SPECIAL REPORT: The Nitty-Gritty of FDII

09.17.2018 | Article
Tax Notes

In this report, Jonathan Brenner and Josiah Child identify anomalies within the rules and definitions for foreign-derived intangible income (FDII), and they describe how those problems, when combined with inconsistencies between the FDII regime and the global intangible low-taxed income regime, distort tax consequences and incentives. Mr. Brenner is a Member and Mr. Child is an Associate in the New York office of Caplin & Drysdale.

Copyright 2018 Jonathan S. Brenner and Josiah P. Child. All rights reserved.

I. Introduction

Before the enactment of the Tax Cuts and Jobs Act (P.L. 115-97), U.S. businesses were generally entitled to defer income earned from serving foreign markets if they served those markets through controlled foreign corporations, but not if they served those markets through domestic corporations. Although a U.S. shareholder of a CFC, as defined in section 951(b), was (and remains) taxable currently on specified categories of income, including passive income, a CFC's business income from selling products and providing services to third parties in foreign markets was generally taxable only when ultimately repatriated as a dividend, subject to a credit for foreign taxes, at the U.S. shareholder's usual marginal rate.

That system created undesirable incentives for U.S. shareholders, particularly when coupled with high statutory rates. In practice, it produced a lockout effect in which a CFC's earnings and profits accumulated as "trapped cash" in foreign corporate solution. Residual U.S. taxation also produced an incentive for some U.S.-parented multinational corporations to invert, becoming foreign-parented, with minimal changes in the location of their active business operations.

The TCJA attempted to address these incentives by, *inter alia*, broadening the current income tax base and reducing rates on income from serving foreign markets. Generally, a U.S. shareholder is permanently exempt from U.S. tax on the non-subpart F earnings of a CFC that do not exceed a notional 10 percent return on its depreciable tangible asset base. If a CFC earns income beyond that threshold, however, the excess constitutes global intangible low-taxed income and is taxable to a U.S. shareholder on a current basis, but a corporate U.S. shareholder is entitled to a deduction of 50 percent of any income exceeding the threshold for a pre-foreign tax credit rate of 10.5 percent. Similarly, a U.S. corporation that serves foreign markets directly (other than through a foreign branch[1]) generally pays full U.S. corporate taxes on the portion of that income that does not exceed a notional 10 percent return on its depreciable tangible asset base. The income exceeding that threshold is denominated foreign-derived intangible income (FDII), and the corporation is entitled to a deduction of 37.5 percent of FDII for a rate of 13.125 percent.[2] Incentives to defer repatriation of a CFC's earnings were ended because those earnings are taxed to a U.S. shareholder either immediately or not at all. Although the result of the GILTI regime is arguably to tax the active earnings of a CFC more harshly than under the pre-TCJA deferral regime, the GILTI and FDII regimes are properly viewed as preferential rates in the post-TCJA environment.

Despite the nomenclature used in the TCJA, the new system is a territorial/participation exemption system in only the narrowest sense of the term; CFC earnings that do not exceed the 10 percent notional return are not

subject to U.S. taxation when earned or when repatriated. The purpose of this report is not to challenge that policy decision but to assess whether it has been carried out by the statute in a manner that is consistent with the decision itself.

One might have thought that in applying a new lower rate to income from serving foreign markets, the TCJA would try to be neutral as between the different legal forms in which that income might be derived (whether through U.S. operations, foreign branches, or CFCs), the types of shareholders who own them (whether corporations, partnerships, or individuals), and the financing of those operations. Moreover, one might have assumed that such a regime would seek to minimize, if not eliminate, incentives to locate substantive business operations abroad. Phrased in terms of concepts introduced by the TCJA, one's intuition would be that either FDII or GILTI would apply to all of a U.S. taxpayer's direct and indirect active outbound income and that the tax rate on that income earned by U.S. operations would be at least as low as the rate on the income earned by non-U.S. operations. One would have also thought that income that would be subpart F income if earned by a CFC, and therefore excluded from the definition of GILTI, would also be ineligible for the FDII deduction.

By this yardstick, FDII is asymmetrical with, and not an adequate counterweight to, GILTI. Some U.S. taxpayers are affected by asymmetries between the scope of the deductions allowed under FDII and GILTI and will have an incentive to serve foreign markets through CFCs. Others will see their FDII deductions vary randomly from year to year because of the inclusion of income or incurrence of expense wholly unrelated to servicing foreign markets. The definitions in the FDII formula contain several other potential distortions and ambiguities that will likely affect taxpayers' choice of entity, capital structure, and operating decisions. U.S. corporations may have incentives to manage the timing of income that is unrelated to serving foreign markets but still affects the calculation of the FDII deduction.

