Ivins, Phillips & Barker
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# FDII Sense

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# Agenda

- Ancient history
- Recent history
- FDII mechanics
  - Breaking down FDII
  - A visual explanation
  - Specialized provisions
- Open issues
- (Not so) Distant future: WTO challenges?

# ANCIENT HISTORY

# Alphabet Soup

U.S. Export Incentives

- DISC – Domestic international sales corporation
- FSC – Foreign sales corporation
- ETI – Extraterritorial income [regime]
- FDII – Foreign derived intangible income

Trade relationships

- GATT – General Agreement on Tariffs and Trade
- WTO – World Trade Organization
- SCM – [WTO] Subsidies and Countervailing Measures Agreement

# Timeline ('highlights')

- 1947 GATT
- 1971 DISC
- 1976 GATT panel ruling: NO to DISC
- 1984 FSC
- 1995 WTO/SCM established
- 1999 WTO panel ruling: NO to FSC
- 2000 ETI
- 2002 WTO panel ruling: NO to ETI
- 03/2004 EU retaliatory tariffs take effect against US
- 11/2004 JOBS Act (ETI repeal & DPAD)

# What's Prohibited?

WTO Agreement on Subsidies and Countervailing Measures
(the "SCM")

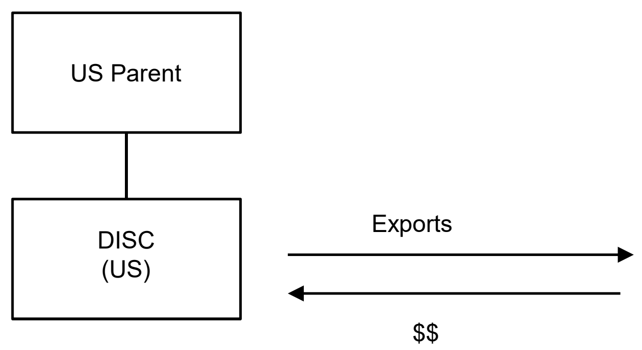
Forbids ***prohibited subsidies***

A ***subsidy*** is a financial contribution by a government conferring a benefit, which includes the non-collection or forgiveness of taxes otherwise due

***Prohibited subsidies*** include
"the allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption" in calculating income taxes

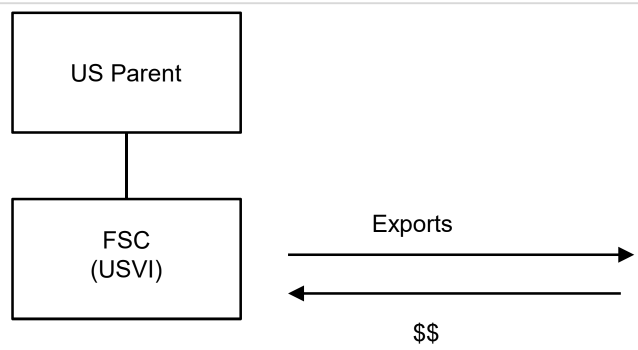
# Problematic History (1/3)

- DISC (1971-1984)
  - Domestic sub of US corporation operating as export agent
  - 50% of DISC's export income sheltered from tax until distributed AND subject to more favorable transfer pricing rules (result: lower export prices)



# PROBLEMATIC HISTORY (2/3)

- FSC (1984-2000)
  - FSC incorporated in a qualified offshore location (e.g., USVI), some additional requirements
  - Portion of FSC's export-related foreign-source income not taxable AND US shareholder exempt from sub F AND any tax on distribution



# Problematic History (3/3)

- ETI (2000-2004)
  - Taxpayer can exclude portion of "extraterritorial income"
    - Earnings from sales, rental, services that involve "qualifying foreign trade property"
      - Property that is manufactured in the US, held for sale outside the US, and no more than 50% of its value attributable to foreign content (WIP, labor)

# All 3 Challenged (1/3)

~~DISC~~

GATT panel ruled that DISC "conferred a tax benefit by way of a subsidy [deferral, transfer pricing, etc.] that was related to US exports" and thus violated agreement's prohibitions on export subsidies

# All 3 Challenged (2/3)

~~FSC~~

WTO panel found the FSC regime was an export subsidy and that the tax exemptions were "financial contributions" – they didn't buy the U.S.'s argument that this was "just" transfer pricing and should be left to treaty relationships to sort out

# All 3 Challenged (3/3)

~~ETI~~

Applying similar reasoning as with the FSC challenge,
a WTO panel found the ETI regime to be a
prohibited export subsidy

# ETI Backlash

- 2002: WTO approved EU's request for retaliatory tariffs
- March 2004: EU tariffs go into effect
- October 2004: US enacts American Jobs Creation Act, which phased out ETI and introduced new, more neutral, corporate tax breaks such as section 199 deduction for manufacturing expenses ("DPAD" – domestic production activities deduction)
- May 2006: Responding to EU complaints, upheld by the WTO, regarding the ETI phaseout rules, the US repeals the phaseouts, thus eliminating ETI entirely

# RECENT HISTORY

# The TCJA: Setting the Stage

- For years, momentum had been building for fundamental corporate tax reform, particularly on the international side
- 2005 – Bush Tax Reform Panel
  - Report becomes priciest door stop in Washington
- "Modern era" of reform kicked off in 2011, with then-W&M Committee Chair Dave Camp's reform proposal
- House GOP issues "blueprint" for tax reform in June 2016
- As time wore on, few thought it was a realistic possibility, until … November 2016!

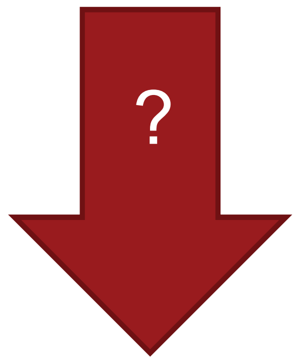
# Recent History moves Fast

- November 2, 2017: W&M Committee Chair Brady introduces Tax Cuts & Jobs Act (no FDII provision)


- By December 22, 2017, we have a signed law (with FDII provision)

# Evolution of FDII

Border-Adjusted Tax (House GOP blueprint)




FDII (Senate proposal)

