CURTIS INSIGHT

U.S. Tax Reform Review: Focus on Cross-Border and International Business Provisions

March 2018

H.R. 1 enacted on December 22, 2017 (the "Act") adopted sweeping changes of the Internal Revenue Code of 1986 that are expected to have a significant impact across a broad spectrum of businesses and taxpayers. The Act dramatically changed both the tax base and the tax rate structure for corporations and individuals, and introduced a substantial tax reduction on income derived from business activities conducted through sole proprietorships and pass-through entities.

Some of the most significant changes adopted by the Act are aimed at the tax treatment of international and cross-border business operations. The new rules are generally intended to incentivize both U.S. and foreign-based corporations to locate business operations in the U.S. and to encourage the repatriation of offshore profits. This is generally intended to be accomplished by:

- reducing the overall tax rates on corporations and businesses;
- providing a special tax incentive for export income;
- broadening the scope of taxation of offshore profits; and
- allowing for the tax-free repatriation of offshore profits.

The Act adopts several rules that are intended to prevent the erosion of the U.S. tax base by:

- imposing significant limitations on the deductibility of interest expense;
- imposing a "base erosion minimum tax"; and
- denying tax benefits with respect to interest and royalty payments involving "hybrid entities" and "hybrid payments".

The international and cross-border provisions of the Act have been scored by to raise significant revenue, thereby paying for other changes adopted by the Act, including the tax rate reductions for corporations and individuals.

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Anti-Base Erosion Provisions

Interest Expense Deduction Limitation

The Act generally limits the amount of interest expenses that corporations can deduct beginning in 2018, with no grandfathering for outstanding debt.[1] Corporations having gross receipts of less than $25 million as well as certain real property, farming and other designated businesses are generally exempt from the limitation.

Under prior law, the deductibility of interest expenses was subject to relatively narrow limitations including the so-called "earnings stripping" limitation under which the deduction for corporate interest expense paid to related parties that were not subject to U.S. taxation was limited to 50% of adjusted taxable income. For this purpose adjusted taxable income was determined in a manner that approximated cash flow of the corporation (i.e., earnings before interest, taxes, depreciation and amortization, "EBITDA").

[1] The Joint Committee on Taxation (the "JCT") expects that this provision will raise approximately $253.4 billion in revenue over the next 10 years.

In general, the Act repeals the prior earnings stripping rule and replaces it with a much broader and more restrictive limitation. The new limitation is applicable to interest paid to both related and unrelated parties and is applicable without regard to whether the interest is subject to taxation.

The Act limits a corporation's interest deduction to the sum of its interest income and 30% of its adjusted taxable income (approximating EBITDA.) Beginning in 2022, the 30% limitation will be based on earnings before interest and taxes ("EBIT"), rather than EBITDA, which will further tighten the limitation. For purposes of computing the limitation, a consolidated group of corporations is treated as a single taxpayer. Under the old law the limitation was generally computed on a "superconsolidated basis" (i.e., by combining separate consolidated groups under common ownership), whereas the new rules are applied separately for each consolidated group. Similar to the old law, any disallowed interest expenses may generally be carried forward indefinitely.

By adding back interest income into the EBITDA base, the rule operates to limit the deduction to net (as opposed to gross) interest expense. That mitigates the impact of the limitation on taxpayers such as banks and other financial institutions that have both significant interest income and interest expenses.

The limitation operates to restrict the deductibility of interest expenses but does not by its terms apply to other forms of financing costs. Thus, alternative financing structures such as sale-leaseback transactions and partnership structures may become more attractive under the new rules.

Base Erosion Minimum Tax

The Act enacts a new form of minimum tax referred to as the "base erosion minimum tax," that is intended to curtail tax benefits resulting from transactions between U.S. and non-U.S. affiliates that are considered to result in base erosion.[2]

The base erosion minimum tax is an additional tax that, beginning in 2018, is generally imposed on corporate taxpayers (with the exceptions of regulated investment companies, real estate investment trusts and S corporations) that have:

(1) $1.5 billion of gross receipts over the three prior taxable years; and

(2) a "base erosion percentage" (defined below) for the taxable year of 3% or higher (or 2% for banks and securities dealers).[3]

[2] The JCT expects that this provision will raise approximately $253.4 billion in revenue over the next 10 years.

For purposes of the gross receipt test, a foreign corporation generally only takes into account income that is treated as effectively connected with the conduct of a U.S. trade or business ("ECI").