II. Background — GILTI

Under the GILTI rules, a U.S. shareholder is exempt from U.S. tax on its net CFC tested income (active outbound income) to the extent that it does not exceed the shareholder's net deemed tangible income return (NDTIR) from all CFCs of which it is a U.S. shareholder.[3] NDTIR is defined to mean 10 percent of the U.S. shareholder's pro rata share of the excess of each CFC's qualified business asset investment (QBAI) over certain interest expense incurred by its CFCs.[4] QBAI, in turn, equals a CFC's adjusted basis in the depreciable tangible property used to produce tested income.[5] A U.S. shareholder must include its net CFC tested income above that threshold (that is, its share of GILTI) on a current basis.[6]

A corporate U.S. shareholder, however, is allowed to deduct 50 percent of this GILTI inclusion and to credit 80 percent of the foreign taxes on GILTI.[7] The net result is to permanently exempt from U.S. taxation a CFC's income from active outbound business up to the NDTIR threshold.[8] Moreover, dividends paid to a corporate U.S. shareholder out of either NDTIR or tested income that is offset by tested loss are eligible for the 100 percent dividends received deduction under section 245A to the extent attributable to foreign-source income. For a corporate U.S. shareholder, the GILTI deduction results in a 10.5 percent tax rate on GILTI, with U.S. corporate income tax fully offset by credits once the effective foreign rate exceeds 13.125 percent. As discussed later, limitations based on overall taxable income apply in a coordinated manner to the GILTI and FDII deductions.

By its terms, the GILTI deduction is available only to U.S. corporations and not to U.S. individuals; section 250 does not even make an exception for an individual who makes a section 962 election. Similarly, section 962

allows electing individual U.S. shareholders to pay tax on their section 951 income (including GILTI) at corporate rates and to claim the indirect FTC, but it does not entitle the individuals to the section 250 deduction by deeming them to hold their interests in CFCs through corporations. The absence of such a deduction for individuals results in disparate treatment of CFC earnings based upon the tax status of the shareholder, for which there is no policy justification, particularly in light of the policy underlying section 962. This disparity in treatment would be eliminated if the GILTI deduction were extended to individual U.S. shareholders who make a section 962 election.[9]

III. FDII

Once Congress determined that the GILTI regime's low minimum rate was to be the preferred alternative to deferral or a pure territorial system, a corresponding tax benefit for U.S. operations serving foreign markets became necessary. Without it, U.S. corporations choosing whether to earn active outbound income through onshore or offshore operations would have a strong incentive to do so through a CFC to benefit from the lower residual U.S. rate, at least if their overall foreign tax rate for that income was less than 21 percent.[10] This motivation for the FDII rules is clear from the legislative history[11] and from the IRS's responses to international suspicion of FDII both as an export subsidy that violates WTO rules and as a “harmful tax practice” under the base erosion and profit-shifting project.

The FDII rules parallel the GILTI rules by providing a 37.5 percent deduction for active outbound income derived from specified U.S. operations above a threshold, below which income is taxed at full rates.[12] The FDII deduction was made available only to U.S. corporations, presumably because they are the subset of U.S. taxpayers eligible to claim the GILTI deduction by operating abroad through CFCs. The deduction is intended to result in a 13.125 percent effective tax rate on FDII.

If the sum of FDII and GILTI exceed overall taxable income, they are each reduced pro rata.[13] Thus, if a U.S. corporation has FDII or GILTI, losses on operations that do not qualify for the FDII deduction, which would be taxed at 21 percent if profitable, are not necessarily carried forward to offset future income taxable at 21 percent. Instead, those losses first reduce the amount of income taxable at the discounted FDII and GILTI rates, diminishing the benefit of the FDII and GILTI deductions. Conversely, losses incurred in serving foreign markets can be used to offset income that would otherwise be taxed at 21 percent.