# THE BAT?

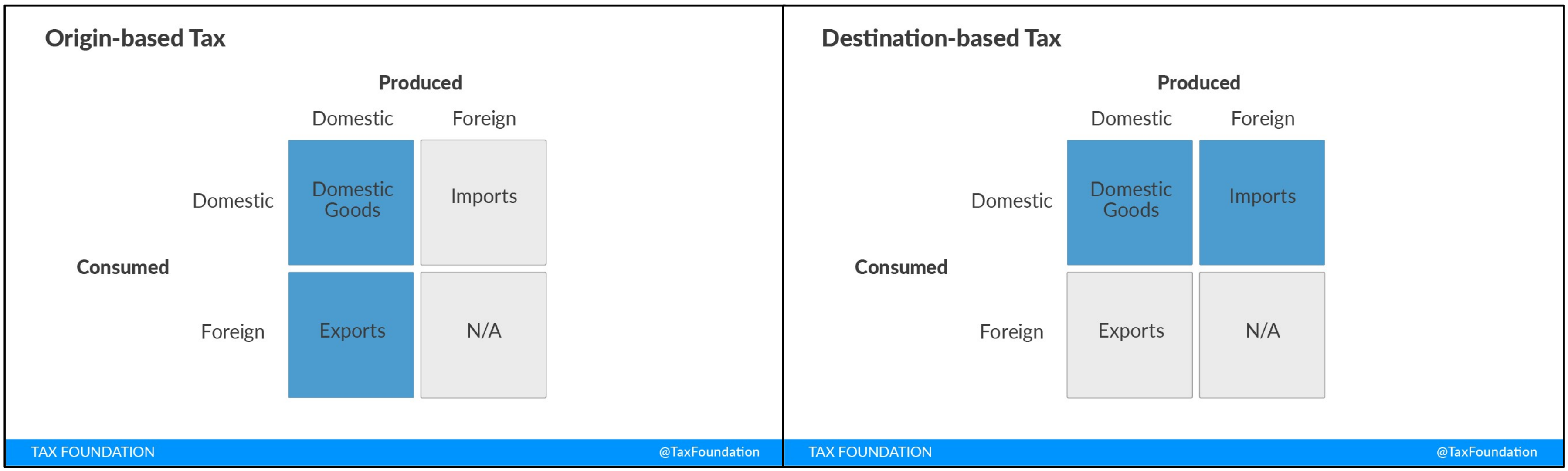
A destination-based cash flow tax.

This Blueprint eliminates the existing self-imposed export penalty and import subsidy by moving to a destination-basis tax system. **Under a destination-basis approach, tax jurisdiction follows the location of consumption rather than the location of production. This Blueprint achieves this by providing for border adjustments exempting exports and taxing imports, not through the addition of a new tax but within the context of the transformed business tax system.** The Blueprint also ends the uncompetitive worldwide tax approach of the United States, replacing it with a territorial tax system that is consistent with the approach used by our major trading partners.

Source, House GOP tax reform "blueprint" (6/24/2016), https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

# The BAT?

A destination-based cash flow tax.




Source: https://taxfoundation.org/understanding-house-gop-border-adjustment/

# FDII MECHANICS

# FDII and GILTI: Carrot and Stick

- GILTI:
  - Minimum tax on intangible income from CFCs
  - Phases out when tax burden reaches 13.125%

- FDII:
  - Deduction tax on foreign-derived intangible income from domestic corporations
  - Results in effective tax rate of 13.125%
  - Reduces the incentive to locate intangibles and associated income outside the U.S.

- FDII and GILTI share basic mechanics
  - Determination of intangible income based on a normal return from tangible business assets
  - Deductions paired together in Section 250, subject to joint limitation based on taxable income

# Eligible Entities

- Domestic corporations

- Not available for . . .
  - Individuals
  - Trusts and estates
  - RICs
  - REITs
  - S corporations

# FDII Mechanics: Outline

- Breaking Down FDII
  - Income, Foreign-Derived, Intangible
- A Visual Explanation
- Specialized Provisions
  - Domestic Intermediary and Related Party rules

# FDII MECHANICS: BREAKING DOWN FDII

# Breaking Down FDII: Income

- Code term:
  - Deduction Eligible Income (DEI)
- Plain English:
  - The portion of the taxpayer's income that could conceivably be from exports the U.S. wants to encourage
- Definition:
  - Gross income, netted against applicable deductions (including taxes), except the portion attributable to . . .
    - Subpart F income
    - GILTI
    - Dividends received from a CFC
    - Foreign branch income
    - Financial services income
    - Domestic oil and gas extraction income

# Breaking Down FDII: Foreign-Derived

- Code term:
  - Foreign-Derived Deduction Eligible Income (FDDEI)
- Plain English:
  - Income actually derived from the types of exports being encouraged
- Definition:
  - The portion of Deduction Eligible Income derived in connection with . . .
    - Property
      - Sold, leased, licensed, or exchanged . . .
      - . . . to non-United States persons . . .
      - . . . for use, consumption, or disposition outside the United States, as established by the taxpayer to the satisfaction of the Secretary.
    - Services
      - Provided to any person or with respect to property located outside the United States, as established by the taxpayer to the satisfaction of the Secretary.

# Breaking Down FDII: Intangible

- Code term:
  - Deemed Tangible Income Return
- Plain English:
  - The normal return on tangible assets used by the taxpayer to produce Deduction Eligible Income
    - This assumed return is not eligible for the FDII deduction
- Mechanism:
  - 10% of QBAI, as determined under the GILTI rules with certain modifications:
    - Includes only the QBAI that is used to produce Deduction Eligible Income (instead of tested income, as under the GILTI rules)
    - QBAI is determined without regard to whether the corporation is a CFC

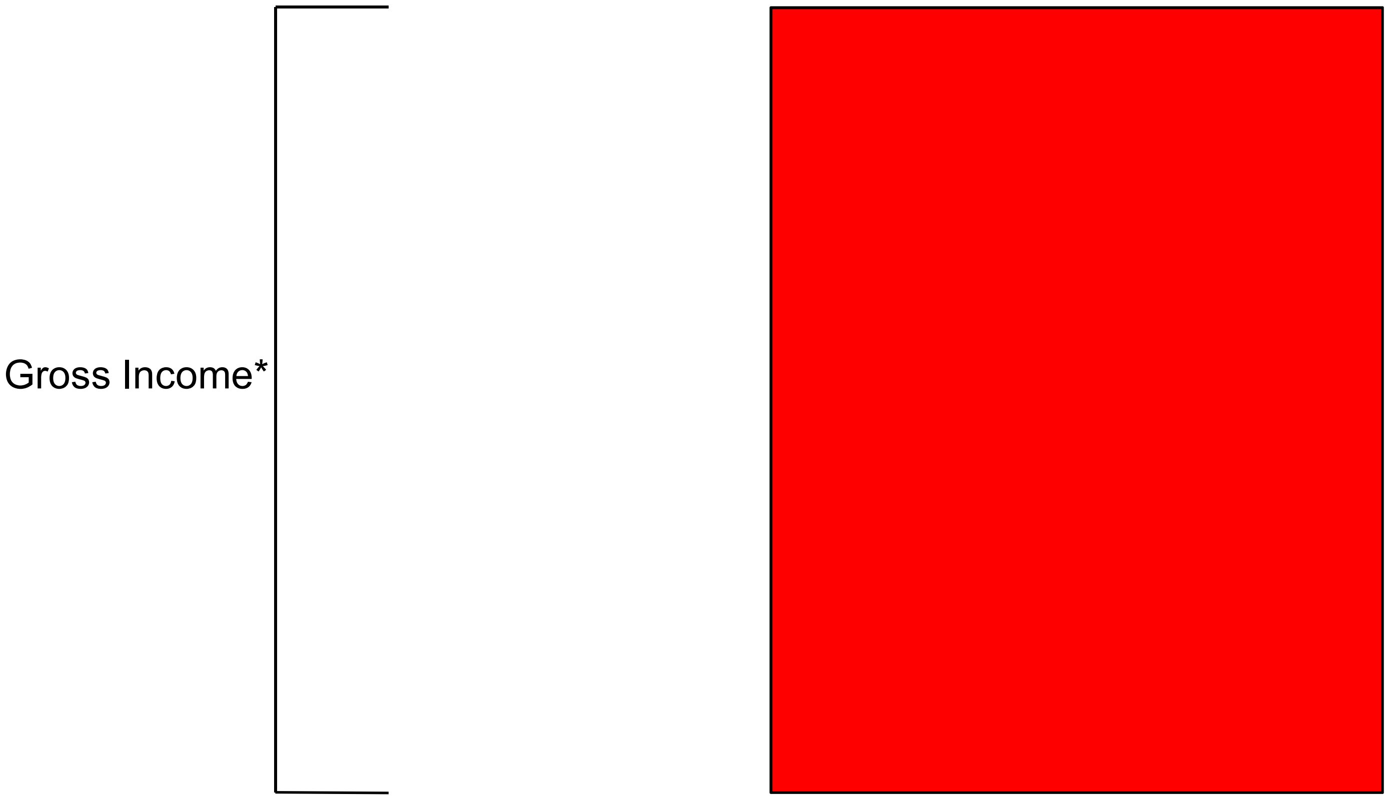
# Building Up FDII:
# Foreign-Derived Intangible Income

