ECONOMIC ANALYSIS

What Economic Purpose Does FDII Serve?
by Martin A. Sullivan

In its rush to get things done last autumn, Congress forgot to explain why it needed to create a strange new tax benefit for domestic corporations with intellectual property as input and foreign sales as output.

The best official word is on page 370 of a Senate Budget Committee report from early December: “Offering similar, preferential rates for intangible income derived from serving foreign markets, whether through U.S.-based operations or through [controlled foreign corporations], reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions.”

Everybody talks about how the section 250 deductions for foreign-derived intangible income (FDII) and global intangible low-taxed income are carrot-and-stick complements for achieving the goal of creating, bringing, and keeping intangible assets in the United States. But why exactly is that a goal? Is it to protect the U.S. tax base? Create jobs? Promote research? Or, in the case of FDII, to increase exports? This article explores the last question. It will show that the notion of targeting tax benefits to income from “serving foreign markets” (aka exports) is problematic on several levels.

A coming companion article will examine how a deduction for domestic excess profits furthers the other non-export objectives. In that article we will suggest, despite what is implied in the quote, that “the one margin” that best justifies FDII’s preferential treatment of excess profits might not be the margin between domestic and foreign intangible income but the margin between domestic and foreign tangible investment.

Overview of the FDII Deduction

Subject to the limits that the deductions for FDII and GILTI may not exceed current-year taxable income, subchapter C corporations are eligible for a deduction equal to 37.5 percent (25.875 percent after 2025) of a rough estimate of intangible profits (possibly associated with exports) multiplied by a ratio of export income to total profits (possibly associated with exports). Using abbreviations suggested by statutory language, the deduction for FDII (through 2025) is:

$$0.375 \times (DEI - 0.1 \times QBAI) \times (FDDEI/DEI)$$

In the statute, the first term in parentheses is called deductible intangible income. Deduction-eligible income (DEI) is taxable income of the corporation less income from activities conducted abroad (that is, subpart F income, GILTI, CFC dividends, and foreign branch income), financial service income, and domestic oil and gas extraction income. DEI is a net amount, so costs must be allocated between the DEI-eligible amount of gross income and the non-DEI components of gross income.

Subtracting 10 percent of QBAI from DEI will repeatedly be referred to as intangible income, but it is critical to remember it is only a clever but still crude estimate of that elusive amount.

Qualified business asset investment (QBAI) is the average of the four end-of-quarter adjusted basis amounts of tangible depreciable property used in the production of DEI. A corporation’s depreciable capital must be allocated between DEI and non-DEI uses. Depreciable basis is determined using the alternative depreciation system. This is slower than the modified accelerated cost recovery system and bonus depreciation most taxpayers will be using, making QBAI larger and the deduction for FDII smaller than it otherwise might be. In most cases it will require depreciation calculations not currently undertaken for domestic plant and equipment.
Land and capital in the form of inventory investment are not included in QBAI. Ten percent is the presumed average normal return tangible investment. Subtracting 10 percent of QBAI from DEI will repeatedly be referred to as intangible income, but it is critical to remember it is only a clever but still crude estimate of that elusive amount. In many cases the calculated amount will have very little to do with the presence of intangible assets. All other things being equal, corporations with lots of tangible capital relative to taxable income get less benefit from the deduction for FDII than other corporations.

As a first approximation, foreign-derived deduction eligible income (FDDEI) can be thought of as income from exports. Defining export income is a big problem for compliance and policy. You don’t have to be an expert in international tax or economics to understand this. A simple analogy illustrates the challenges.

Suppose Congress decides to provide a preferential rate of tax for income associated with the sale of vegetables for consumption by children. First, we have the problem of identifying qualified income. Does it include the income of the farmer, the wholesaler, or just the retail grocer? If it is the latter, why should vertically integrated retailers get more of a break? Why should the incentive effect vary across retailers with different profitability?

Second, after determining whatever gross income is qualified, costs must be allocated to determine net income. To minimize taxes, the retailer will choose an allocation method that minimizes costs assigned to tax-favored income. What safeguards can prevent the retailer from shifting costs away from non-vegetable sales to increase vegetable profits?