For example, assume a U.S. service corporation (with negligible QBAI) has $1,000 of FDII and overall taxable income of zero (that is, a loss of $1,000 from servicing domestic markets) in year 1. In year 2 it has income of $1,000, none of which qualifies as FDII. Because the FDII deduction does not carry over, the corporation will pay $210 of federal income tax in year 2 even though over the two-year period it had $1,000 of FDII and no income that was attributable to servicing domestic markets. If the same results had been realized in a single year, its tax liability would be $131.25. Similarly, assume that the corporation has $1,000 of income that would not qualify for FDII and overall taxable income of zero (that is, a loss of $1,000 on servicing foreign markets) in year 1. In year 2, it has income of $1,000, all of which qualifies as FDII. The corporation will pay $131.25 of federal income tax in year 2 even though over the two-year period it had zero FDII and $1,000 of income attributable to U.S. markets.

As discussed earlier, the 13.125 percent target effective rate for FDII equals the minimum foreign tax rate at which no residual U.S. tax is imposed on GILTI. The FDII rate is therefore higher than the 10.5 percent rate of tax on GILTI. The effective FDII tax rate of 13.125 percent will be particularly attractive if the use of a CFC would

attract a foreign tax at a rate of 13.125 percent or more, but the U.S. corporation can earn FDII without incurring foreign tax. If, however, the income earned from serving foreign markets can be earned in a tax haven jurisdiction or in a special economic zone and be subject to little or no foreign tax, the GILTI regime's 10.5 percent effective tax rate would be preferable to FDII's 13.125 percent. That inconsistency is a function of the interplay between the GILTI deduction and its 20 percent haircut of FTCs.

Hence, based on the rates alone, and before accounting for other effects discussed later, the new rules still encourage U.S. corporations to earn GILTI in low-tax jurisdictions rather than FDII at home. Additional incentives arise from the structure of the FDII computation, as discussed next.

A. FDII's Basic Building Blocks

A brief description of the defined terms used to compute FDII will be useful as a reference in further discussion of the regime and the incentives it creates, as compared with GILTI.

1. Deduction-eligible income.

Deduction-eligible income (DEI) is defined as the U.S. corporation's gross income, less specified exclusions, less deductions properly allocable thereto.[14] It is intended to be the FDII analogue to GILTI's net CFC tested income, although it does not play the same role in determining the amount of the deduction, since DEI (unlike net CFC tested income) must be allocated between income that is and is not derived from specific aspects of servicing foreign markets. The exclusions are (1) income from CFCs (subpart F income, section 956 inclusions, GILTI, and dividends received from CFCs); (2) foreign branch income; (3) certain financial services income; and (4) domestic oil and gas extraction income. Exclusions from DEI have the effect of removing items from the FDII computation entirely (that is, they do not influence foreign-derived deduction-eligible income (FDDEI) or QBAI).

2. Foreign-derived deduction-eligible income.

FDDEI is any deduction-eligible income derived in connection with (1) property sold to a non-U.S. person that is established to be for a foreign use; or (2) services provided to a person or with respect to property not located in the United States.[15] Foreign use is defined as "any use, consumption, or disposition which is not within the United States."[16] The term "sold" includes "any lease, license, exchange, or other disposition."[17] As discussed later, because DEI is a net quantity (that is, is reduced by properly allocable deductions), FDDEI is also a net quantity.[18]

3. Qualified business asset investment.

The definition of QBAI under the FDII rules is similar to its definition under the GILTI rules. QBAI is defined to mean depreciable tangible business property used to produce DEI (rather than tested income) with pro rata apportionment of dual-use property.[19] QBAI is used to define a deemed tangible income return (DTIR), which is roughly analogous to NDTIR under the GILTI rules. However, whereas a CFC crosses the NDTIR threshold when it earns a return of at least 10 percent of QBAI *before* financing costs, a U.S. corporation crosses the DTIR threshold only if it earns a return of at least 10 percent of QBAI *after* financing costs.

For example, suppose that under the GILTI rules a U.S. corporation's wholly owned CFC has $100 of QBAI, gross tested income of $20, and third-party interest expense of $10 properly allocable to the CFC's gross tested

income. The U.S. corporation will include $10 of GILTI, even though its net CFC tested income is $10 and the 10 percent of QBAI threshold is also $10, because the $10 of interest expense will reduce its NDTIR to zero. By contrast, if a U.S. corporation has QBAI of $100, gross income included in DEI of $20, and $10 of interest expense properly allocable to the DEI, the U.S. corporation has no FDII because its DEI of $10 does not exceed 10 percent of QBAI.