- Code term:
  - Foreign-Derived Intangible Income
- Plain English:
  - The amount eligible for a 37.5%* deduction, which, together with the GILTI deduction, is limited by the taxpayer's taxable income.
- Calculation:
  - The remaining Foreign-Derived Deduction Eligible Income, if any, after being reduced by the attributable portion of the Deemed Tangible Income Return when applied proportionally across the taxpayer's Deduction Eligible Income.

* The deduction is reduced to 21.875% for taxable years beginning after December 31, 2025.

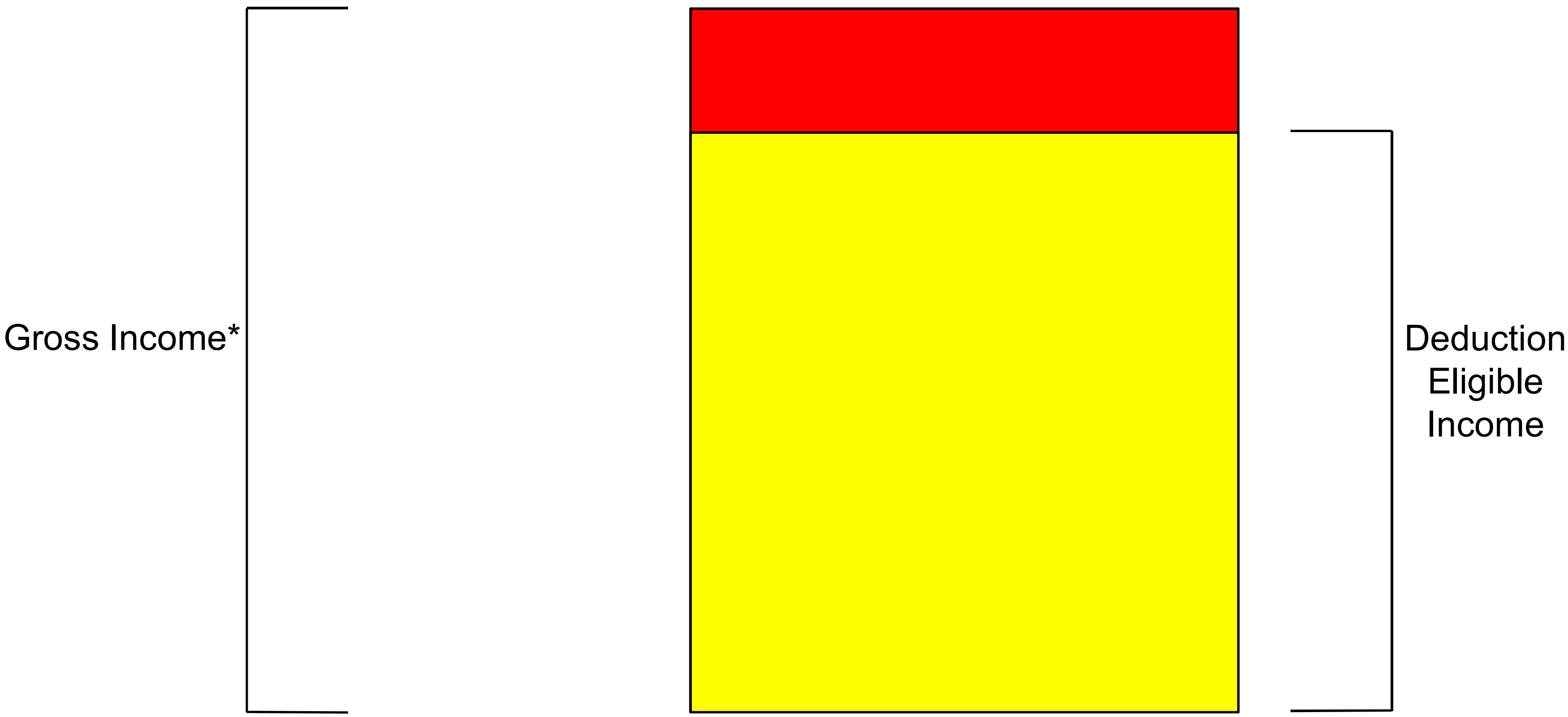
# FDII MECHANICS:
# A VISUAL EXPLANATION

