Mexico offers online protests and an online tax court.

So what is Italy doing? Well, there’s electronic invoicing for VAT, Barbantini responded, and his agency is trying to use current information better.

Think the relative strength of a country’s currency is irrelevant to tax administration? Britain has a strong currency, in part because the London laundromat has pulled in bank deposits of roughly four times the country’s GDP. The United Kingdom strives to have a balanced budget because its government believes it is essential to maintaining the strength of sterling. But one thing it doesn’t do is collect taxes aggressively from businesses.

British restraint in tax administration was confirmed at the recent Tillinghast lecture at New York University Law School, given by a British lawyer who had unusual experience in both tax policy and tax administration. “The ability to tax corporations effectively underpins the whole system,” said Edward Troup, former executive chair of HMRC, who added that it is important to public confidence in government.

Uh-huh. Then why isn’t Britain doing real-time audits like Latin America? Russia uses real-time audits for VAT, Troup noted. “There’s more data progress where there’s less democracy,” Troup said.

So the British government cannot go digital because there would be a lot of pushback, according to Troup. British customs of self-reporting and taxpayer privacy date back to Prime Minister William Pitt, who introduced the first income tax in 1799 to finance the Napoleonic wars. Like the U.S. government, the British government does not bring a lot of criminal tax cases.

Troup compared the British tax gap to the U.S. tax gap, implying that HMRC is doing a better job, when the size of the tax gap is really a reflection of the luxury of a strong currency. “The tax gap is a political choice,” he said.

ECONOMIC ANALYSIS

What Economic Purpose Does FDII Serve? Part 2
by Martin A. Sullivan

Arguments made in last week’s article support dropping the export-relatedness requirement from the deduction for foreign-derived intangible income (FDII) — all we need to do is overcome policymaking inertia and special interest politics. If dropping the “FD” from the deduction for FDII is considered worthwhile, that leaves us with the question: Should we provide preferential taxation for excess domestic profits?

Without much strain on our economic muscles, we find at least four major side effects that probably make a cure worse than any disease remedied by a novel tax break like a deduction for excess profit. And as for positive effects of the deduction for excess profit, it’s our impression that they are limited, and in any case, the goals could be better achieved through more conventional policies.

Magic Taxes

Let’s start with some simple but relevant economic analysis. Suppose a U.S. corporation has a range of investment opportunities, lined up left to right in order of decreasing profitability. The corporation will keep moving right until it has invested in all the projects that generate returns exceeding its cost of capital — that is, right up to the hurdle rate and no more. (If done graphically, it would show a downward-sloping demand schedule for capital.) The last investment undertaken is commonly referred to as the marginal investment. All infra-marginal investment (to the left of the marginal investment) earns excess returns.

In theory, all excess returns could be taxed at 100 percent with no effect on investment. As a profit maximizer, the corporation will be disappointed with that policy, but it will invest because it is still making money. Over the long run we would expect these excess returns to shrink as efficient competitors enter the market. If there is little or no competition (often because of intangible assets), the excess profit may persist. In this case, we can call excess profit oligopolistic or
monopolistic profit. But in any case, taxation of excess profit (as defined here) is a highly efficient tax because it does not distort behavior.

Although nobody in a real-world setting (where the necessary theoretical assumptions don’t hold) would suggest a 100 percent tax on excess profits, this general line of reasoning is a strong justification for taxing excess domestic profits at a higher rate than normal profits. That is the exact opposite of what the deduction for FDII provides.

If your goal is efficient taxation of excess profit, the theoretically proper rate of return for separating excess and normal (non-excess) profits is the rate of return on marginal investment. This rate of return (assuming you can determine its levels) is then multiplied by the market value of your capital stock (assuming you can measure that) to determine normal profits. Excess profit is the residual when this normal profit is subtracted from total profit. In practice, it’s usually impossible for economists to measure the return on marginal investment. Almost all measured profit rates you see are average rates that invariably will be higher than marginal rates ideally needed to tax excess profits (as measured in this context).

An Efficient Investment Subsidy

Continuing with the example of a corporation that has lined up investments in order of decreasing profitability, economic logic tells us that, if possible, it would be most efficient for any tax incentive to apply subsidies only to low-profit investments far to the right. Why waste incentive dollars on infra-marginal investments (with excess returns) that will be undertaken without any incentive? This is the idea, although imperfectly implemented, behind the incremental investment credits enacted into law for research and development in 1981 and proposed for tangible capital in 1992. (Prior analysis: Tax Notes, Jan. 11, 1993, p. 209.)