Incentives to move operations abroad arise if a U.S. corporation could earn active outbound income eligible for the GILTI deduction if it operated through a CFC in a low-tax jurisdiction but would be ineligible for the FDII deduction if it operated in the United States. Next, we examine these definitions through that lens.

B. Rearranging the FDII Computation

The statutory formula for FDII uses additional terms that are themselves defined in terms of the building blocks discussed above, specifically DTIR, which is 10 percent of QBAI, and deemed intangible income (DII), which is DEI less DTIR. Simple algebra can eliminate these terms, the use of which obscures some relationships between the building blocks.

In particular, starting from the statutory language, it is possible to rearrange the formula so that DEI, QBAI, and FDDEI each occurs exactly once in the computation of FDII:

FDII = DII (FDDEI/DEI)

= (DEI - DTIR) (FDDEI/DEI)

[substituting (DEI - DTIR) for DII]

= (DEI - (10 percent QBAI)) (FDDEI/DEI)

[substituting (10 percent QBAI) for DTIR]

= DEI (FDDEI/DEI) - (10 percent QBAI) (FDDEI)/DEI

[multiplying through]

= FDDEI - (10 percent QBAI) (FDDEI/DEI)

[simplifying]

= FDDEI (1 - (10 percent QBAI/DEI))

[factoring out FDDEI]

This rearrangement makes it easier to demonstrate how FDII will vary with changes in each term in the formula. FDII will increase if:

- DEI increases with no change in QBAI or FDDEI;

- QBAI declines with no change in FDDEI or DEI; or
- FDDEI increases with no change in the ratio of QBAI to DEI.

Obviously, these terms may not be independent as a business matter, and an increase in one quantity may be tied to a change in another. As discussed later, however, that is not always the case, which may create distortions and opportunities for careful planning.

IV. Scope Anomalies

If the yardstick is neutrality in the taxation of a U.S. taxpayer's income from serving foreign markets, the universe of taxpayers eligible for the FDII deduction contains unwarranted exclusions. These have the effect of influencing the legal form of ownership of active outbound business operations in ways unmotivated by an identifiable tax policy.

A. Exclusion of Individual U.S. Shareholders

The FDII deduction, like the GILTI deduction, is available only to U.S. corporations and not to U.S. individuals. There is no policy justification for basing the availability of the deduction for income from servicing foreign markets on the form of entity chosen to serve those markets. Permitting U.S. individuals access to the FDII deduction to achieve symmetry with corporations would best be accomplished by a new statute providing a section 962-style election for individuals conducting domestic operations through partnerships or as sole proprietorships.

B. Exclusion of Foreign Branch Income

Foreign branch income is ineligible for the FDII deduction through an exclusion from DEI.[20] The reason is self-evident if the FDII deduction is viewed as an export incentive, because the production of goods or provision of services through a foreign branch does not create U.S. jobs. That explanation does not bear scrutiny, however, given that the GILTI deduction is available for active outbound income from foreign operations conducted through CFCs, not to mention Treasury's denial that FDII was intended to be an export incentive.[21] Under a regime allowing the GILTI deduction, the exclusion of foreign branch income from the FDII-eligible base simply encourages U.S. corporations to conduct active foreign operations through CFCs in any jurisdiction in which the tax rate is less than 21 percent.

The bias toward conducting foreign operations through CFCs rather than branches does not serve any obvious U.S. tax policy. In the absence of a policy basis, the lack of consistency appears arbitrary and only serves to prejudice businesses that need to operate in branch form for legitimate nontax reasons.

V. Asymmetry Between FDII and GILTI

In several respects, the definition of DEI fails to mirror the definition of net CFC tested income, causing asymmetries between the availability of the FDII deduction and the GILTI deduction in similar circumstances. Some of these discrepancies involve situations in which the definition of DEI includes income that would be subpart F income; others exclude income that would be net CFC tested income if the U.S. corporation were a CFC. The FDII rules would have hewed closer to their stated purpose of counterbalancing a U.S. corporation's incentives to earn GILTI had the definition of DEI tracked the distinction between income that would or would

not have been subpart F income if the U.S. corporation were a CFC.

A. Excluded Financial Services Income

DEI excludes "any financial services income (as defined in section 904(d)(2)(D)) of such corporation."[22] Treasury regulations define financial services income as income earned by a financial services entity derived from various active and passive sources in an active financing business.[23] The exclusion of financial services income is unwarranted to the extent it excludes active earnings that would be eligible for the GILTI deduction if conducted through a CFC. As it stands, however, active financing income excepted from subpart F income under section 954(h) is eligible for the GILTI deduction but, if earned by a financial services entity, not for a corresponding FDII deduction.