The third type of problem arises because of the difficulty in identifying sales that not only meet the letter of the law, but also provide at least a good approximation of policy objectives. Should a retailer making a tax-favored sale to an adult trust that those vegetables will be fed to a child? If purchased by a child, what is to prevent the child from selling or giving vegetables to adults? What is to prevent the child from selling the vegetables back to the retailer? Do the answers to these questions change if the vegetables are not eaten but processed into other foods (like carrot cake or potato chips)?

Regarding the first issue, the statute basically says only the income of the exporting corporation (at the end of the domestic supply chain) qualifies for the FDII deduction. Regarding cost allocation, the statute provides nothing more than the self-evident stock phraseology that to arrive at net income, subtractions for gross income should include “the deductions (including taxes) properly allocable to such gross income.”

Concerning the all-important question of identifying subsidy-worthy exports, the statute predominantly focuses on preventing abusive round-tripping of exported products and services back into the United States. Somehow the exporting corporation must certify that products sold to a related or unrelated foreign party are ultimately for “foreign use” — a term ambiguously defined as “use, consumption, or disposition” outside the United States. Qualified services can be performed in the United States for anybody as long as the recipient is in a foreign location and doesn’t sell the same services back into the United States.

**Mechanics in Motion**

For a corporation with non-zero QBAI, increasing DEI will increase the deduction for FDII. The amount of that increase depends on whether the DEI is export-derived (that is, FDDEI). The increase in the tax benefit is larger if the increase in DEI is FDDEI. But that there is any increase for income unrelated to exports demonstrates that the proposal isn’t an accurately targeted export incentive. Examples 1 and 2 illustrate these points.

**Example 1:** In year 1, U.S. Corp. A has $100 of taxable income (all DEI), of which $75 is export income (FDDEI). Its QBAI is $500, so its deemed tangible income is $50. In year 2, everything remains the same (including export income) except the corporation increases its domestic sales so its total taxable income increases from $100 to $125. Its year 1 FDII deduction is 0.375 * ($100 - $50) * ($75/$100) = $14.06. Its year 2 FDII deduction is 0.375 * ($125 - $50) * ($75/$125) = $16.88.

**Example 2:** Everything is the same in Example 1 except that in year 2, instead of increasing non-
FDDEI by $25, Corp. A increases FDDEI by $25. Its year 1 FDII deduction is 0.375 * ($100 - $50) * ($75/$100) = $14.06. Its year 2 FDII deduction is 0.375 * ($125 - $50) * ($100/$125) = $22.50.

The less QBAI a corporation has relative to its DEI, the more benefit it gets per dollar of export income. At the limit, if a corporation has zero QBAI, FDII would equal 0.375 * FDDEI. This is shown in Example 3.

Example 3: As in Example 2, Corp. A in year 2 has $100 of FDDEI, $25 of non-FDDEI taxable income, and $500 of QBAI. U.S. Corp. B competes with Corp. A and has the same profile, except it only has tangible capital (QBAI) of $100. For Corp. A everything is the same, so its FDII deduction is $22.50. The FDII deduction of Corp. B is 0.375 * ($125 - $50) * ($100/$125) = $34.50.

Just Say No

By tradition and training, economists are predisposed to conceptualizing a world in which government lurks unobtrusively in the background, larger companies have no production advantages over smaller companies (no economics of scale), all information is freely available, and investors and consumers have IQs exceeding 200. Those assumptions result in a free market in which business output is produced, and consumers’ desires satisfied, with peak efficiency. In international economics, this inclines economists to strongly favor free trade. Tariffs and export subsidies cause a lot of redistribution within the economy, but on net they are harmful to residents of the intervening country. For an export subsidy like the deduction for FDII, the increase in benefits to the exports sector is outweighed by the losses in higher domestic prices (that hurt domestic consumers) and reduced government revenue. The losses are even greater when foreign governments retaliate.