# A Visual Explanation (1 of 5)



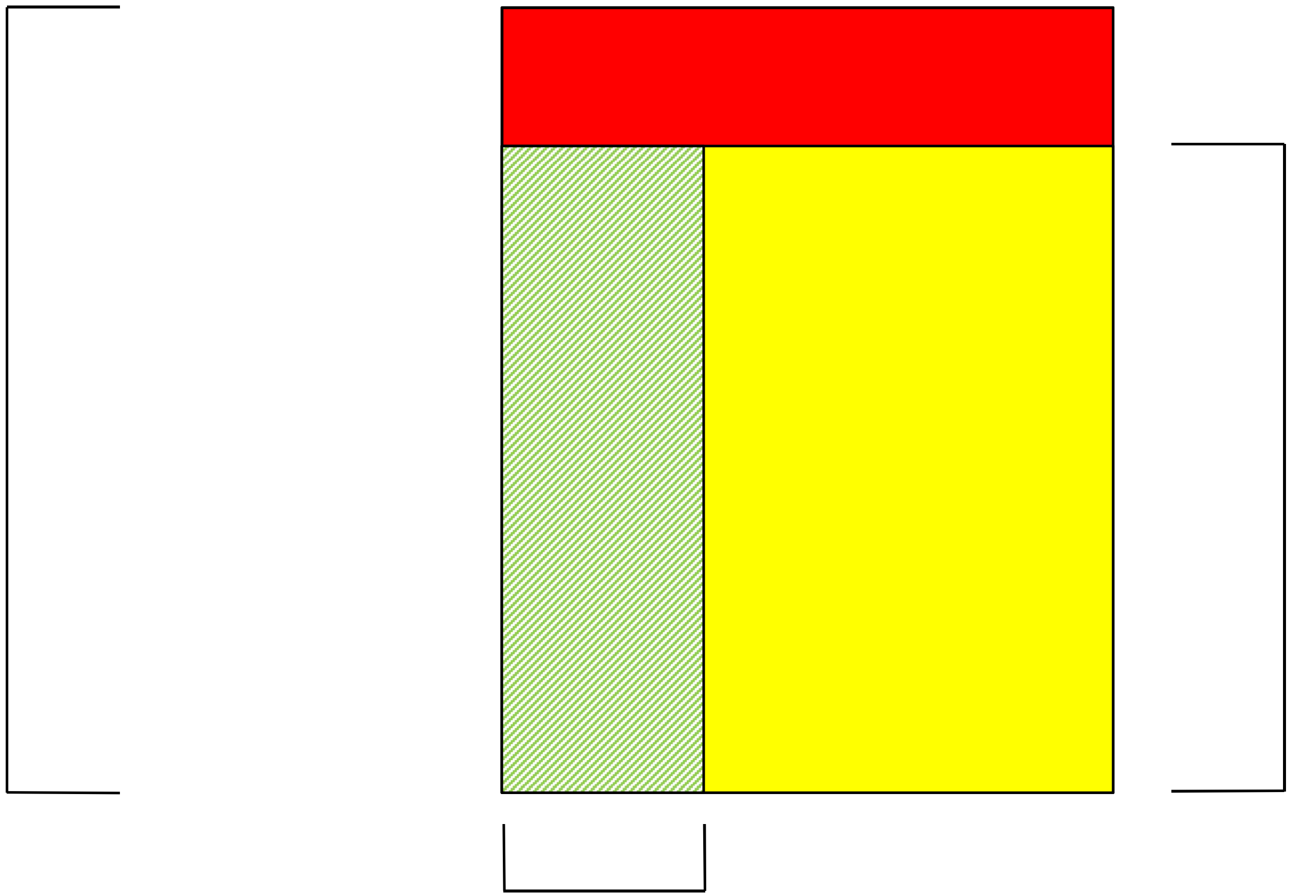

* Less related deductions.

# A Visual Explanation (2 of 5)



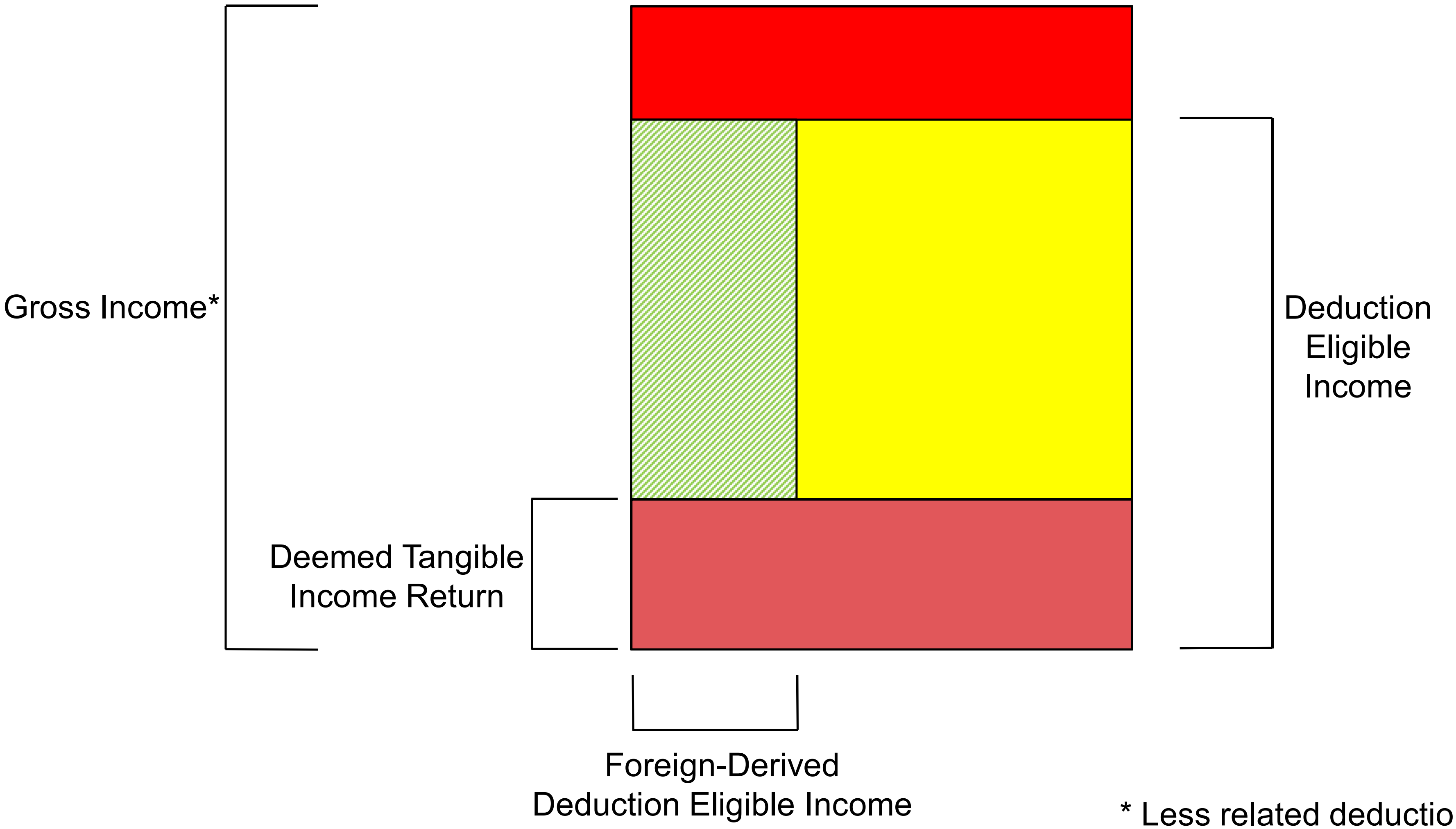

* Less related deductions.