A flat tax incentive (a credit or other subsidy that applies to all new investment, not just increments above some base amount) provides less bang for the buck than a well-functioning incremental credit. But here, it still doesn’t make sense to provide a tax benefit for returns exceeding a normal return because those dollars do not directly change investment behavior. Although it cannot compare with an incremental incentive, a flat investment incentive has a larger incentive effect per dollar of revenue loss than a rate cut (or its equivalent, an FDII-like deduction equal to a percentage of income) because it applies only to new investment (which is the only investment that a current policy can affect).

The complex procedure for separating excess and normal returns described above — requiring estimates of both capital and a marginal rate of return — can be circumvented by allowing expensing for the total purchase price (or construction costs) of tangible capital. The present value of measured profits when capital purchases are expensed (instead of depreciated) — negative in the first year, larger than under economic depreciation in all the following years — will equal the present value of excess profits. This wonderful little trick of the economics trade doesn’t require determination of a normal rate of return or the value (depreciated or appreciated) of previously purchased capital. So expensing is a fine and simple alternative method of providing an incentive for excess returns that may result from tangible capital.

Vulnerable to International Competition

Now what other need might tax policymakers have to separate normal from excess returns? In their much-cited and multifaceted 2013 article, Harry Grubert and Rosanne Altshuler observed that the existence of excess profits was often an indicator that a company possessed unique intangible assets. Intangible assets give businesses market power that can fend off competition. In an international context, Grubert and Altshuler made the novel observation that it might be possible to differentially tax outbound investment in a way that reduces tax burdens on industries that face more international competition than others. Grubert and Altshuler described a U.S. minimum tax on foreign profits that imposed higher rates of tax on excess profits than normal profits. Unlike an FDII or global intangible low-taxed income approach to measuring excess profits, their method of identifying excess profits was not to multiply tangible assets by a rate of return but to simply calculate foreign profits with expensing. (See

Capital export neutrality provides that foreign profits of U.S. multinationals are taxed at the same rate as U.S. profits. Capital import neutrality provides that foreign profits of U.S. multinationals are taxed at the same rate as profits generated in foreign jurisdictions. Grubert and Altshuler’s plan spared the most vulnerable U.S. businesses from foreign competition while extracting revenue from those businesses that shouldn’t need special treatment. “A minimum tax with expensing therefore has the virtue of moving the system towards [capital export neutrality] for foreign investments with large excess returns and little competition, and towards [capital import neutrality] for more basic real investments that compete with close rivals in foreign locations for normal returns.”

In its broad brushstrokes, the Grubert-Altshuler minimum tax is similar to GILTI. Surely it was on the minds of congressional staff when GILTI was drafted. Can the same rationale be used to support FDII, which is often described as the mirror image of GILTI?

The answer is an absolute no. In fact, if we follow Grubert and Altshuler’s reasoning, we are led to recommend the opposite of what FDII does: The United States should tax high-profit domestic investment facing little competition at a higher rate than low-profit investment with lots of competition.

**Promoting Domestic Research**

Can FDII be justified as a subsidy for domestic investment in research, advertising, training, design, and other expenditures that create intangible capital? Not easily. First, for the FDII deduction to be properly targeted to a justifiably subsidized activity, that activity must generate positive externalities. It is widely accepted that for research, especially basic research, subsidies are justified. That’s because the business doing the research will invest below what is optimal because the business cannot exploit all the valuable scientific and engineering knowledge the research could produce.

Unfortunately, the formulaic approach used by FDII to identify intangible income calculates excess profit as a residual that cannot distinguish income from patents and other subsidy-worthy assets from other excess income. Moreover, we already have two well-established tax incentives for research. Even if it could be targeted, it is unclear what can be provided by a backloaded incentive that could not be equaled or bettered by the front-loaded incentives of sections 41 and 174.

**The Current-Law Mechanism**

Now let’s look at how section 250 FDII operates. We will omit many details, because we want to illustrate big-picture economic effects without needlessly confusing the reader. Below is an expression for a corporation’s U.S. profit. It assumes all profits are measured accurately so there is no international profit shifting. Or just think of the corporation as being a purely domestic business:

\[ R_{US} = R_{NUS} + R_{XUS} + R_{NUS} + R_{XUS} \]

U.S. profit equals normal profit from tangible assets, excess profit from tangible assets, normal profit from intangible assets, and excess profit from intangible assets. Alternatively, this may be expressed as:

\[ R_{US} = K_{NUS} (r_N + r_X) + K_{XUS} (r_N + r_X) \]

where \( r_N \) is the rate of normal return and \( r_X \) is the rate of excess return.

