disallowance-payment to high-tax foreign	250 19			250 19
Additional tax under SHIELD	75			75
ETR with SHIELD	66%	5%	20%	51%

In this example, the additional tax under SHIELD would significantly exceed the entire profit in the low-tax affiliate.

In contrast, under the UTPR, the additional tax would be limited to the differential in the tax paid in the low-tax foreign affiliate and the tax that would be paid using the minimum tax rate. In this example, with a lower profit margin, the tax differential would be 5 (15% minimum rate applied to the affiliate's 50 of profit minus local tax of 2.50).

	U.S. Sub	Low-Tax Foreign	High-Tax Foreign	Total
Additional tax under UTPR	5			5
ETR with UTPR	31%	5%	20%	25%

In this example, the additional tax under SHIELD (75) would be 15 times the additional tax (5) under the UTPR (compared to 7.9 times in the original example). Moreover, the US and overall global effective tax rates that would result under SHIELD, which are 66% and 51% respectively, would be more than double the effective tax rates that would result under the UTPR, which are 31% and 25% percent respectively.

SHIELD is Not Aligned With Objective of Comprehensive Minimum Taxation

As this series of examples illustrates, the design of SHIELD causes unbalanced results that are inconsistent with the objective of minimum taxation creating a level playing field. The tax under SHIELD is not based on the additional tax that would be needed to bring a multinational group's low-tax profit up to the agreed minimum tax level. Indeed, the additional tax under SHIELD could exceed the shortfall in tax on the group's income in a low-tax jurisdiction, relative to the agreed minimum, by many multiples. Moreover, the overreach of SHIELD is more pronounced the closer the tax rate in the low-tax jurisdiction is to the agreed minimum rate. The overreach of SHIELD also is more pronounced the lower the group's profit margin is in the low-tax jurisdiction.

Overreach of SHIELD Exacerbates Key Design Issues

SHIELD's lack of alignment with the tax shortfall relative to the agreed level of minimum tax for a multinational group exacerbates the detrimental impact of several other features of the SHIELD design.

Partial Disallowance of Payments to Non-low-tax Affiliates Adds to SHIELD's Overreach

In addition to the full disallowance of deductions for payments from the U.S. affiliate to low-tax affiliates, SHIELD also partially disallows deductions for payments to affiliates that are not in low-tax jurisdictions based on the low-tax proportion of the group's total profit. As the above examples illustrate, the tax resulting from this partial disallowance could supplement additional tax arising from the disallowance of deductions for payments to low-tax affiliates that itself is significantly in excess of the group's tax shortfall relative to the agreed minimum tax level. Moreover, the payments made to affiliates that are at or above the agreed minimum tax level may have no connection to the group's low-tax affiliates – in this regard, the U.S. affiliate may have no connection whatsoever to the low-tax affiliate or its business. There is no legitimate basis for a disallowance of deductions in these circumstances.

Use of Financial Statement ETR Can Exacerbate SHIELD's Overreach

For purposes of SHIELD, the determination of whether an affiliate is considered to be low tax is to be made by reference to the affiliate's ETR determined based on its separate financial statements (or a jurisdictional disaggregation of the group's consolidated financial statements). The description of the SHIELD proposal notes the intention that Treasury be granted authority to address differences between the income tax base and the base determined under financial accounting. The differences between financial accounting and income tax accounting can be substantial. Such differences also can vary dramatically across industries and business profiles. These differences mean that an affiliate in a relatively high-tax jurisdiction could have an ETR for

SHIELD purposes that would subject the U.S. affiliate to significant additional tax, tax that would bear no relationship to the amount of tax shortfall, if any, in the group. Properly addressing these differences to ensure an appropriate ETR computation is too important to the operation of SHIELD to leave to regulatory authority alone.

Moreover, where an apparent tax shortfall is based on a timing difference between tax and financial statement accounting, the special rules that would need to be incorporated in SHIELD legislation could be very complicated and may not be sufficient to full resolve the difference. Consider a situation where the affiliate makes a large investment that is eligible for immediate expensing for tax purposes (incidentally, a tax benefit the United States also provides in its tax code). In the absence of an adjustment, the affiliate's ETR could appear to be below the agreed minimum even though its jurisdiction is relatively high-tax and SHIELD could apply to disallow a deduction for any payment made by a U.S. affiliate to such affiliate. Even if an offsetting deduction enhancement were to be allowed in a subsequent year when the timing difference reverses, the additional tax under SHIELD in the immediate expensing year could far exceed the benefit of such expensing. This further confirms that the SHIELD design does not target low-tax jurisdictions, base erosion, or tax avoidance, but rather would create tax policy that could adversely impact U.S. investment and also give rise to retaliation by foreign countries.

These complex issues are the subject of current work in the OECD/G20 Inclusive Framework effort. The continued participation of the United States in those discussions would contribute to the development of effective solutions to be incorporated in the agreed minimum tax framework. These same solutions could then be included in a refined SHIELD that is aligned with the agreed framework. There is no reason for the United States to tackle these issues unilaterally – and doing so would risk an outcome that further disadvantages the United States.

Denial of COGS Could Threaten the Viability of U.S. Manufacturing Operations

For purposes of SHIELD, a payment made by a U.S. affiliate to a low-tax affiliate for costs of goods sold (COGS) would effectively be disallowed through the denial of other deductions up to the amount of the payment. When a multinational group conducts manufacturing operations in various locations around the world including the United States, an important element of the COGS in those operations are payments to affiliates for centrally produced or developed components or other inputs. These payments, whether for raw materials that cannot be grown in the United States, products that cannot be produced in the United States or intellectual property that is necessary to manufacture the product in the United States, are ordinary and necessary business inputs that are an essential part of COGS and for which a full tax deduction is equally essential. It would not be efficient or practical – and in many cases it would not be feasible – to produce those inputs in each location. This is true for U.S. affiliates of foreign-headquartered groups, just as it is true of foreign affiliates of U.S.-headquartered groups.

In situations where the COGS incurred by a U.S. affiliate include payments to a low-tax foreign affiliate, the tax imposed under SHIELD could be substantial. The cost of SHIELD could be multiples higher than the shortfall in the low-tax affiliate's tax burden relative to the level of the minimum tax. Moreover, the tax under SHIELD potentially could exceed the total profit in the low-tax affiliate. The burden of the tax under SHIELD could force the multinational group to terminate its U.S. manufacturing operations and instead serve the U.S. market with products manufactured by the group elsewhere and distributed in the United States through a third-party distributor, thus eliminating its exposure to SHIELD. This would reduce jobs and investment in the United States, while also reducing the contribution to the U.S. tax base from the net profit of the U.S. manufacturing operation to the net profit of the third-party distributor.

*****

The SHIELD proposal, as currently designed, is not aligned with the objective of a comprehensive global minimum taxation and would have unbalanced effect. The overreach of SHIELD in terms of its tax cost relative to tax at the agreed minimum level could be so prohibitive as to drive foreign-headquartered multinationals to close their U.S. operations, which would reduce U.S. jobs and U.S. investment and contract the U.S. tax base. In order to avoid significant disadvantages for the United States, the SHIELD proposal should be put on hold while work toward a global minimum tax agreement is completed in order to ensure that the ultimate U.S. approach to global minimum tax rules reflects that agreement.