# A Visual Explanation (3 of 5)



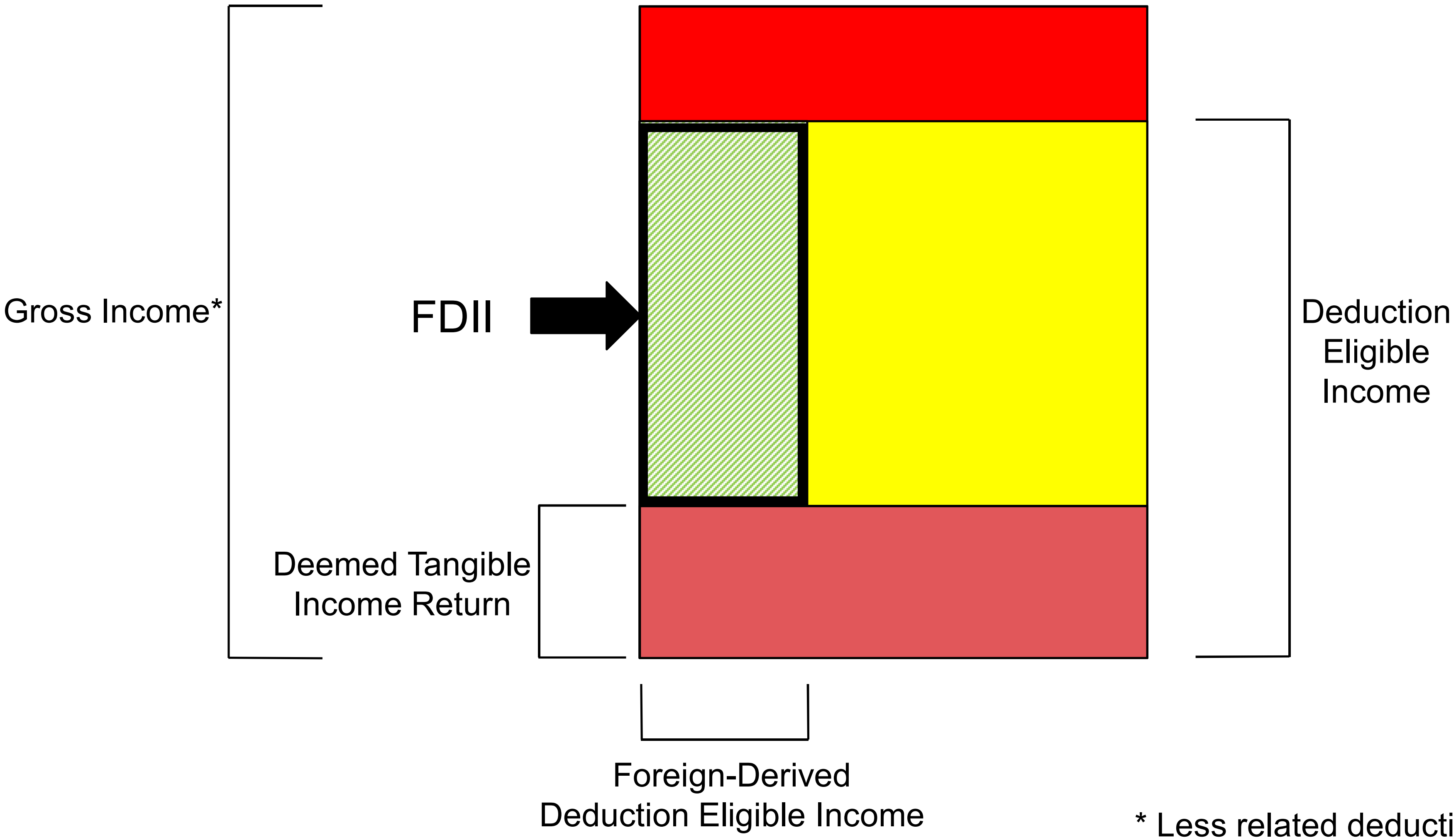

* Less related deductions.

# A Visual Explanation (4 of 5)




* Less related deductions.

# A Visual Explanation (5 of 5)




* Less related deductions.

# Alphabet Soup: Part II

- DEI – Deduction Eligible Income

$$DEI = Gross\ Income^{*} - Excluded\ Income^{*}$$

- FDDEI – Foreign-Derived Deduction Eligible Income

$$FDDEI = Qualified\ Sales\ of\ Property + Qualified\ Provision\ of\ Services$$

- DTIR – Deemed Tangible Income Return
- QBAI – Qualified Business Asset Investment

$$DTIR = 10\% \times QBAI$$

- DII – Deemed Intangible Income

$$DII = DEI - DTIR$$

- FDII – Foreign-Derived Intangible Income

$$FDII = DII \times \frac{FDDEI}{DEI}$$

# Example #1: The Scenario

- Engines, Inc. is a U.S. corporation.
  - Engines, Inc. manufactures and sells aircraft engines to U.S. and non-U.S. persons.
  - All non-U.S. customers of Engines, Inc. use the aircraft engines outside the United States.
- Engines, Inc. manufactures most of its engines in the United States, and sells them from there.
- Engines, Inc. also manufactures and sells some of its engines from a branch in Mexico.

# Example #1: The Scenario

- Total gross income, less related deductions:
  - $1,100,000
- Total foreign branch income, less related deductions:
  - $100,000
- Total income attributable to sales from U.S. to non-U.S. persons for foreign use, less related deductions:
  - $500,000
- Qualified business asset investment:
  - $1,000,000

# Example #1: The Mechanics

$$DEI = Gross\ Income^{*} - Excluded\ Income^{*}$$

| # | Step |
|---|---|
| **1** | **Calculate DEI** |
| 2 | Calculate FDDEI |
| 3 | Calculate DTIR |
| 4 | Calculate DII |
| 5 | Calculate FDII |
| 6 | Limitation |

- Gross income, less related deductions:
  - $1,100,000
- Foreign branch income, less related deductions:
  - $100,000

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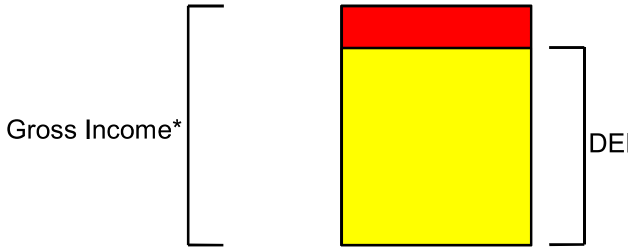
- Deduction Eligible Income:
  - $1,000,000

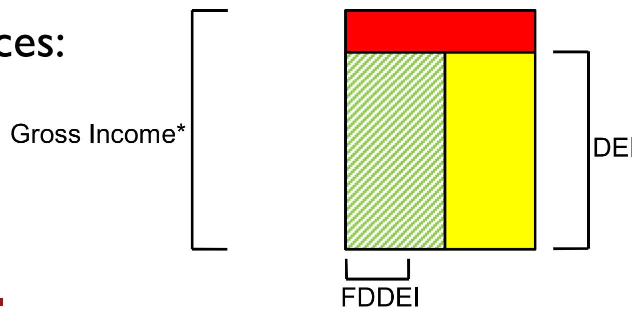


# EXAMPLE #1: THE MECHANICS

$$FDDEI = Qualified\ Sales\ of\ Property + Qualified\ Provision\ of\ Services$$

| # | Step |
|---|---|
| 1 | Calculate DEI |
| 2 | **Calculate FDDEI** |
| 3 | Calculate DTIR |
| 4 | Calculate DII |
| 5 | Calculate FDII |
| 6 | Limitation |

- FDDEI from sales of property:
  - $500,000
- FDDEI from provision of services:
  - $0



