SHIELD Details and GILTI Changes Headline Green Book Proposals

by Andrew Velarde

The Biden administration has provided numerous insights into its boldest international tax proposals in a much-anticipated release from Treasury, but some of the added details raise more questions than answers.

Released May 28, the green book offers new detail on the administration's proposed changes that would drastically alter the international taxation landscape, fleshing out proposals previously laid out, including in its Made in America Tax Plan.

Practitioners were quick to note the significance of the changes.

A U.S.-based multinational is modeling out global intangible low-taxed income, foreign-derived intangible income, and its foreign tax credit as well as analyzing its base erosion and antiabuse tax liability, noted Joseph Calianno of Andersen Tax LLC. "If this all gets enacted, it really does turn the world a little bit upside down," he said.

John L. Harrington of Dentons said that the green book generally is limited to descriptions of existing proposals.

"The value in the green book is therefore in the detail it provides regarding the previously unveiled proposals, 'new' proposals that were presumably too small to be specifically identified in the American Jobs Plan and American Families Plan, and the effective dates of the proposals," Harrington said. "Of those proposals that Congress may pass in one form or another, it also remains to be seen whether Congress will use these or other effective dates. I expect the effective-date answer to be the result of weighing the various tax policy concerns, fairness issues, and need for revenue."

Hammering Out the SHIELD

Practitioners were demanding more information about proposed changes, especially related to the GILTI provision and the newly conceived stopping harmful inversions and ending low-tax developments (SHIELD) proposal.

The administration has been vocal in its criticism of the BEAT, so its move to replace it with SHIELD should come as no surprise.

Like the BEAT, the proposed SHIELD would generally apply to payments that pose a risk to the U.S. tax base. However, SHIELD would do away with the BEAT and its trigger mechanism — which generally applies when cross-border related-party payments exceed 3 percent of total deductions — in favor of an effective tax rate threshold. As proposed, SHIELD would also differ from the BEAT by denying the deductions for the relevant payments instead of imposing a minimum tax on some adjusted measure of taxable income.

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According to the green book, under SHIELD, a deduction is disallowed to a domestic corporation or branch on gross payments made to low-taxed financial reporting group members. The minimum tax rate is set at the pillar 2 agreed rate or, if an agreement is not reached before SHIELD's enactment, at the new GILTI rate of 21 percent.

A group member's effective tax rate is based on income earned, both related and unrelated, and taxes paid or accrued in a jurisdiction based on separate financial statements or consolidated financial statements disaggregated by jurisdiction. The green book also states that rules will be drafted to account for permanent and temporary differences between the income tax base and the financial accounting base and for net operating losses.

Payments that are deductible costs will be disallowed entirely, and payments such as cost of goods sold and unrelated-party deductions would be disallowed up to the amount of the payment. Payments to group members who are not low-taxed would be partially subject to SHIELD to the extent that other group members were subject to a tax rate below the minimum threshold. The proposal also exempts payments made to investment funds, pensions, international organizations, nonprofit entities, and those accounted for by partnerships. SHIELD would apply to groups with greater than $500 million in annual revenue.

Ken Brewer of Alvarez & Marsal Taxand LLC said large gaps remain to be filled regarding SHIELD. Disallowing deductions for payments to companies that are high-taxed because other companies in a group are low-taxed is an idea that needs more elaboration, he said. And the disallowance of costs of goods sold could raise a constitutional issue, he said.

"Taxing gross receipts is not an income tax and therefore doesn't fall under the 16th Amendment," Brewer said. "It converts what would be an income tax into a . . . direct tax, and direct taxes are theoretically unconstitutional unless they are apportioned to the states."

Kevin M. Jacobs of Alvarez & Marsal said that SHIELD's focus on financial statements is interesting. Brewer agreed, adding that it raises questions about whether it would be more desirable for a company to report under generally accepted accounting principles or international financial reporting standards, depending on their SHIELD results.

Jacobs added that the proposal seems to suggest that each member only paid tax in a single jurisdiction.

"Companies are now going to have to say, 'Within this jurisdiction, what does our potential financial statement look like?' This information may not be how they prepare their financial statements," Jacobs said. "It seems like . . . you are not determining a group member's effective tax rate; you are now determining an effective tax rate for a jurisdiction for the whole group."

Jacobs added that having the revenue threshold set annually could also introduce complexity when compared with the BEAT, which looked at an average.

"Now each year you are going to have to determine whether or not you hit it. Query when do you prepare your year-end financial statements to determine whether or not you have this $500 million and the time frame you have to determine the application of these rules," Jacobs said. "If you hit the threshold, you now need to run and do this thing and oh, by the way, we have this estimated tax payment due."

Less Is Success

A Treasury official said on a media call May 28 that the green book proposal on SHIELD is in keeping with the concept previously outlined by the administration, albeit with more details about how legislation could be drafted that would be compatible with treaties and international tax goals generally.