Now let’s impose U.S. corporate tax on this profit under an FDII-like regime (assuming no export requirement). Tax liability with preferential treatment for excess profit is:

\[ t_m (1 - 0.375) \times \left[ K_{NUS} (r_N + r_X) + K_{XUS} (r_N + r_X) \right] + t_m 0.375 \times K_{XUS} r_Q \]

\( r_Q \) is the statutory deemed rate of return on tangible capital, equal to 10 percent under current law. The first term in brackets is total profit (before the FDII deduction). If the U.S. corporate tax rate is 21 percent, that amount is taxed at 13.125 percent. If \( K_{XUS} \) is zero, the average tax rate for the corporation is 13.125 percent. But there is no symmetry. If \( K_{XUS} \) is zero, the average tax rate of
the corporation may be below or equal to 21 percent. (Technically, it cannot exceed 21 percent because “deductible intangible income” cannot be negative. Section 250(b)(2)(A).)

So no taxpayer should be ungrateful, because the section 250 FDII deduction can only reduce taxes or leave them unchanged. But it’s also the case that whatever the benefit may be, it is reduced by subtraction of the deemed tangible return. Even if the statutory deemed rate of return on tangible investment is reduced from 10 percent to 5 percent or even 1 percent, the limitation of benefits to deemed tangible returns raises taxes.

How the FDII deduction affects the marginal rate of tax — the rate that matters for determining incentive effects — is not necessarily always an incentive for U.S. investment. This can be seen a bit more easily by rearranging the previous equation:

$$t_m = \frac{0.375 \times (r_N + r_X) + 0.21 \times (K_f^a (r_N + r_X))}{0.375 \times (r_N + r_X) + 0.21 \times (K_f^a (r_N + r_X))}$$

**Example:** Assume the U.S. tax rate is 21 percent, the section 250 deemed tangible rate of return is 10 percent, and a corporation has $1,000 of both tangible and intangible capital. The normal rate of return is 5 percent, and the excess rate of return is 3 percent. The corporation’s regular tax is 21 percent of $160 or $33.60. The reduction for excess income is 0.375 * 0.21 * ($1,000 * (-0.02) + $1,000 * (0.08)) = 0.07875 * ($-20 + $80) = $4.73. Net tax is $28.88. Now suppose we increase tangible investment by $1,000 and therefore total taxable income by $80. Total regular tax is now 21 percent of $240 or $50.40. The subtraction for excess return is 0.375 * 0.21 * ($2,000 * (-0.02) + $1,000 * (0.08)) = 0.07875 * (-$40 + $80) = $3.15. Total tax is $47.25. The marginal effective tax rate is the difference in tax over the difference in income, that is ($47.25 - $28.88)/$80 = 0.2297, or 23 percent.

If the actual rate of return on tangible capital is less than the statutory deemed rate of return on tangible capital, the adjustment for tangible capital increases the marginal effective tax rate on investment above the 21 percent statutory rate. Ouch! That’s not a nice thing for an investment incentive to do. Of course, in many if not most cases, the expected marginal return on investment will exceed 10 percent. But that is not always the case. And didn’t Grubert and Altshuler say those low-return investments are the ones that should get preferential treatment?

**Relocating Invisible Stuff**

Everybody keeps saying we need to get all those patents, trademarks, and other valuable intangible assets now parked in tax havens back into the United States. A 37.5 percent deduction on excess income otherwise taxed at a 21 percent rate will result in an effective rate of tax on U.S. intangible income of 13.125 percent. If that income is in fact generated by intangible assets, that increases the likelihood that multinational corporations will relocate intangible asset ownership to the United States. As is always possible with highly mobile assets, a carefully calibrated reduction in tax rates could increase revenue.

But what about creating U.S. jobs? Let’s be clear: We’re not talking about machinery or tools or factories that complement job creation and increase labor productivity where those assets are located. We are talking about ownership rights on pieces of paper called contracts, which are owned by other pieces of paper — called corporations — that happen to have their legal residence in lovely low-tax locations like Luxembourg. Those corporations are often owned by large U.S. multinational corporations. These multinationals usually perform most research and development in the United States. And then they deploy it anywhere in the world they choose. If those ownership rights are transferred from Luxembourg to the United States, how does that change anything in the last three sentences? More to the point, how does it help create jobs or increase worker productivity in the United States?