The base erosion minimum tax is imposed at a rate of 5% for taxable years beginning in 2018, which is then increased to 10% for subsequent years, with a further increase of 12.5% beginning in 2025. For consolidated groups that include banks or securities dealers, the base erosion minimum tax rates are 1 percentage point higher (i.e., 6%, 11% and 13.5%).

Determination of Base Erosion Minimum Tax

The base erosion minimum tax is determined in accordance with this formula:

Base erosion minimum tax = (tax rate x modified taxable income) - regular tax liability.

"*Modified taxable income*" is generally taxable income increased by any (X) deduction, depreciation or amortization ("base erosion tax benefits") allowed with respect to amounts paid or accrued to related foreign persons, including amounts paid for the acquisition of depreciable or amortizable property ("base erosion payments"), and (Y) the "base erosion percentage" (defined below) of any net operating loss deduction allowed for the taxable year.

The "base erosion percentage" is generally the aggregate amount of the base erosion tax benefits over the aggregate amount of deductions allowed.

Base erosion tax benefits are generally disregarded if the base erosion payment was subject to U.S. withholding tax (subject to adjustments for payments that qualify for a special treaty rate). However, base erosion benefits generally include deductions attributable to payments that are subject to U.S. taxation as ECI.

Base erosion payments generally do not include:

(1) Payments that reduce gross revenue as basis or cost of goods sold unless paid or accrued to certain related inverted corporations;

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[3] The Act authorizes the Treasury to prescribe additional reporting requirements that allow it to determine the base erosion minimum tax amount, the base erosion payments, and the base erosion benefits. If a corporation fails to furnish any required information to the Internal Revenue Service or fails to maintain sufficient records, such corporation could be subject to a $25,000 penalty for each taxable year with respect to such failure.

(2) Payments for services provided that such payments satisfy the services cost method under the Section 482 regulations; and

(3) Payments made pursuant to certain derivatives and contracts.

For purposes of the base erosion minimum tax formula, the *"regular tax liability"* is generally reduced by income tax credits allowed other than the research and development credits and 80% of certain other credits including renewable electricity production credits and energy credits. However, for taxable years beginning after 2025, the regular tax liability is reduced by all income tax credits.

Cost of Goods Sold; Capitalized Costs

The exclusion of payments that reduce gross income as basis or cost of goods sold is very important as it permits the importation of goods from related persons for manufacturing and production of property without implicating the base erosion minimum tax. However, the scope of this exclusion is potentially much broader in that it excludes a broad range of payments for direct or indirect manufacturing or production costs that are capitalized into costs of goods sold such as certain royalties, service fees and even interest.

"Related Person"; Definition and Practical Considerations

A fundamental concept of the base erosion minimum tax is the definition of a "related person." A "related person" is generally defined broadly to include:

- any 25% or greater owner of the taxpayer;
- any person that is related (within the meaning of Section 267(b) or 707(b)(1) of the Internal Revenue Code) to the taxpayer or to any 25% owner of the taxpayer; or
- any other person that is related (within the meaning of section 482 of the Internal Revenue Code) to the taxpayer.

For purposes of applying the "related person" rules, the ownership attribution rules under Section 318 of the internal Revenue Code are generally applicable, subject to modifications (including the lowering of the percentage limitation in Section 318(a)(2)(C) from 50% to 10%).

The definition of a related person is both broad and highly technical and may cause persons that are remotely related to the taxpayer to be considered a related person.

The definition of a "related person" effectively impose significant compliance requirements because of the need to identify and keep track of the related person status of all foreign counterparties to which the taxpayer makes deductible payments or from whom the taxpayer purchases depreciable or amortizable property. Those compliance issues will not be present with respect to transactions with U.S. counterparties. Taxpayers may or may not be able to obtain cooperation from the relevant counterparties in order to establish that the counterparty is not related to the taxpayer within the meaning of the applicable rules.

Thus, from a tax compliance perspective, because transactions with U.S. counterparties are not subject to base erosion minimum tax it may be significantly less onerous for a taxpayer to engage in transactions or purchase depreciable or amortizable property from U.S. persons rather than foreign persons.