The OECD is leading negotiations among the 139 member jurisdictions of the inclusive framework on base erosion and profit-shifting in hopes of reaching a consensus, including on pillar 2, that focuses on global minimum taxation. The United States has proposed a 15 percent rate for the global minimum tax as a starting point during the negotiations.

According to the administration's revenue estimates, the replacement of the BEAT with SHIELD is expected to raise $390 billion over 10 years.

The official said the SHIELD revenue estimate was difficult to make because it depended on the actions of other countries. Traditionally, scorekeepers have not made presumptions about foreign actions, the official added, but the score accounts for behavioral responses, including companies rerouting payments to unrelated companies.

SHIELD's success would lead to a revenue decline for the provision as countries move to avoid being caught in the regime's denial of deductions, the official said.

Reiteration on GILTI

The green book also illuminates Treasury's proposed change for GILTI. There too, the administration had attacked what it perceived as shortcomings with the provision, much to the consternation of multinationals, calling for an end to the exemption for returns of qualified business asset investment, a move to a country-by-country application, and an increase in the rate.

"Determining a taxpayer's global minimum tax inclusion and residual U.S. tax liability on such inclusions on a jurisdiction-by-jurisdiction basis would be a stronger deterrent to profit shifting and offshoring because residual U.S. tax would be due on every dollar earned in a low-tax jurisdiction at the minimum rate, with no ability to reduce that residual U.S. tax for excess foreign taxes paid to higher-tax jurisdictions," the green book states.

Under section 951A, GILTI acts as a minimum tax on foreign profits. Each U.S. shareholder of a controlled foreign corporation is subject to tax on GILTI, defined as the excess of its pro rata share of tested CFC income over a 10 percent return on its pro rata share of the depreciable tangible property of each CFC (QBAI). There is a 50 percent deduction against GILTI under section 250.

> ***Harrington said the GILTI proposal adds significant details, including the applicability of the jurisdiction-by-jurisdiction limitation for foreign branch income.***

The green book mainly reiterates the previous GILTI reform plans, including reducing the section 250 deduction to 25 percent. As for the country-by-country application, a separate FTC limitation would be required for each jurisdiction. The jurisdiction-by-jurisdiction approach would also be used for foreign branch income.

Calianno said the green book proposal on GILTI was not a surprise generally, given what the administration previously released.

But Harrington said it adds significant details, including the applicability of the jurisdiction-by-jurisdiction limitation for foreign branch income.

"That is a somewhat surprising expansion because part of the earlier rationale for the GILTI changes was based on a CFC's ability to earn income in low-tax jurisdictions while using foreign tax credits from high-taxed income. That kind of income shifting is much harder to do with income that falls within the foreign branch income basket, and so the earlier rationale seems weaker regarding foreign branch income," Harrington said. "Treasury may have been concerned that if it did not make a conforming change to the foreign branch income basket, though, taxpayers might shift out of CFCs and into earning the income directly in a foreign jurisdiction if they got a better foreign tax credit result."

Harrington also pointed out the green book's clarification that the jurisdiction-by-jurisdiction limitation applies based on where the CFC conducts business and not where it is formed or located, which he said was not surprising.

For Jacobs, it was notable what wasn't addressed in the green book on GILTI.

"There's been an outcry from the tax bar to address certain things . . . like the use of losses and the carryover of tested losses. There's none of that," Jacobs said.

Doing Away With High-Tax Exclusion

The proposal would also completely repeal the subpart F high-tax exemption and, by extension, the cross-reference to the GILTI high-tax exclusion in the rules there. Here it resembles the No Tax Breaks for Outsourcing Act (S. 714), proposed in March.

Regs on the high-tax exclusion (T.D. 9902, REG-127732-19) have sought conformity between the GILTI high-tax exclusion and the subpart F high-tax exception and, for the sake of administrability, have moved toward a more targeted approach of using tested units to determine eligibility and permit some income blending under a combination rule. The high-tax exception rules under GILTI and subpart F were pegged by Mark Mazur as guidance that could be revisited before he joined the administration as acting Treasury assistant secretary for tax policy.

"There's always been the view with some taxpayers that feel comfortable in a high enough jurisdiction to back-of-the-envelope say that [they] don't need to go through and determine [earnings and profits], determine subpart F income," Jacobs said. "Now, with the elimination of this, it is really forcing everyone to maintain all of these records."

The GILTI revisions would be for tax years beginning after December 31, 2021. Harrington argued that realistically, that was the earliest the administration could propose.

Revisions to the minimum tax regime, the disallowance of deductions attributable to exempt income, and limitations on inversions are expected to raise $534 billion over 10 years, according to the administration's revenue estimates. This makes it the second largest corporate revenue raiser after the increased rate.