B. Periodic Income From Securities

DEI includes periodic income from securities even though that income could never produce FDDEI (because it is not from the sale of property or the performance of services) and would never require the use of QBAI (because it is earned on intangible property).[24] For example, DEI includes dividends on the stock of a non-consolidated U.S. subsidiary, interest income that is neither financial services income nor foreign branch income, and periodic income on financial instruments from U.S. or non-U.S. counterparties, if the amounts are earned by the U.S. business (rather than booked to a foreign branch) and are not earned by a financial services entity.

Earning financial income of this kind will generally increase the FDII deduction, which can be seen most clearly from the version of the formula in which FDII is expressed as FDDEI((1 - 10 percent) (QBAI/DEI)). Increasing DEI without affecting QBAI or FDDEI increases the amount of income eligible for the FDII deduction. The inclusion of that income in DEI thus allows taxpayers to manipulate their FDII deduction by controlling the timing of these items to the extent they can, and it subjects them to a random distortion of their FDII deduction to the extent they cannot. Consistency with GILTI and the subpart F regime suggests that this sort of income should not have been included in DEI.

C. Gains on the Sale of Securities

DEI includes gains on the sale of financial instruments.[25] Gains on the disposition of securities should have been excluded from DEI to the extent the gains would constitute subpart F income, and thus excluded from GILTI, if earned by a CFC.

There is a distinction between periodic income and disposition gains from securities, however, in that disposition gains could produce FDDEI if the sale were made to a foreign buyer for a foreign use. The IRS should use its regulatory discretion to provide that a foreign purchaser's acquisition of a financial instrument is per se not for a foreign use. The basis for that regulation would be that a security cannot be held for use in a trade or business but rather is held merely for the production of income.[26] There are some financial assets, such as those used for hedging, that are appropriately taken into account when calculating FDDEI, but, as discussed later, the inclusion of income on those instruments may be better addressed by including that income as FDDEI rather than testing for a foreign use.

By our metric, such a regulation would be an appropriate exercise of regulatory authority because it would align FDII more closely with the income eligible for the GILTI deduction. This is, however, only a partial remedy. Although excluding that income from eligibility for the FDII deduction would be desirable, the income would continue to be included in DEI with the distortive effect on the FDII deduction discussed earlier.

D. Passive Royalties

Passive royalties are included in DEI, and, if derived from a foreign person, will generally qualify as earned from a sale for a foreign use because the definition of a sale to a foreign person includes income from a license or similar arrangement.[27] Passive royalties are thus generally eligible for the FDII deduction, even though they would be subpart F income, and ineligible for the GILTI deduction, if earned by a CFC. Absent a compelling policy reason to the contrary, consistency with GILTI and subpart F suggests that the income should have been excluded from DEI.[28]

VI. Complications Arising From FDDEI

FDII requires an apportionment of DEI between FDDEI and non-FDDEI based on whether the gross item included in DEI was derived from the enumerated aspects of serving foreign markets.

A. Hedging Transactions

U.S. corporations may hedge active business income through financial transactions that give rise to periodic income or deduction and/or gain or loss upon sale or exchange. Although both periodic income and gain or loss from hedging transactions is included in DEI, absent regulatory relief most of those items will not be included in FDDEI because periodic income from a hedge does not constitute income in connection with the sale of property, and gains would be included only if the hedge were sold to a non-U.S. person for a foreign use. As a policy matter, the consequence of hedging FDDEI should not depend on the form of the hedge or the identity of the counterparty.

For example, imagine that a U.S. corporation expects to sell widgets on an ongoing basis to customers in the United Kingdom for £100 when £1 is worth $1.50, and the company hedges its exposure to the pound. Before maturity of the hedging transaction, the value of the pound declines relative to the dollar, so the U.S. corporation’s foreign-derived income of £100 has a dollar value of $125, and it receives $25 under the hedging transaction. Although the U.S. corporation still receives $150 under the transaction considered as a whole, the FDII rules may not, by their terms, permit the income earned on the hedging transaction to be included with the income from the outbound sales, depending on the form of the hedging transaction and the identity of the counterparty. As a result, although the $150 would be included in the U.S. corporation’s DEI, only $125 would be certain to count as FDDEI.[29]

The definition of foreign personal holding company income in section 954(c)(1)(C), (D), and (F) excludes from subpart F income, and thus includes as GILTI, gains or losses arising out of some commodities hedging transactions, including foreign currency gains attributable to section 988 transactions, foreign currency gains directly related to the business needs of the CFC, and income and gains from notional principal contracts (swaps).