Impact of Utilization Credits

The base erosion minimum tax may have an unexpected impact on corporate taxpayers who generate or have access to significant amounts of tax credits to offset their tax liability. The base erosion minimum tax is generally imposed if the corporation's modified taxable income multiplied by 10% (5% for 2018) is greater than the corporation's regular tax liability, as reduced by credits. Therefore, if a corporation uses tax credits (except for research and development credits or certain renewable energy credits which are carved out until 2025) to pay for its corporate tax liability, that could put the corporation in the position of being liable to base erosion minimum tax in addition to owing its regular tax. Ironically, this could occur even if the corporation does not have any base erosion tax benefits. Stated differently, even if a corporation does not have any base erosion tax benefits, it would be subject to base erosion minimum tax if it uses tax credits to reduce its cash tax liability below 10% (5% in 2018). For a corporation that discharges its tax liability by using credits, thus, the base erosion minimum tax could become an incremental tax that is imposed in addition to its regular tax, rather than a "minimum tax."

Overlap of the Base Erosion Minimum Tax and the Interest Deduction Limitation

To the extent that a taxpayer is subject to the 30% interest deduction limitation (discussed above), the Act provides that the interest paid to unrelated parties is disallowed prior to disallowing any interest paid to foreign related parties. The effect of this rule is thus to preserve the deductions for interest paid to foreign related persons for purposes of the base erosion minimum tax computation. Accordingly, this rule maximizes the amount of payments to foreign related persons which are treated as base erosion payments.

Application to Branches of Foreign Corporations

The base erosion minimum tax applies to foreign corporations conducting business operations in the U.S. through branches (this would include many foreign banks). However the statute contains little guidance regarding the determination of the modified taxable income of a branch. In addition, it is unclear how the imposition of base erosion minimum tax on foreign corporations may be impacted by tax treaty obligations as well as the interplay between the base erosion minimum tax and the branch profits tax.

Treasury to Issue Guidance

It is expected that guidance on the application of the base erosion minimum tax will be issued in 2018, perhaps as early as this summer, and that the guidance will have retroactive effect. It is expected that such guidance will address several technical issues raised by the statute (including, for example, the application of the aggregation rule in Section 59A(e)(3)).

The Act generally authorizes the Treasury to issue regulations or other guidance to prevent the avoidance of the base erosion minimum tax, including through:

(1) the use of unrelated persons, conduit transactions, or other intermediaries; or

(2) transactions or arrangements designed in whole or in part to characterize payments otherwise subject to this provision as payments not subject to this provision or to substitute payments not subject to this provision for payments otherwise subject to this provision.

Payments Involving Hybrid Transactions or Hybrid Entities

Under current law, a taxpayer may generally be denied tax treaty benefits with respect to payments involving "hybrids entities" that are not subject to taxation or deductible in the treaty jurisdiction.[4]

The Act greatly expands the rules targeting "hybrids" by including provisions which, beginning in 2018, generally deny deductions for any interest or royalties paid or accrued to certain related parties pursuant to a "hybrid transaction" or by, or to, a "hybrid entity" to the extent that:

(1) such payment is not included in the related party's income under the tax laws of its country of residence; or

[4] The JCT did not separately estimate the amount of revenue that this provision will raise.

(2) such related party is allowed a deduction with respect to such payment under the tax laws of its country of residence.

As under existing law, compliance with these rules can be complex as the application of the rules depend on and require analysis of the tax treatment of payments, transactions and entities under foreign law.

A *"hybrid transaction"* is generally any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for U.S. federal income tax purposes but which are not so treated by the residence country.

A "*hybrid entity*" is generally any entity which is treated as fiscally transparent for U.S. federal income tax purposes but which is not so treated by the residence country, or vice versa.

Deductions are generally allowed for interest or royalties to the extent they are included in the gross income of a U.S. shareholder under the Subpart F regime.

The Act authorizes the Treasury to issue regulations or other guidance to carry out the purposes of this provision, including: conduit rules, rules for determining the tax residence of the foreign entity, certain structured transactions, and information reporting. It is not clear when such regulations or other guidance will be issued.

Guidance will be needed in many areas relating to the new anti-hybrid rules. For example, it is unclear whether interest or royalty payments to jurisdictions that do not impose income tax (e.g., tax havens) are considered "hybrid transactions".

Impact on Limited Liability Companies, Trusts and Transparent Entities

Legal structures that include U.S. limited liability companies may be impacted by the hybrid entity rules. The characterization of U.S. limited liability companies for non-U.S. tax purposes is unsettled in many foreign jurisdictions. If a foreign jurisdiction treats a U.S. limited liability company that has elected to be treated as a corporation for U.S. tax purposes as transparent, the limited liability company would be a "hybrid entity," thus bringing it under the scope of the under the hybrid entity rules. Conversely, if a foreign jurisdiction treats a limited liability company that has *not* elected to be treated as a corporation for U.S. tax purposes as a corporation, the limited liability company would similarly be treated as a hybrid entity.