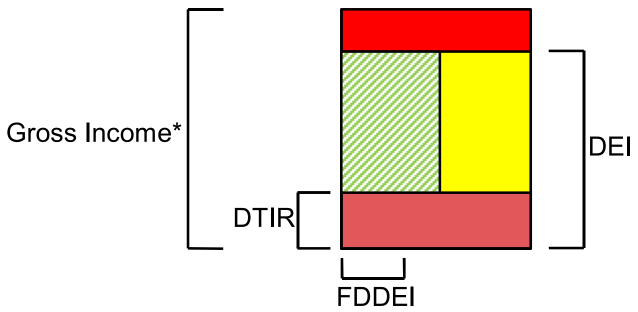

- Total FDDEI:
  - $500,000

# Example #1: The Mechanics

$$DTIR = 10\% \times QBAI$$

| # | Step |
|---|---|
| 1 | Calculate DEI |
| 2 | Calculate FDDEI |
| **3** | **Calculate DTIR** |
| 4 | Calculate DII |
| 5 | Calculate FDII |
| 6 | Limitation |

- QBAI:
  - $1,000,000



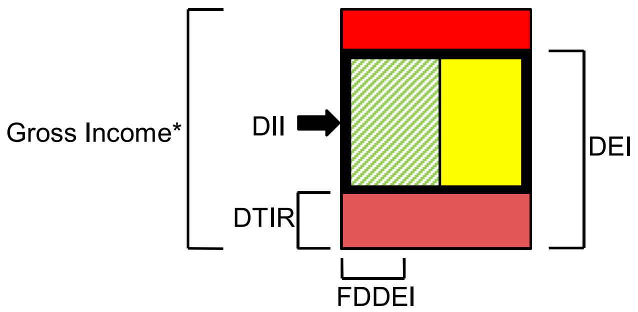

- DTIR:
  - $100,000

# Example #1: The Mechanics

$$DII = DEI - DTIR$$

| # | Step |
|---|---|
| 1 | Calculate DEI |
| 2 | Calculate FDDEI |
| 3 | Calculate DTIR |
| **4** | **Calculate DII** |
| 5 | Calculate FDII |
| 6 | Limitation |

- DEI:
  - $1,000,000
- DTIR:
  - $100,000



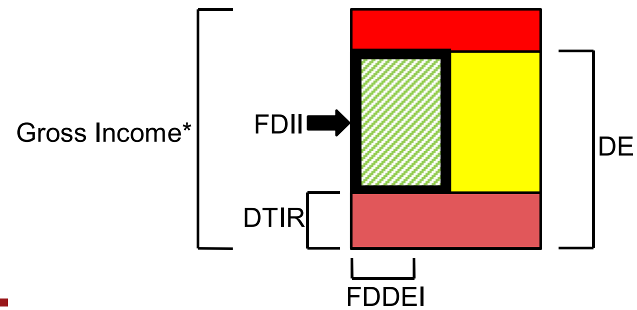

- DII:
  - $900,000

# Example #1: The Mechanics

$$FDII = DII \times \frac{FDDEI}{DEI}$$

| # | Step |
|---|---|
| 1 | Calculate DEI |
| 2 | Calculate FDDEI |
| 3 | Calculate DTIR |
| 4 | Calculate DII |
| **5** | **Calculate FDII** |
| 6 | Limitation |

- DII:
  - $900,000
- FDDEI:
  - $500,000
- DEI:
  - $1,000,000




- FDII:
  - $450,000
  - The FDII deduction is 37.5% of $450,000, or $168,750, subject to potential limitation.

# Example #1: The Mechanics

$$FDII \ \& \ GILTI \ Deduction \leq Taxable \ Income$$

| # | Step |
|---|---|
| 1 | Calculate DEI |
| 2 | Calculate FDDEI |
| 3 | Calculate DTIR |
| 4 | Calculate DII |
| 5 | Calculate FDII |
| **6** | **Limitation** |

If the taxpayer's total taxable income is less than the combined GILTI and FDII deduction, the GILTI/FDII deduction is limited.

# Example #1: Notes

- "Intangible"
  - There is no direct measurement of income from intangibles.
  - In this example, there need not have been any intangible assets at all.

- The FDII/GILTI deduction cannot create or expand an NOL.

# SPECIALIZED PROVISIONS

# Specialized Provisions: Outline

- Domestic Intermediaries
  - Property
  - Services

- Related Parties
  - Definition
  - Property
  - Services

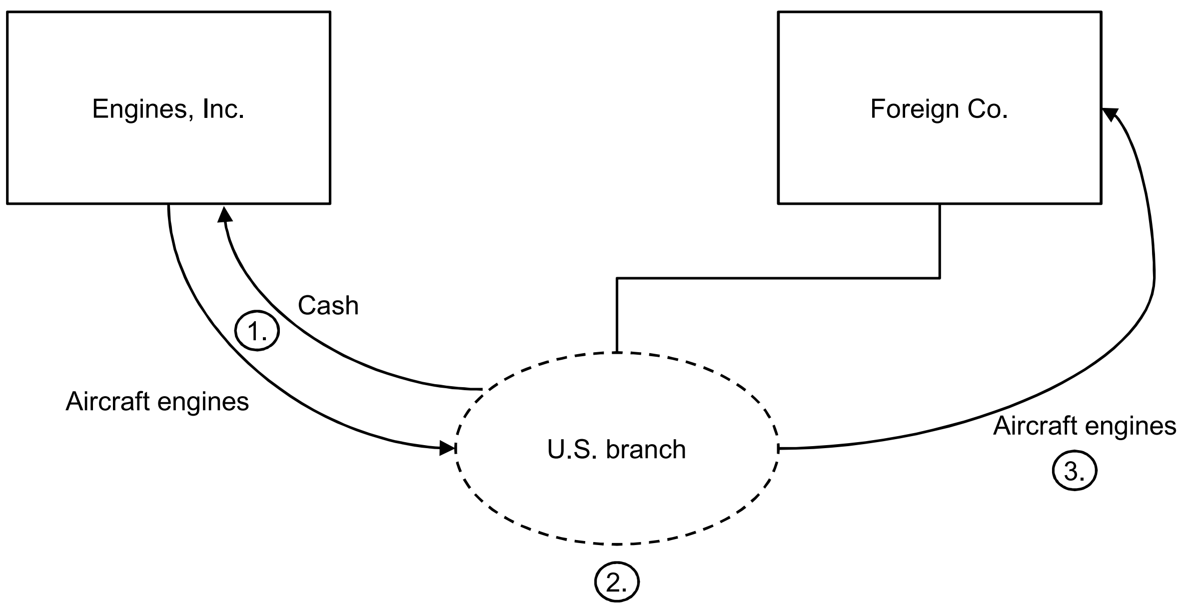
# Domestic Intermediaries: Property

- If a taxpayer sells property . . .

  - To another person (other than a related party) for further manufacture or other modification within the United States . . .

  - Such property shall not be treated as sold for a foreign use even if such other person subsequently uses such property for a foreign use.

# Example #2: Domestic Intermediary




## Facts

- Engines, Inc. sells aircraft engines to the U.S. branch of Foreign Co.
- The U.S. branch of Foreign Co. carries out "further manufacture or other modification" on the aircraft engines within the United States.
- The U.S. branch of Foreign Co. transfers the aircraft engines to Foreign Co. for foreign use.