The absence of a rule permitting hedging income or deductions to be taken into account in determining FDDEI reduces the efficacy of the hedge and the FDII regime and is inconsistent with the treatment of those hedges in determining GILTI. Although it is not entirely clear that Treasury has the authority to do so, particularly given that the treatment of hedges for purposes of subpart F is statutorily prescribed, we believe the agency should push the limits of its authority under section 250(c) to include income from a hedge as part of the underlying FDDEI to the extent that the risk being hedged would affect FDDEI. Thus, income, deduction, gain, or loss on hedges of raw materials used in the production of property sold for use abroad, as well as hedges of the sale price of that property, should be treated as FDDEI, as should foreign currency gain or loss.

B. Allocation of Deductions to FDDEI

FDDEI is defined as a subset of DEI, which is a net amount (gross items less allocable deductions). FDDEI thus must be a net amount, even though it is identified solely by reference to receipts from foreign markets, which are gross items. There is no explicit rule for determining FDDEI by allocating a portion of the deductions included in DEI against the items of gross income that define FDDEI. Indeed, the most natural reading of the phrase “any deduction-eligible income which is derived in connection with” appears to allocate DEI based on the amount of gross income attributable to income that is and is not FDDEI, which would have the effect of apportioning all deductions used to determine DEI pro rata based on the gross income included in or excluded from FDDEI.

Potentially significant distortions can arise from the use of pro rata allocations in this context. The use of pro rata allocations rather than a tracing rule may create scope for tax arbitrage if a U.S. corporation can leverage its domestic operations, deduct its financing costs at the blended rate, and include FDDEI at the lower marginal rate. Further, a pro rata rule is particularly distortive when deductions incurred to produce DEI that can never qualify as FDDEI are taken into account. For example, interest expense incurred to carry financial assets that are ineligible to be treated as FDDEI should not reduce FDDEI but will do so absent a tracing rule. To avoid these distortions, Treasury should interpret section 250(b)(4) to determine FDDEI by requiring deductions attributable to FDDEI to be subtracted from the gross items that comprise FDDEI (for example, by interpreting the definition of FDDEI to include a “properly allocable” standard such as the one for DEI in section 250(b)(3)(A)(ii)).

C. Pro Rata Apportionment of QBAI

The FDII rules implicitly apportion QBAI pro rata between income that is and is not FDDEI when determining QBAI’s effect on the FDII deduction, which can be seen most clearly in the version of the earlier formula that calculates FDII as FDDEI - (10 percent QBAI) (FDDEI/DEI). Although an apportionment rule is reasonable as a policy matter given administrative burdens, it is less precise than a tracing rule. In particular, apportionment means that a U.S. corporation’s FDII deduction will decrease if it earns income from both foreign and domestic markets and invests in depreciable tangible property to serve domestic markets, whenever the return on the investment (after financing costs) is less than 10 percent.

VII. Capital Structure Bias

Leasing property is often a viable economic alternative to making a debt-financed purchase. Nonetheless, and for no discernable policy reason, the FDII rules encourage U.S. corporations to lease their tangible business assets, whereas the GILTI rules encourage CFCs to purchase those assets. Of course, in any particular case, a

U.S. corporation's tax incentives may be overshadowed by business needs of ownership, and the tax analysis itself will be complicated by other provisions of the code, such as the ability to expense the cost of QBAI under section 168(k) and limitations on interest expense deductions under section 163(j).

A U.S. corporation that enters into a true lease of equipment used to produce FDDEI does not increase its QBAI. By contrast, debt-financing an acquisition of the equipment would raise the threshold for the FDII deduction.

A CFC would generally have an incentive to acquire debt-financed QBAI to increase the exempt threshold under GILTI. However, the relevant return on QBAI is determined differently under the GILTI rules than under FDII. Under FDII, the DTIR threshold is 10 percent of QBAI, whereas under GILTI, the NDTIR threshold is 10 percent of QBAI reduced by interest expense. If the CFC is in a low-tax jurisdiction and can borrow at an interest rate of less than 10 percent per year, its U.S. shareholders will benefit if the CFC makes a debt-financed purchase rather than entering into a lease.