In a haphazard internet search for answers to that question, this author happened upon comments on a macroeconomic model that generated growth from repatriation of intangible “firm specific capital.” A few years ago, when patent boxes were all the rage, William McBride of the Tax Foundation wrote:

Diamond and Zodrow find that U.S. workers and ordinary capital would be more productive under [House Ways and Means Committee Chair Dave] Camp’s plan due to patents and other intangibles.
sited in the U.S. rather than in the foreign subsidiaries of U.S. multinational companies. It is unclear how Apple workers or Apple machines, for example, would be significantly more productive if Apple patents were sited in the U.S. Are the patents somehow inaccessible currently by the U.S. parent company? (See McBride, “Some Questions Regarding the Diamond and Zodrow Modeling of Camp’s Tax Plan,” Tax Foundation (Mar. 17, 2014).)

That’s reassuring because your author can’t think of any good answer either. One possibility, discussed above, is that tax incentives for excess returns could encourage research and development jobs in the United States. To comments made previously, we can add here that excess profits (as measured by the FDII excess profit mechanism) are not always intangible and, as cost-sharing arrangements make plainly evident, the ultimate residence of the intangible may have little to do with where the research jobs are performed. And it is important to point out that while those ownership rights can fly over national borders at the speed of light, the smart folks who make intangible assets are fussy about where they work. If research jobs depended on tax rates, Silicon Valley would be in North Dakota instead of California.

Another possibility receiving a lot of attention because of the OECD’s base erosion and profit-shifting project is that jobs must follow intangible profits. In the era before BEPS fever swept the worldwide tax scene, you could put your intangible in a file cabinet in, say, the Cayman Islands. Yes, that little corporation inside the cabinet would have to make a buy-in payment to own the asset and make ongoing cost-sharing payments, but no physical presence would necessarily be required to park profits in that 100 percent controlled Cayman corporation.

Because of the BEPS project, the days of shifting intellectual property rights to a shell company without personnel or operations are over. The question is how and to what degree physical activity must be associated with intangible profit. The answer invariably is fuzzy. You usually hear something like: On a case-by-case basis, there will be a facts and circumstances determination. Since the BEPS publication of action 8 on transfer pricing issues related to transactions involving intangibles, there is much talk about value creation, economic substance, people functions, and DEMPE. That last item is the acronym for what functions should be performed — development, enhancement, maintenance, protection, and exploitation of intangibles — by a corporation in a low-tax jurisdiction if some ownership rights and the corresponding income are to be assigned to that corporation in the low-tax jurisdiction.

As sure as night follows day, tax practitioners are scrambling to determine the exact character and amount of DEMPE necessary to squeeze the maximum amount of intangible income into a tax haven. Could it be four midlevel executives who manage a company’s patent and rent office space in a tax haven? Or is it a research laboratory where white-coated scientists contribute to the development of new technologies? A safe bet is something closer to the former than the latter. (By the way, expanding economic substance requirements from near nonexistent to mildly substantial would translate into a fantastically negative marginal effective tax rate on whatever investment is necessary to satisfy DEMPE requirements. For example, if a $1 million annual investment in Zug allows $100 million of intangible income to be subject to that canton’s tax rate that is, let’s say, 10 percentage points lower than it would be otherwise, the negative effective tax rate (the subsidy rate) on investment income could well be in the neighborhood of 1,000 percent. (Prior analysis: Tax Notes, Jan. 4, 2016, p. 38.))

If that’s the case — if a U.S. 13.125 percent rate on intangible income can actually shift intangible ownership from Switzerland — it might reduce job creation in Switzerland. And maybe even some of those functions formerly performed in Switzerland will be performed in the United States (as opposed to other non-U.S. jurisdictions). But this potential relocation is probably small if DEMPE requirements are limited.
Expensing

Under the Tax Cuts and Jobs Act (P.L. 115-97), full expensing is allowed on new investment placed in service through 2022 and is phased out ratably until it is eliminated in 2027. While we’re on the topic, we should also note that most deductions for developing intangible assets, at least since 1954, have been eligible to be written as they are incurred under section 162 or 174. So normal returns generated by intangible capital are effectively exempt from tax.

As noted above, another measure of excess profits is to subtract profits calculated using economic depreciation from profits calculated with expensing of tangible assets. This eliminates all the rigmarole of calculating qualified business asset investment (QBAI) as required by FDII, as well as all the hand-wringing over when the statutorily determined 10 percent deemed tangible rate of return is the “right” rate. This would be a significant simplification, and given the arbitrariness in the calculation of deemed intangible income under current law, the use of expensing for isolation of excess returns deserves serious consideration on that count alone.

But a few comments are necessary before we become too enamored with this possibility. The equivalence between expensing and nontaxation of average profit only holds in present value terms. From year to year, expensing would result in an extremely low and perhaps negative tentative calculation of tangible profit in the first year. Because tangible profit cannot be negative (under the current statute), this could result in understatements of what should be deductible tangible income in the early years of implementation. This bumpy result can be avoided by spreading out depreciation deductions over time (the sum in excess of original cost) that are equal in present value to 100 percent expensing in the first year. This adoption of what is known as the neutral cost recovery system would get the job done (assuming targeting tax benefits in excess of normal profits from tangible investment is your goal) but would add back some complexity.