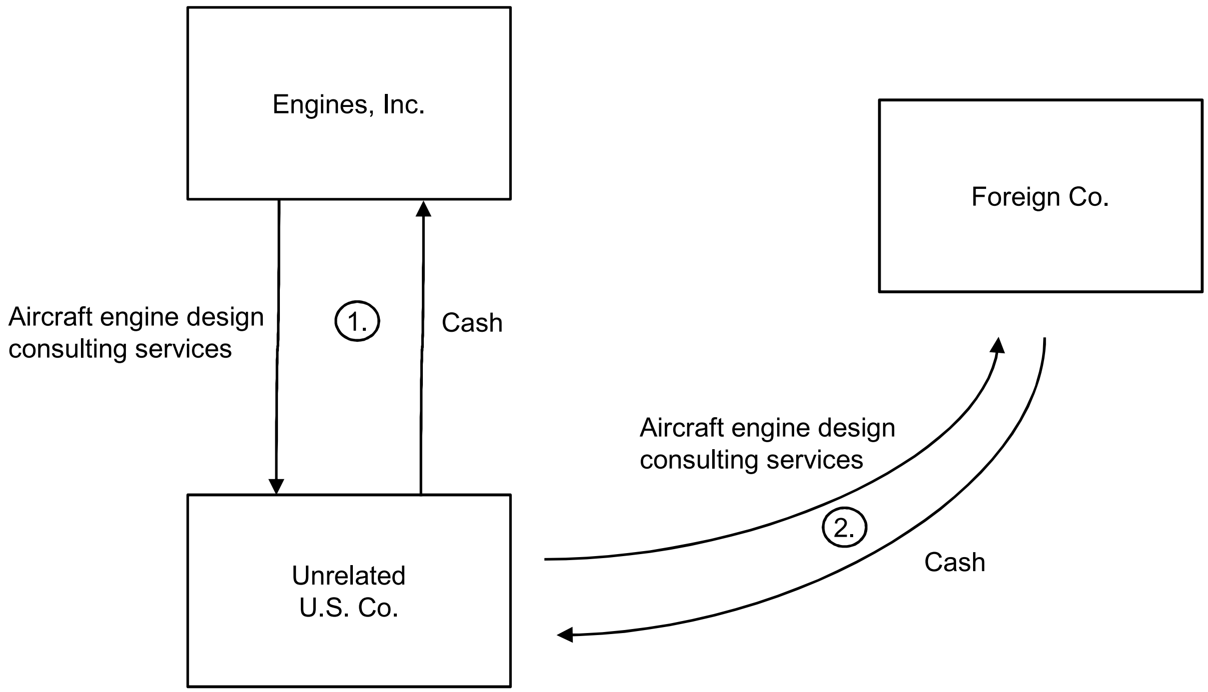
## Outcome

- Engines, Inc.'s sale of aircraft engines to the U.S. branch is not eligible for the FDII deduction.

# Domestic Intermediaries: Services

- If a taxpayer provides services…
  - To another person (other than a related party) located within the United States …
  - Such services shall not be treated as foreign-derived even if such other person uses such services in providing services which are so described.

# Example #3: Domestic Intermediary




## Facts

- Engines, Inc. provides aircraft engine design consulting services to an unrelated person located within the United States.
- The unrelated person uses such services in providing aircraft engine design consulting services to Foreign Co.

## Outcome

- Engines, Inc.'s provision of aircraft engine design consulting services is not eligible for the FDII deduction.

# Related Parties: Definition

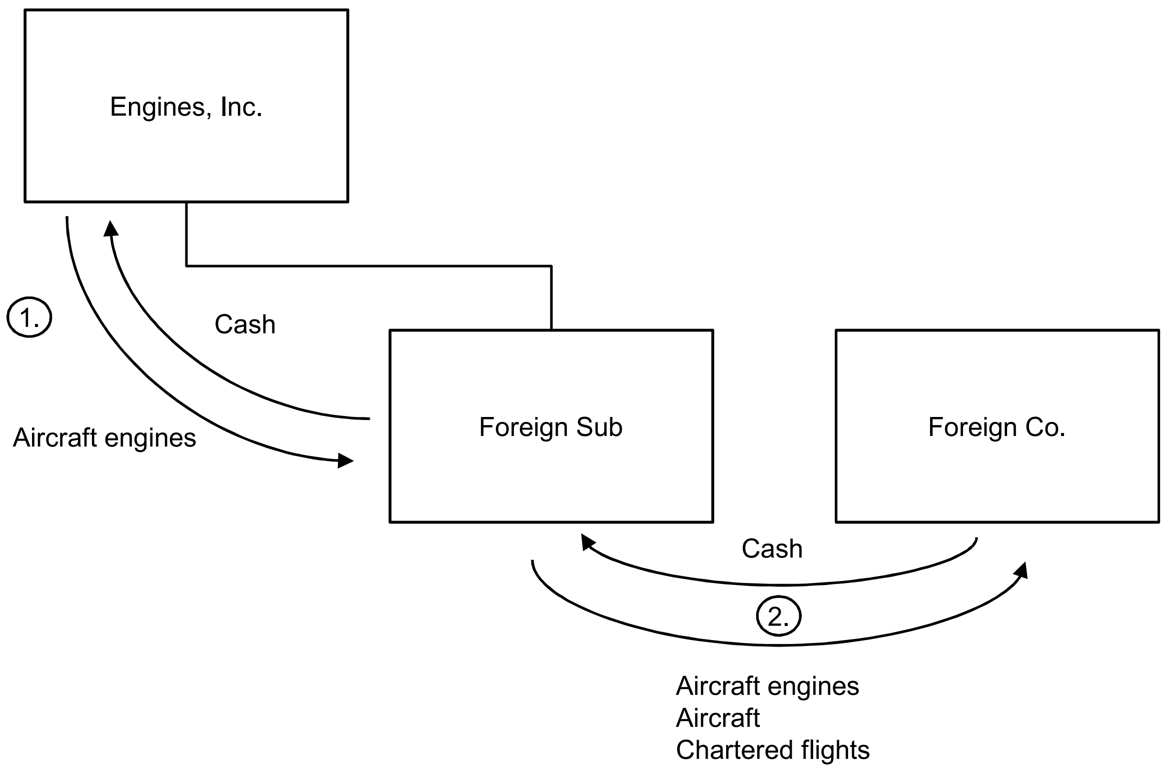
- Plain English:
  - Corporations are related parties to one another if they are linked by a chain of ownership with greater than 50% voting power and value at each link, and are not of a type excluded from the provision.
    - Excluded corporations include, for example, tax-exempt corporations, insurance companies, RICs and REITs.
- Definition:
  - A member of an affiliated group, as defined in Section 1504(a), with modifications:
    - Replacing "at least 80 percent" with "more than 50 percent"
    - Without respect to Section 1504(b)(3) and (4)
      - This means that ownership does flow through foreign corporations and possessions corporations

# Related Parties: Sales of Property

- If property is sold to a related party who is not a United States person…
- Such sale shall not be treated as for a foreign use unless …
- Such property is ultimately sold by a related party, or used by a related party in connection with property which is sold or the provision of services, to another person who is not a United States person, and …
- The taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use.