Issues similar to those affecting limited liability companies are likely to arise with respect to trusts (foreign as well as U.S. trusts) because the "transparentness" of trusts under U.S. and foreign tax laws is frequently different.

In light of the new rules, U.S. taxpayers who engage in cross-border transactions involving interest or royalties, or cross-border transactions involving limited liability companies, partnerships or trusts, whether such entities are organized onshore or offshore, may need to review such transactions and entities for compliance with the new rules.

Taxation of Offshore Business Operations

Movement Toward a Territorial System

The Act introduces sweeping changes to U.S. international taxation rules. Prior to the Act, under a "deferral regime," U.S. corporations were taxed on their foreign profits when the profits were repatriated to the U.S., subject to the allowance of foreign tax credits. Taxpayers were generally allowed a deferral on certain (generally, active) income that was kept abroad. The Act fundamentally changes this system by ending the tax on repatriated earnings and imposing current taxation on a broader category of offshore income. It accomplishes these changes by:

(1) establishing a participation exemption for the foreign source portion of dividends;

(2) introducing a one-time repatriation tax on accumulated untaxed earnings of foreign corporations; and

(3) retaining the Subpart F anti-deferral regime and imposing a current minimum U.S. tax on a new category of income, "global intangible low taxed income" or "GILTI".

Participation Exemption

The Act introduces elements of a territorial system under which U.S. corporations that have foreign subsidiaries will no longer be subject to tax when the foreign subsidiaries' foreign earnings are repatriated to the U.S. This is implemented through a dividend exemption system that allows U.S. corporations a 100% deduction for the foreign source portion of dividends received from a "specified 10% owned foreign corporation" (the deduction is referred to as a "DRD").

A "specified 10% owned foreign corporation" is any foreign corporation (other than a passive foreign investment company that is not also a CFC) with respect to which there is at least one domestic corporate shareholder which owns 10% or more of its stock. No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to the exempt portion of the dividend (i.e., the portion with respect to which the DRD is available) and the domestic corporate shareholder of the specified 10% owned foreign

corporation must compute its foreign source taxable income for purposes of the tax credit limitation by excluding the exempt portion of the dividend and any deductions attributable to such exempt portion. Generally, a one-year holding period is required to claim the DRD. Solely for purposes of determining a loss, a domestic corporate shareholder's basis in the stock of a specified 10% owned foreign corporation must be reduced by the exempt portion of the dividend.

To the extent gain from the sale of stock in a foreign corporation is treated as a dividend under Section 1248, it would also be eligible for the DRD.

Repatriation Tax

Without a repatriation tax, the new participation exemption would allow U.S. corporations to repatriate trillions of dollars of offshore earnings accumulated before 2018, without to any U.S. tax. Congress enacted a one-time transition tax which provides that U.S. shareholders of specified 10% owned foreign corporations must include into income the accumulated foreign earnings and profits of such corporation.

Under the Act, accumulated foreign earnings held in cash are, effectively, taxed at a 15.5% rate and accumulated foreign earnings held in illiquid assets are, effectively, taxed at an 8% rate. However, the mechanics of the inclusion are more complex. The Act implements the mandatory inclusion using a modified version of the existing Subpart F regime. Because the Act's drafters chose this mechanism, they had to provide for a deduction regime in order to arrive at the intended tax results (i.e., a 15.5% tax on accumulated foreign earnings and profits held in cash and an 8% tax on accumulated foreign earnings and profits held in illiquid assets). The Act also limits the amount of foreign taxes that are creditable against the mandatory inclusion.

Controlled Foreign Corporations

Despite the movement towards a territorial tax system, the Act not only retains but expands the "Subpart F rules" applicable to "controlled foreign corporations" that were the cornerstones of the anti-deferral provisions under the prior tax regime.

The Act modifies and expands the attribution rules for purposes of determining the status of a corporation as a CFC and a shareholder as a U.S. shareholder. In particular, it allows the stock owned by a foreign person to be attributed to a U.S. corporation owned by such foreign person. This rule would effectively treat "brother-sister" affiliates of a U.S. corporation owned by a foreign parent as a CFC.

It appears that not all ramifications of the modification of the CFC ownership attribution rules were intended. While the modification may not necessarily change the scope of a Subpart F inclusions (which are based on direct and indirect ownership, but not on constructive ownership), it is a trap for the unwary. On January 19, 2018, the IRS

published Notice 2018-13, where it provided relief from certain reporting requirements (e.g., the filing of Form 5471) with respect to foreign corporations that are CFCs solely because a U.S. person is considered to own the stock of the CFC as a result of the "downward attribution" rules.