In the 1980s, the notion of free trade as the guiding principle for policy was challenged by economic research showing that government intervention could produce better results for the domestic economy than free trade (James A. Brander and Barbara J. Spencer, “Export Subsidies and International Market Share Rivalry,” 18 J. of Int’l Econ. 83 (1985)). A simple example illustrates the potential benefits of what is referred to as “strategic trade policy.”

Suppose a U.S. corporation and a Japanese corporation are the only two companies (a duopoly) that can produce oil drilling equipment for specific geological formations found in a third country. If a $500 million subsidy to the U.S. company can drive the Japanese company out of business and the U.S. company can then earn $1 billion of monopoly profit, national income can be increased by the U.S. subsidy. (Try, if you can, to ignore the politics of redistribution.)

Given its long history of denouncing politicians who favor interventionist and mercantilist policies, the economics profession submitted strategic trade theory to the utmost scrutiny. The flurry of research in the wake of the Brander and Spencer paper taught us that in practice, it is extremely difficult to know if the conditions for successful strategic trade policy exist and to what industries they may apply. And even if we did know, our imperfect policymaking process would be unlikely to bring it about.

Where does that leave us? Perhaps Paul Krugman, whose academic career centered on the economics of international trade, said it best: “The theory of strategic trade policy has been subject to an unusually detailed academic critique, the upshot of which has been to show that what Brander and Spencer offered was an example, not a general result” (Krugman, “Introduction to ‘Empirical Studies of Strategic Trade Policy,’” (1994)). Given that there is little actionable economic evidence for an export subsidy generally, it is completely reasonable to object to the export-subsidy component of the deduction for FDII.

If You Can’t Say No

If we must have an export subsidy, either because our economic judgment is proved wrong or the domestic political situation demands it, how should we rate FDII? Daniel N. Shaviro suggests that we should not judge the deduction for FDII too harshly in light of political realities, especially when we compare it with other prior export incentives. (Prior analysis: Tax Notes, July 9, 2018, p. 171.) The title passage rule increased the foreign tax credit limitation by arbitrarily sourcing half the income related to exports as foreign if legal title passed outside the United States. The title passage rule wasn’t challenged...
under WTO rules. Nevertheless, it was repealed by the Tax Cuts and Jobs Act (P.L. 115-97). The extraterritorial income provisions, the successor to the WTO-failed domestic international sales corporation and foreign sales corporation rules, were repealed in 2004 after the WTO ruled definitively against them in 2002.

The efficacy of the deduction for FDII compared with these subsidies depends in part on its viability under WTO rules. Stating a view shared by many others, Reuven S. Avi-Yonah writes that “FDII is a blatant violation of the World Trade Organization’s export subsidy rules” (Avi-Yonah, “The Tax Act Actually Promotes Off-Shore Tax Tricks,” The American Prospect (June 28, 2018)). WTO rules do not allow export-contingent income tax relief for the sale of goods. But, as Chris William Sanchirico points out, WTO agreements don’t prohibit subsidies for exports of services. Further, the deduction for FDII might not in fact meet the WTO definition of a prohibited subsidy if it can be shown that it actually raises revenue (Sanchirico, “The New U.S. Tax Preference for Foreign-Derived Intangible Income,” 71 Tax L. Rev. (Apr. 30, 2018)).

As shown in the figure, the official estimates from the Joint Committee on Taxation indicate that the provision is expected to raise revenue initially but lose it in the long run.

*For no discernible reason, the subsidy is zero for export income earned by S corporations, partnerships, limited liability companies, and individuals.*

Although there is no apparent justification for a broad-based export subsidy like the deduction for FDII, we will nevertheless take a leap here and assume for argument’s sake that one goal of the provision is to increase exports. We will even go a step further and assume that all exports equally support the policy objective, so that export subsidies should be uniform as a percentage export price. Of course, there are a host of reasons we might want to subsidize exports differentially, including the presence of externalities, differences in supply-and-demand elasticities, and the aforementioned strategic trade policy goals. But in the absence of information that reveals these factors, the possibility that reasons exist for multiple subsidy levels is not an excuse for arbitrarily distinguishing subsidy levels.
The deduction for FDII provides a subsidy that, as a percentage of export prices, is anything but uniform. First, for no discernible reason, the subsidy is zero for export income earned by S corporations, partnerships, limited liability companies, and individuals. Second, without any apparent justification, the subsidy is not available for exports of services by a major U.S. industry, the financial services sector. Third, the reduction of the deduction equal to 10 percent of QBAI favors exports by the least capital-intensive industries (for example, pharmaceutical, technology, and service companies are favored over manufacturing).