* This provision breaks apart a sale of property into deemed sales of each of the components of such property.

# Example #4: Related Party Property




## Facts

- Engines, Inc. sells aircraft engines to its foreign subsidiary.
- The foreign subsidiary sells the aircraft engines, aircraft made with the engines, and/or chartered flights using aircraft made with the aircraft engines to Foreign Co. for use outside the United States.

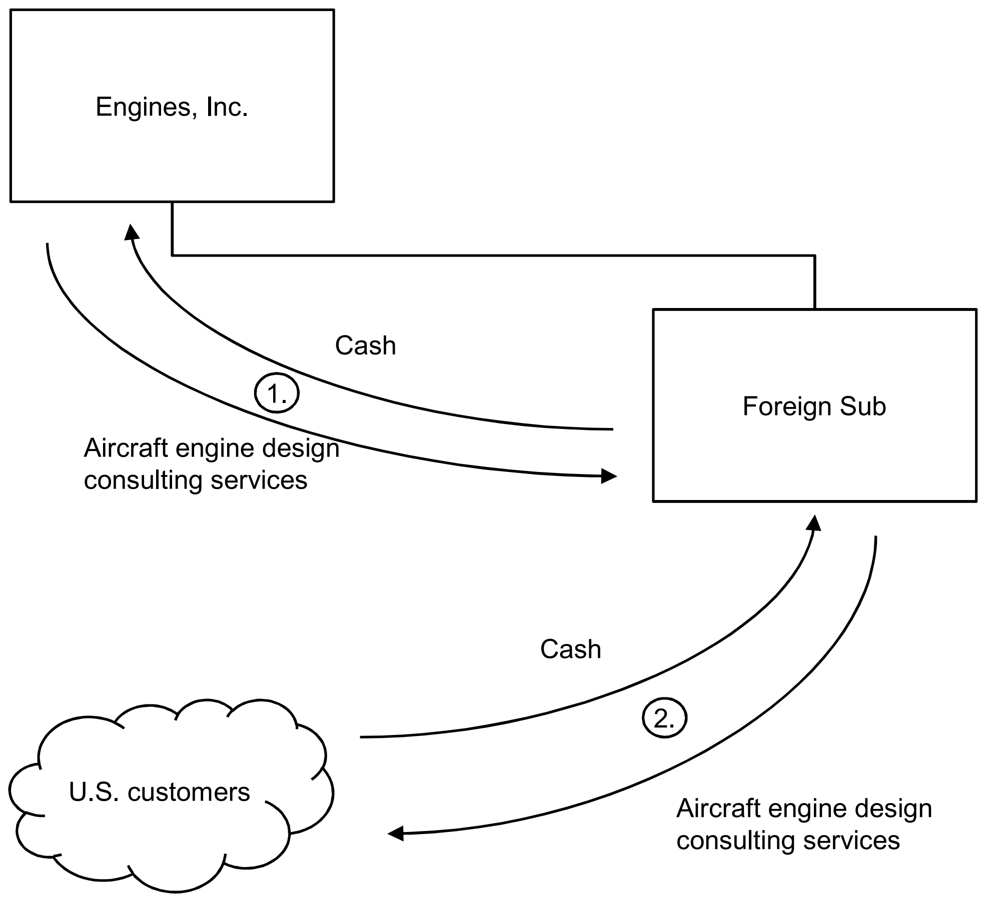
## Outcome

- The sale from Engines, Inc. to its foreign subsidiary can be eligible for the FDII deduction.

# Related Parties: Provision of Services

- If a service is provided to a related party who is not located in the United States . . .
- . . . Such service shall not be treated as FDDEI unless . . .
- . . .The taxpayer established to the satisfaction of the Secretary that such service is not substantially similar to services provided by such related party to persons located within the United States.

# Example #5: Related Party Services




## Facts

- Engines, Inc. sells services to its foreign subsidiary.
- The foreign subsidiary sells "substantially similar" services to customers in the U.S.

## Outcome

- Engines, Inc.'s sale to its foreign subsidiary is not eligible for the FDII deduction.

## Question

- What if the services sold to U.S. customers are insignificant compared to sales to non-U.S. customers?

# OPEN ISSUES

# Open Issues

- "[A]ny use, consumption, or disposition which is not within the United States"
  - What is a disposition?
  - Can intangibles be consumed?
  - Where does a use, consumption, or disposition take place?
    - Apply source rules?

# Open Issues (Cont.)

- Is a taxpayer eligible for a FDII deduction where FDDEI is positive, DEI is negative, and Taxable Income is positive?
  - Consider a taxpayer who, with no QBAI . . .
    - Generates gains of $.5M on exports of property;
    - Generates losses of $1M on domestic sales of property; and
    - Generates gains of $1M from excluded categories of income.
  - This taxpayer would have . . .
    - FDDEI of $.5M;
    - DEI of -$.5M; and
    - Taxable Income of $.5M.

# Open Issues (Cont.)

- Consolidated groups:
  - Is FDII determined corporation-by-corporation, for the group as a whole, or by a hybrid method?
    - QBAI?
    - The taxable income limitation?
    - Indications are that single corporation treatment is most likely.

# (NOT SO) DISTANT FUTURE: WTO CHALLENGE?

# What's Prohibited? Reprise

WTO Agreement on Subsidies and Countervailing Measures
(the "SCM")

Forbids ***prohibited subsidies***

A ***subsidy*** is a financial contribution by a government conferring a benefit, which includes the non-collection or forgiveness of taxes otherwise due

***Prohibited subsidies*** include
"the allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption" in calculating income taxes

# FDII: What's the Problem?

What IS the FDII?

- Special deduction
- For the export of goods and services
  - Doesn't apply to sale of same goods for domestic consumption
- Results in a lower rate (13.125% vs. 21%) on a domestic US corporation's sales of goods to a foreign person, foreign use

'the allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption'

# Potential US Arguments: Would FDII Survive*? (1/2)

It is "contingent upon export performance," but is it a "subsidy"???

What's a "subsidy"?

It's a subsidy if "government revenue that is otherwise due is foregone"

Won't taxpayers adjust?
If you remove it, wouldn't taxpayers simply shift operations into foreign subs?
And now, that just means US residual on 10.5% (GILTI) vs. 13.125% (FDII)?

*See, Sanchirico, "The New US Preference for 'Foreign-derived Intangible Income'" (April 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171091

# Potential US Arguments: Would FDII Survive*? (2/2)

1. Rebalancing argument: Export-related tax breaks help level the playing field between US worldwide system and ROW territorial system.

Against backdrop of tax reform, does this hold water?

2. Double tax argument: SCM says it's OK to give special treatment to help alleviate double taxation of foreign-source income

But income from exports typically aren't subject to tax in the importing foreign country

*See, Avi-Yonah & Vallespinos, "The Elephant Always Forgets: US Tax Reform and the WTO," (January 2018), last revised April 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3113059

# Possible US Response

Finance ministers from UK, Germany, France, Italy, and Spain complained about the tax reform bill before it even became law, raised possibility of retaliation months ago

**Does the U.S. care???**

# QUESTIONS?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