The explanation for why the QBAI threshold should be determined before financing costs under the FDII rules when it is determined after financing costs under the GILTI rules would seem to be the drafters' bias toward reducing the threshold for exemption under the GILTI rules and increasing the threshold for taxation at the normal U.S. corporate rate under the FDII rules.[30] FDII should not, however, be about maximizing revenue for the fisc, but about parity with GILTI.

The different determinations of the return on QBAI mean that a debt-financed business is likely to be taxed more favorably under GILTI than under FDII. For example, suppose an active business has $100 of QBAI financed by debt at 7 percent per annum. It earns $15 per year from foreign markets:

- If conducted through a CFC, under the GILTI rules, the $8 of tested income would be exempt up to the $3 NDTIR ($10 from QBAI, less $7 interest), and the remaining $5 would be taxable at 10.5 percent.
- If conducted through a U.S. corporation with no other operations, under the FDII rules, the $8 of FDDEI would be taxable in full at a 21 percent rate because DEI does not exceed 10 percent of QBAI (or $10).

By contrast, if the U.S. corporation leased its property rather than acquiring it in a debt-financed purchase, all its FDDEI would be FDII because it would have no QBAI.

These incentives are inherent in the use of the DTIR and NDTIR thresholds under both the FDII and the GILTI rules, respectively, and we see no solution to this in the FDII context absent a change in the GILTI regime.

VIII. Conclusion

The reason for the FDII deduction was to counterbalance a U.S. taxpayer's incentive to conduct active business operations abroad through CFCs to benefit from the GILTI deduction. Taken together, however, they are anything but a unified regime to tax U.S. persons on their income from directly and indirectly serving foreign markets. The numerous inconsistencies between income eligible for the FDII deduction relative to income eligible for the GILTI deduction, and the anomalous operation of the FDII rules and their definitions, create unexplainable deviations between the two regimes that will benefit or burden different taxpayers, or even the same taxpayer from year to year, on a seemingly random basis.

In evaluating the effect of the GILTI regime, and in comparing the use of a CFC in lieu of a domestic corporation eligible for the FDII deduction, U.S. corporations will need to model their income and expenses to account for foreign taxes, the ability to cross-credit those taxes, and the exemption from U.S. tax of income below the NDTIR threshold applicable to GILTI.

In some cases, the problems are inherent in the structure of the GILTI rules themselves; in others, they are inherent in the FDII rules as an inadequate mirror to GILTI. Some problems can be mitigated by exercise of Treasury's regulatory authority under section 250, but most cannot. Combined with the existence of low-tax jurisdictions in which CFCs can conduct real-world business operations — both now or in the future as other countries respond to U.S. tax reform — the problems will create incentives for U.S. businesses to invest in production facilities abroad rather than at home. Wholly apart from the question of whether FDII is good policy, or even compliant with WTO rules, it should be amended to a substantial extent if it is to work mechanically with GILTI to produce a unified regime for taxing U.S. persons on their income from serving foreign markets.

Reprinted with the permission of *Tax Notes*.

Footnotes

[1] *See* discussion in Section IV.B.

[2] For tax years beginning after 2025, the GILTI deduction is reduced to 37.5 percent, increasing the effective tax rate on GILTI to 13.125 percent, and the FDII deduction is reduced to 21.875 percent, increasing the effective tax rate to 16.406 percent. Section 250(a)(3).

[3] Section 951A(b)(1). Because a U.S. shareholder must aggregate its pro rata shares of the tested income and loss of each CFC to determine its net CFC tested income, tested income of one CFC may be reduced by the tested loss of another CFC. To the extent so offset, a particular CFC's tested income will not give rise to a GILTI inclusion even if it exceeds the NDTIR threshold for that CFC. For simplicity, this report assumes that the U.S. shareholder is such for only one CFC.

[4] Section 951A(b)(2). The exclusion is for interest expense paid to any lender other than in a case in which the lender is a CFC and the same U.S. shareholder is required to include the corresponding interest income in its calculation of GILTI tested income. Thus, NDTIR is reduced by interest expense even if the U.S. shareholder is the lender and is required to include the related interest income directly, which is an anomalous result.

[5] Section 951A(d).

[6] Section 951A(a).