To make matters even worse, FDII benefits are available only to the extent the exporting company has sufficient taxable income in the current year (because there are no carryforwards and carrybacks of FDII losses.) This puts exports of companies with an occasional loss or in cyclical industries at a disadvantage. Why should those exports be disfavored? And as pointed out by Tim Dowd and Paul Landefeld in a paper presented at the 48th annual National Tax Association spring meeting, tax benefits will be cut during a recession, meaning — in the parlance of macroeconomics — the deduction for FDII is an automatic destabilizer that reduces tax benefits when businesses need them the most (Dowd and Landefeld, “The Business Cycle and the Deduction for Foreign Derived Intangible Income: A Historical Perspective” (Apr. 2018)).

These self-inflicted wounds can be corrected by straightforward amendments to section 250. But the deduction for FDII also suffers from flaws inherent in the statute’s approach of using an income tax to promote exports. Most notably, only the income of the exporter at the end of the U.S. supply chain is eligible for benefits. This application of an income tax subsidy at the final stage of domestic value added is the reverse of the cascade effect that arises from a gross receipts tax at all stages of production. Unlike a VAT, which is neutral in its treatment of exports, the section 250 tax benefit for exports varies widely depending on the degree of vertical integration or, more precisely, the degree of value added by the exporter at the end of the supply chain. A corporation may contribute most of the value added to an exported product, but if the product is sold to an unrelated party “for further manufacture or other modification within the United States,” that corporation receives no deduction for FDII (section 250(b)(5)(B)).

For products or services moving through the related-party domestic supply chain, the degree of consolidation allowed in determining FDII is critical. Manal S. Corwin and coauthors at KPMG LLP point out that application of intercompany transaction regulations (reg. section 1.1502-13) will allow an exporting corporation that is part of a consolidated group to include income of a related-party supplier in FDII. (Prior analysis: Tax Notes, Mar. 12, 2018, p. 1505.) Thus, the intercompany transaction regulations come to the “rescue” of the taxpayer. But they don’t rescue the economy from the fundamental flaws of using income tax incentives to promote exports.

For example, the application of intercompany transaction rules creates a disparity between an exporter with a related-party supplier in a consolidated group and an exporter that is supplied by an unrelated party — in other words, favoritism to vertically integrated businesses. No matter what degree of consolidation is allowed, the regime encourages artificial tax planning in the form of profit shifting to maximize foreign-derived income within a multinational and inefficient tax-motivated intercompany restructuring (for example, mergers) so a single unrelated low-margin distributor is not the exporter.

The rules in the statutory language of section 250 for determining what exactly qualifies as export income are, to put it mildly, fuzzy. Round-tripping of cross-border sales presents a special problem for determining FDII. Round-tripping comes in two flavors. The first occurs when a corporation imports an item or service into the United States and then re-exports. The potential benefit here is that the corporation gets a preferential rate of 13.125 percent on any net FDDEI it can assign to the round-tripped good or service. There are no special rules in section 250 to...
prevent this. If either the import or export transaction is with a related party, this puts pressure on transfer pricing rules, as taxpayers will try to assign as much income as possible to items temporarily staying in the United States. This is a mildly surprising realization for those of us who envision the TCJA’s international provisions as reducing reliance on arm’s-length pricing.

The second type of round-tripping occurs when a corporation exports a good or service from the United States and the good or service is imported back into the United States. This type of round-tripping gets a lot of attention in the statute. To discourage it, there are different rules for exported products and for exported services. There are different rules for exports to related parties and to unrelated parties.