Finally, it’s more than a little weird to provide a tax break for excess profits using one mechanism. This weirdness is in fact part of current law when you combine 100 percent first-year depreciation with the favorably treated excess profit as determined under FDII. Section 168(k), as amended by the TCJA, increases the allowable first-year depreciation deduction for qualified property from 50 percent to 100 percent through 2022. Included in the definition of qualified personal property is tangible personal property with a recovery period of 20 years or less.

So unlike the prior equations (which assumed the FDII excess profit mechanism was overlaid on a tax system that measured economic income), let’s look at a bit more realistic representation of the effective tax rate on domestic income of a corporation. For simplicity’s sake, let’s assume that all tangible investment is 100 percent expensed and, as has long been the case for most intangible development costs, all intangible development costs are likewise deductible in the first year:

\[
t_or\left[\left(K^{\text{US}} + K^{\text{IS}}\right)r_x\right] - 0.375 \times \left[K^{\text{US}} \left(r_N + r_x - r_o\right) + K^{\text{IS}} \left(r_x\right)\right]
\]

In this case the first term in brackets is taxing, for both tangible and intangible capital, only excess profits (as defined by reference to the marginal return on capital). The second term is providing tax relief for excess return on the same intangible income and some tax relief (or penalty) for tangible capital. This system has all the logic, utility, and aesthetics of re-siding half of your wooden home with aluminum and the other half with vinyl.

If we use expensing (in the spirit of Grubert and Altshuler) instead of regular income minus a deemed statutory rate of return on QBAI, the expression simplifies to:

\[
t_or\left[\left(K^{\text{US}} + K^{\text{IS}}\right)r_x\right] - 0.375 \times \left[K^{\text{US}} \left(r_x\right) + K^{\text{IS}} \left(r_x\right)\right]
\]

With a 21 percent corporate rate, this expression can be restated simply as:

\[0.1325 \times \left(K^{\text{IS}} + K^{\text{US}}\right) \left(r_x\right)\]
One shorthand way of describing a revision to current law that combines a subsidy for excess profits (without any export requirement) and with 100 percent expensing of tangible capital is that we are imposing a reduced rate of tax — here, 13.125 percent — on all domestic taxable profits when taxable profits are calculated with expensing. If there are excess profits in the United States not because of properly measured excess profit but because of profit shifting from outside the country (not accounted for in the above equation), these too would be subject to a 13.125 percent rate.

Conclusion

If the preliminary economic criticisms highlighted in this article and the Part 1 companion stand up to further scrutiny, it is difficult to see why Congress should not give serious consideration to entirely replacing the deduction for FDII with a revenue-neutral reduction in the current 21 percent corporate rate.

NEWS ANALYSIS

Who Will Win on the Digital Economy?
by Marie Sapirie

A few months before the interim proposal to tax U.S. tech companies more heavily, the European Union launched a colorful website designed to teach children about taxation. Announcing “Tax builds my future,” the site cheerfully explains in shades of teal and hot pink that taxes pay for playgrounds and parks and encourages children to learn about taxes by doing internet searches, considering a scenario about intellectual property rights and digital music, and connecting with TAXEDU on Facebook. The only thing missing is a chirpy directive to little Europeans to ask Alexa about taxation. Europe has a complicated relationship with U.S.-developed tech.

The European Commission’s pitch for its “temporary” 3 percent revenue-based digital services tax is about as persuasive as its online educational efforts. In contrast, the United Kingdom has begun to be transparent about its change in intentions. While French Finance Minister Bruno Le Maire has been careful to say recently that Europe shouldn’t give the impression of attacking the United States, U.K. Chancellor of the Exchequer Philip Hammond has in the past six months gone from proclaiming that the United Kingdom considers a global solution to digital taxation the only way forward to threatening to impose a digital services tax unilaterally. Hammond was right when he noted in April that the Trump administration would regard a digital services tax as a hostile act. Recent trade developments, including the U.S.-Mexico-Canada Agreement (USMCA), surely can’t have assuaged Hammond’s concerns much.

Developing a British Model

The United Kingdom recently hired Jason Furman, former chair of the Council of Economic Advisers in the Obama administration, to help design a digital competition policy for the country that “will inform the work of HM Treasury.” Furman’s fellow panelists are all U.K. academics, but his hiring will be seen as a move of political significance.