[7] Sections 250(a)(1)(B) and 960(d). FTCs for GILTI are in a separate basket, with no carryovers. Section 904(d)(1)(A) and (c). A taxpayer can, however, cross-credit taxes paid on GILTI between GILTI earned in different countries.

[8] Note, however, that the NDTIR threshold is calculated annually with no carryover, rather than as an average rate or an internal rate of return. It will thus disadvantage CFCs with large fluctuations in profitability from year to year. By comparison, the similar calculation of deemed tangible income return (DTIR) under the FDII rules

may benefit domestic corporations whose income is subject to those fluctuations.

[9] Some tax practitioners have speculated that Treasury could promulgate regulations extending the ambit of section 962 to allow electing individuals to claim the section 250 credit.

[10] The Treasury deputy assistant secretary for international tax affairs has stated that FDII is “designed to take away a tax incentive to transfer intangibles and other mobile factors out of the United States into a low-tax foreign subsidiary.” *See* Ryan Finley, “FDII Rules Are Not Harmful Tax Practices, Treasury Official Says” (Feb. 16, 2018).

[11] The Senate Budget Committee report states: “The Committee believes that offering similar, preferential rates for intangible income derived from serving foreign markets, whether through U.S.-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions.” *See* Senate Budget Committee explanation of the bill as passed by the Senate Finance Committee, at 370 (Dec. 7, 2017).

[12] Section 250(a)(1)(A).

[13] Section 250(a)(2).

[14] Section 250(b)(2).

[15] Section 250(b)(4).

[16] Section 250(b)(5)(A).

[17] Section 250(b)(5)(E).

[18] Additional FDDEI rules that police round-tripping transactions are beyond the scope of this report. *See* section 250(b)(5)(B) and (C).

[19] Section 250(b)(2)(B).

[20] Section 250(b)(3)(A)(i)(VI).

[21] *See* Finley, *supra* note 10.

[22] Section 250(b)(3)(A)(i)(III).

[23] Reg. section 1.904-4(e).

[24] For related observations, see Jasper L. Cummings, Jr., “Foreign-Derived Intangible Income Deduction,” *Tax Notes*, May 7, 2018, p. 853.

[25] DEI specifically excludes dividends, GILTI, and subpart F income received from a CFC, but not dividends from a U.S. subsidiary, dividends from a foreign portfolio subsidiary, or capital gain on the sale of stock in a subsidiary (whether foreign or domestic). Section 250(b)(3).

[26] As others have observed, "It is unclear whether or how the 'use' of stock can be classified as domestic or foreign, or how this use would be established." Scott M. Levine and Christopher S. Hanfling, "Back to the Dry-Erase Board: Redrawing Cross-Border M&A Structures Post-Tax Reform," *DTR*, Apr. 6, 2018. In other contexts, a distinction is made between an asset held for use in a trade or business and one held for the production of income. *Compare* sections 162 and 212. Similarly, when testing a U.S. corporation for status as a U.S. real property holding company, its securities are generally excluded from its base of assets held for use in an active business unless its principal business is investment for its own account. Reg. section 1.897-2(e) and (f).

[27] Section 250(b)(5)(E).

[28] The same logic would apply to passive rents received from foreign persons for the use of property abroad, although it would be unusual for a U.S. corporation to earn those items directly rather than through a foreign branch (or CFC).

[29] In limited situations, U.S. corporations may have access to relief under current rules, which permit integration of foreign currency hedges with identified executory contracts. *See* reg. section 1.988-5(b). Regulations also provide the IRS broad authority to grant advance rulings on the integration for net hedging arrangements and anticipatory hedging systems involving nonfunctional currency. *See* reg. section 1.988-5(e). However, just as the foreign personal holding company rules of section 954 exclude hedges from subpart F income in situations beyond those in which section 988 creates that integration, it would be appropriate to allow that broader inclusion for purposes of determining FDDEI.

[30] *See*, *e.g.*, Jerred G. Blanchard Jr., "More on Tax Reform: Intercompany Transactions, Single-Entity Issues," *Tax Notes*, May 28, 2018, p. 1263 n.49 ("Obviously, this is because DTIR reduces a deduction in the section 250 context, whereas NDTIR decreases an inclusion in the section 951A context.").

Attorneys

Jonathan S. Brenner
(212) 379-6050
jbrenner@capdale.com

Josiah Child
(212) 379-6097
jchild@capdale.com

Related Practices/Industries

Business, Investment & Transactional Tax

International Tax