To qualify for FDII benefits, corporate income related to sales of property to an unrelated party must be to a party that is not a U.S. person and that exporting corporation “establishes to the satisfaction of the Secretary is for a foreign use” where foreign use means “any use, consumption, or disposition which is not within the United States.” What information will satisfy Treasury regulations is far from clear. Even more unclear is how the taxpayer (or, in many cases, even the buyer!) will know where the property will ultimately be used. For export of goods to a related party, the exporting corporation must establish that the related-party buyer sells to an unrelated party and there ultimately is foreign use.

Footnote 1522 on page 497 of the joint explanatory statement seems to provide significant leeway for round-tripping of tangible goods. It states: “If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.” In other words, if the exported product is a component of a product later imported or if it is subject to some yet-to-be-determined level of additional foreign process and then imported, the income associated with the initial export is eligible for the FDII deduction. If this interpretation of foreign use prevails, it could be an incentive for adding a foreign component to a production chain that previously had been entirely domestic.

To qualify for FDII benefits, corporate income related to the provision of services can be provided to any (domestic or foreign person) and the services performed in any (domestic or foreign) location as long as the exporting corporation “establishes to the satisfaction of the Secretary” that the person receiving the services, or the property to which the services pertain, is not located in the United States. For any service provided to a related party, the exporting corporation has the added requirement of establishing that the related party does not turn around and provide substantially similar services to persons located within the United States.

Those differences in the treatment of different categories of exports create opportunities that tax planners thrive on. The differences can also result in inefficient distortions of investment and supply chain structuring.

Michael L. Schler warned before the final enactment of the TCJA that enforcing FDII provisions will require “elaborate regulations . . . to show how a taxpayer can establish that goods are sold for foreign use and will not be resold back into the United States.” (Prior analysis: Tax Notes, Dec. 18, 2017, p. 1731.) In its report to Treasury on FDII, the New York State Bar Association took the path of least resistance. NYSBA’s recommendations rightly pointed out that there are “practical limitations” on what a taxpayer can know about foreign use. Regulations may have to rely on “reasonably available information,” “presumption of foreign use,” “information routinely collected,” and proxies based on “information readily available” when “actual location of consumption or business use” is not readily observable (NYSBA, “Report No. 1399 on Foreign Derived Intangible Income” (Sept. 4, 2018)).

For taxpayers struggling to gather and organize information and provide documentation whenever possible, these are reasonable compromises. But it still leaves open the real economic damage that may occur through what is unknowable about future sales by a third party.
inadequate or biased reporting on the part of the ultimate third-party purchaser (who has no reason to assist the IRS), and a look-the-other-way approach by more aggressive U.S. taxpayers. Unless Treasury regulations are much tougher than NYSBA suggests (and it is difficult to imagine how that practically could be achieved), Schler’s pessimistic prediction will bear out: “It is doubtful that the IRS will be able to enforce these rules on a worldwide basis.”

The headache-inducing FDII foreign-use and foreign-location requirements stand out because there are no corresponding requirements for income eligible for GILTI. You can obtain the 50 percent GILTI deduction if you invest abroad and sell into the United States. That disparity calls into question the committee report explanation quoted in the opening paragraph of this article. The tax benefits for GILTI and FDII are supposed to level the playing field between intangible income “derived from serving foreign markets, whether through U.S.-based operations or through CFCs.” If products are imported into the United States from CFCs, that income isn’t derived from serving foreign markets, but it still gets preferential treatment.

What? If GILTI doesn’t discourage runaway plants that provide products and services to U.S. markets (for example, by denying the section 250 deduction to U.S.-derived eligible income), why are FDII benefits denied to products and services for U.S. markets? Or to phrase it in a more politically charged manner, why do U.S. tax rules favor foreign production over domestic production for goods and services provided to Americans? This disparity could be resolved by adding anti-import features to GILTI (as under former House Ways and Means Committee Chair Dave Camp’s option C). But two wrongs don’t make a right. The better approach for attaining evenhandedness is to remove the export-related requirement of FDII.