GILTI

Prior to the Act, the Subpart F anti-deferral regime covered only certain types of income (generally, passive income) so that U.S. corporations could generally defer U.S. taxation of non-Subpart F income (generally, active income). The Act expands the anti-deferral regime by imposing current taxation on a new category of income called the "global intangible low-taxed income" or "GILTI."

While its name suggests that the GILTI tax is aimed at income generated by intangibles, it is important to note that the scope of the GILTI tax is much broader than that. The GILTI tax covers income from a broad range of profitable offshore businesses, and may potentially apply to offshore businesses that generate little or no income from intangibles.

Generally, GILTI is determined under the following formula:

GILTI = *the shareholder CFC's "tested income" - the shareholder's "net deemed tangible income return."*

- *"tested income"* refers to a CFC's aggregate net income excluding Subpart F income and effectively connected income.

- *"net deemed tangible income return"* is an amount equal to a 10% return on the adjusted tax basis of depreciable tangible property used in the CFC's trade or business, less certain interest expenses allocable to the CFC.

GILTI is thus generally determined as the residual income left after subtraction of a deemed 10% return on depreciable assets. The impact of that, of course, is to potentially capture the income of the CFC without regard to whether it owns or uses intangibles to generate income.

The GILTI tax generally disincentivizes taxpayers from holding low-basis assets in low-tax jurisdictions. Conversely, the tax incentivizes taxpayers to hold high-basis assets in low-tax jurisdictions. Foreign corporations with little basis in depreciable tangible property, such as service corporations, as well as corporations with high-value intangibles, may have a significant portion of their income classified as GILTI.

Determination of GILTI Tax

The full amount of GILTI is included in the U.S. shareholder's income as a Subpart F inclusion, but the U.S. shareholder is then allowed a 50% deduction (reduced to 37.5% in 2026) for GILTI.[5] Foreign tax credits are still allowed to offset U.S. tax on GILTI, but they are limited to 80% of foreign taxes paid. In addition, the Act creates a separate basket for foreign tax credits paid with respect to GILTI. Such foreign tax credits can only be used to offset tax on the GILTI inclusion; they cannot offset other types of income nor can they be carried back or forward.

As a result of the deduction for GILTI and an 80% credit for foreign taxes:

- If the foreign tax rate on GILTI is zero, the U.S. residual tax rate on GILTI is 10.5%;

- The minimum foreign tax rate with respect to GILTI at which no residual U.S. tax is owed is 13.125% (13.125% X 80%= 10.5%);

- For foreign tax rates on GILTI ranging between zero and 13.125%, the total combined U.S. and foreign tax rate on GILTI ranges between 10.5 and 13.125%; and

- For foreign taxes greater than 13.125%, there is no residual U.S. tax on GILTI and the effective U.S. and foreign tax rate on GILTI is the foreign rate.

To illustrate, assuming foreign taxes on GILTI are 13.125%:

Basis in Depreciable Tangible Assets	0%
Income	100%
Foreign Tax	13.125%
Tested Income	86.875%
Deemed Tangible Return	0%
Section 78 Gross-Up	13.125%

[5] Including the Section 78 gross-up for foreign taxes paid.

Section 951A Inclusion	100%
50% GILTI Deduction	50%
Taxable Income	50%
Tax at 21%	10.5%
Tax Credit (80% of Foreign Tax)	10.5%
Incremental Tax in U.S.	0%
Effective Tax Rate	13.125%

The deduction for GILTI is only available to C corporations that are not regulated investment companies or real estate investment trusts.

Changes to Section 367

The Act repeals the active trade or business exception to Section 367(a), which allowed transfers of property used in active conduct of a trade or business to a foreign corporation without a charge.

Taxation of Export Income

Foreign Derived Intangible Income

The Act creates a special preferential tax regime for the taxation of income derived by U.S. corporations from sale of tangible as well as intangible property to foreign persons, and the provision of services outside the U.S. The new regime, enacted as Section 250 of the Internal Revenue Code, is referred to as "foreign-derived intangible income" ("FDII") and, as explained below, reduces the effective tax rate on FDII from the statutory rate of 21% to 13.125%. The FDII regime could produce significant tax benefits for exporters, including foreign-owned exporters, and could provide a powerful incentive for export businesses to locate in the U.S.