The Promote America's Competitive Economy Coalition, whose steering members include the U.S. Chamber of Commerce, the National Association of Manufacturers, the Business Roundtable, and the National Foreign Trade Council, condemned the proposed GILTI reform almost immediately.

"The proposed change will significantly increase the tax burden on globally engaged American companies, making it harder to compete abroad with foreign competitors that are not subject to a similar level of taxation," a May 28 release from the group says.

Inversions Revisited

The proposal makes no mention of the FTC haircut to GILTI, which only provides for an allowance of 80 percent of FTCs against GILTI, although Kimberly Clausing, Treasury deputy assistant secretary for tax analysis, has said the haircut will remain.

Treasury officials told *Tax Notes* that they are not proposing to change the haircut but that they are open to working with Congress on the details of the proposal.

Some have argued that a GILTI rate of 21 percent combined with an FTC haircut, resulting in a rate near 26 percent, could pressure U.S. companies to invert, given the large potential difference in minimum tax rates between the United States and the rest of the world.

The officials also told *Tax Notes* that the proposals substantially lower the difference between the minimum tax rate of 10.5 percent that exists under U.S. law and the nonexistent foreign agreed-on minimum rate. It would shrink to 6 percentage points or less with a 15 percent global minimum rate, not accounting for the FTC haircut.

The green book also calls for a strengthening of anti-inversion rules. Like in the proposal previously outlined, foreign companies will be considered U.S. residents if post-acquisition former shareholders of the expatriated U.S. entity retain at least a 50 percent ownership interest. And an inversion transaction will be deemed to have occurred if the fair market value of the domestic entity is larger than that of the foreign acquirer, the expanded group is primarily managed and controlled in the United States, and the group does not conduct substantial business activities in the foreign acquirer's country of organization. The proposal would also expand the definition of an acquisition for section 7874 purposes.

"If this were to pass, it would really expand the web of transactions that could be caught in the inversion area," Calianno said.

Jacobs pointed to the proposal's determination of an inversion regardless of shareholder continuity and said that he was left "scratching his head," given the focus on the expanded affiliated group.

"You need to determine where the affiliated group is primarily managed and controlled. How do you even determine that when you have this large multinational?" Jacobs asked, noting that the third prong also focuses on the expanded group. "It poses some really interesting questions."

Harrington said that the reduction to 50 percent ownership threshold isn't a surprise, given that it "has been for years a staple of bills that would expand section 7874." Other changes to the inversion rules are more novel, he added, as related to management and control.

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"This departure from the shareholder continuity test that section 7874 has historically used is a significant expansion," Harrington said, while also noting the expansion of categories of transactions under the ambit of section 7874. "In particular, it would subject domestic corporations to the same 'substantially all of the properties constituting a trade or business' rule that currently applies only to domestic partnerships, and it would pull within the scope of section 7874 foreign partnerships that have a U.S. trade or business. Distributions of foreign corporate stock by a domestic corporation or a partnership could be pulled into section 7874 as well."

According to Brewer, given the whole of the international reform measures, companies may be driven to inversions. With an effective date on the inversion rules' strengthening being set at the date of enactment, the clock may be ticking for companies to get out of the U.S. tax web, he said.

"Companies that may have since 2017 put the brakes on undergoing inversions . . . may say now is the time to do it because this thing becomes effective several months from now," Brewer said.

Details Lacking on FDII Replacement

A new proposal flagged by Harrington in the green book is the call for a limit on FTCs from sales of hybrid entities. The proposal would apply section 338(h)(16) to the direct and indirect disposition of hybrid entities.

"Presumably, it was too small or technical to merit a mention in the American Jobs Plan descriptions," Harrington said. "It may take a while to appreciate the significance of this proposal."

Elaborating only slightly on a previous goal, the green book also calls for the elimination of the FDII provision.

Designed as a counterweight to GILTI, FDII provides a 37.5 percent deduction under section 250 for a U.S. corporation's deemed intangible income earned from the sale of property or services for foreign use. But the provision has consistently come under fire from the administration for encouraging offshoring of tangible assets.

The proposed elimination has its share of critics, including the Tax Foundation, which says it will serve to increase profit shifting, in contravention of Biden's stated goals.

The administration estimates that the FDII elimination will raise $124 billion over 10 years, which will be entirely offset by additional research and experimentation incentives. The Treasury official acknowledged the lack of detail on what those additional incentives would be.

The official argued that FDII only encouraged research and development for a subset of exporters and rewarded past investments rather than current ones. The official added that one future option could be to change the research expense provision away from amortization, scheduled to kick in next year, and back to expensing. Another option could be to make research credits more generous, the official added.

The plan would be to address R&D more directly with the revenue gained from FDII repeal, the official said. ■