A Possible Loophole

As noted earlier, for any one year in which a taxpayer has sufficient taxable income, to maximize deductions for FDII, the taxpayer will want to maximize DEI. If one policy objective of section 250 is to promote exports, it makes sense that FDII should preemptively omit corporate income from production that occurs outside the United States. That is why DEI excludes GILTI, subpart F income, dividends received from a CFC, and foreign branch income.

The TCJA provides a definition of foreign branch income in subparagraph 904(d)(2)(J). It tells us that foreign branch income means the business profits (excluding passive income) of a U.S. person that are attributable to one or more qualified business units (QBUS) in one or more foreign countries. Section 989(a) defines a QBU as any separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records. The concept of a QBU was introduced into the code in 1986 as part of new rules for foreign currency gains and losses. The detailed rules defining a QBU are in reg. section 1.989(a)-1. What exactly comprises a separate and clearly identified business unit and what constitutes adequately maintained book and records are open to interpretation.

Sanchirico writes that borrowing the QBU concept “from a setting in which taxpayers generally want to establish foreign QBUs” and using it in the FDII context — when taxpayers generally want to avoid QBU status — could provide significant tax planning opportunities. Sanchirico notes, “The ease of defeating QBU status, formerly not a primary concern, now moves to center stage.” If foreign branches of U.S. corporations can conduct activities that generate foreign sales and the corresponding income is not excluded from DEI, the deduction for FDII is providing a tax benefit for foreign investment instead of exports.

Conclusion

Taking into account all the matters discussed so far — the absence of a solid policy justification, the numerous efficiency-draining distortions, the formidable problems of tax administration and compliance — Congress should consider disconnecting its incentive for domestic intangible income from any requirement that this income be export-related.

The more interesting question that enactment of the deduction for FDII has brought to the fore — more easily lending itself to analysis once all the distortions and distractions arising from identifying export-relatedness are removed — is
whether Congress should retain the deduction for domestic intangible income.

Why so interesting? For one thing, a basic tenet of tax economics is that taxation of profits that exceed normal returns is non-distortionary. The deduction for FDII seems to precisely contradict this notion by providing preferential treatment for excess profits. On the other hand, if the code’s new measure of excess profits reduces profit shifting (regardless of whether that shifting is attributable to mispriced transfers of intangible assets), it could reduce the negative effective rates on foreign tangible investment associated with that profit shifting. (Prior analysis: Tax Notes, May 13, 2013, p. 698.)

The tax treatment of domestic excess profits without the “FD” component will be the subject of Part 2.

TAX HISTORY

Friends, Enemies, and the Deductibility of Capital Losses
by Joseph J. Thorndike

In a perfect world, tax law would be the product of high-minded ideals tempered by practical necessity. In the actual world, tax law is often the product of a pitched battle to help friends and punish enemies.

No, this is not an article about the Tax Cuts and Jobs Act (P.L. 115-97) and its limitation on the deduction for state and local taxes. Rather, it explores a different question of deductibility: the proper tax treatment of capital losses.

The deductibility of capital losses is an old issue, dating to the dawn of the modern income tax. Congress created the problem with some notably vague statutory language in 1913, and lawmakers struggled with it for the next 30 years. The story is interesting because it illuminates the contentious battles over fairness and progressivity that animated early attempts to create a workable income tax.

However, the story of capital losses also sheds light on the broader dynamics of tax policymaking. Specifically, it underscores the political importance of both sympathy and hostility; inflection points in the history of how the tax law has treated capital losses often reflected changing perceptions of who was being victimized by existing policy — and who deserved to be victimized a little more.

Zelenak Redux

Once again, our guide to this historical debate is Lawrence Zelenak, a Duke University law professor whose new book, Figuring Out the Tax, explores the early income tax with an eye toward explaining the broader dynamics of tax policy formulation. (Prior analysis: Tax Notes, Oct. 1, 2018, p. 21.)

Zelenak begins the story with a moment of confusion, as lawmakers in 1913 struggled to figure out how the new individual income tax should deal with capital income. Many other countries, notably Great Britain, ignored capital gains and losses entirely. American lawmakers charted their own course, however, deciding that...