The reference to "intangible income" is a misnomer in that, as in the case of the GILTI tax discussed above, the preferential tax regime is available with respect to sale of goods, tangible and intangible property and the provision of services regardless of whether the

income is attributable to intangibles or the taxpayer is employing intangibles to produce the income.

In order to assess the impact of the FDII regime, it is helpful to consider the FDII regime together with its companion provision the GILTI regime. The GILTI regime is aimed at U.S.-based companies operating offshore. Under the GILTI regime, income derived by foreign subsidiaries of U.S. corporations is subject to U.S. taxation on a current basis at a rate of 10.5%.

The combined effect of the FDII and the GILTI regimes is thus to incentivize U.S. corporations to locate businesses that serve export markets in the U.S. rather than offshore jurisdictions. This is achieved by using a carrot in the form of FDII and a stick in the form of GILTI.

Determination of FDII and Computation of Tax

Under the FDII regime, U.S., corporations are entitled to a special deduction equal to 37.5% of a U.S. corporation's FDII against a U.S. corporation's taxable income. The 37.5% deduction is reduced to 21.875% after year 2025. As illustrated below, the 37.5% deduction reduces the effective tax rate on FDII from 21% to 13.125% (16.406% after 2025).

Generally, the determination of a corporation's FDII under Section 250(b) of the Internal Revenue Code can be illustrated by the following formula:

FDII = "*deemed intangible income*" x ("*foreign derived deduction eligible income*" / "*deduction eligible income*")

- "Deemed intangible income" refers to a corporation's "deduction eligible income" reduced by its "deemed tangible income";
- "Deemed tangible income" is generally equal to 10% of the average adjusted tax basis of the corporation in depreciable tangible property;
- "Deduction eligible income" is generally a corporation's net income, excluding certain types of income that is already subject to U.S. tax under different regimes, such as subpart F income and GILTI;
- "Foreign derived deduction eligible income" generally means income that is derived from the sale of tangible or intangible property to foreign persons, or the provisions of services outside the U.S.

On the face of the statute, thus, the greater the amount of "foreign derived deduction eligible income", the greater the amount of the FDII deduction. In other words, the greater the amount of income from exports of property and services, the greater the FDII deduction.

FDII Applies to Sales of Property and Has Little or No Correlation to Intangible Income

As indicated above, the FDII deduction is available with respect to sales of goods, property or provision of services regardless of whether the taxpayer is employing intangibles to produce the income.

In general, as indicated above, the starting point for determining a taxpayer's FDII deduction is the taxpayer's "deemed intangible income". The "deemed intangible income" is the residual amount remaining after subtracting from the taxpayer's "deduction eligible income" (i.e., the taxpayer's net taxable income subject to certain adjustments) an amount equal to 10% of the taxpayer's tax basis in depreciable assets (if any). The subtraction of 10% of the taxpayer's tax basis in depreciable assets represents a hypothetical deemed economic return on the taxpayer's tangible assets. Accordingly, subject to certain adjustments, a taxpayer's "deemed intangible income" is all of the taxpayer's taxable income from all sources (irrespective of whether such income is produced by intangibles or other assets) less a deemed return of 10% of the taxpayer's tax basis in depreciable assets. Stated differently, the entire net income of the taxpayer in excess of
10% of its tax basis in depreciable assets is deemed to be attributable to intangibles even if the taxpayer employs little or no intangibles to produce the income.

It should be noted that by using 10% of the taxpayer's tax basis in depreciable assets as the proxy for the economic return from tangible assets, the real economic return from tangible assets will in many cases be significantly understated (and FDII correspondingly overstated) because the taxpayer may have little or no basis in its depreciable assets, if any. For example, the taxpayer may have fully depreciated all of its assets for tax purposes, may hold non-depreciable rather than depreciable assets or may simply be engaged in a business which require little or no depreciable assets. In addition, by using tax basis as the measure of assets, the true economic value of the tangible assets will in many cases be understated.

Following the determination of the taxpayer's "deemed intangible income", FDII is then computed by multiplying the "deemed intangible income" by a fraction, the numerator of which is the taxpayer's "foreign derived deduction eligible income" and the denominator of which is the taxpayer's "deduction eligible income". For this purpose the "foreign derived deduction eligible income" is the taxpayer's gross income derived from the sale of property to foreign persons and the provision of services outside the U.S. Thus, the numerator reflects sales of both tangible and intangible property, as well as

the provision of services. The fraction therefore has no correlation to income produced by intangibles, which may be nil.

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