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FDII (Foreign Derived Intangible Income)

New tax incentives encourage companies to keep operations and intangible property in the U.S.

Key Takeaways

- FDII introduces an attractive incentive for companies to keep their operations and intangible property in the U.S.—especially companies with minimal fixed assets.
- The rate on FDII through 2025 is 13.125 percent. This reduces or eliminates the relative tax advantage of owning property and conducting operations in a foreign subsidiary.
- Companies should analyze the impact of the TCJA and FDII on their operations and structure appropriately going forward.

Introduction

The landmark Tax Cuts and Jobs Act (TCJA) passed in late December introduced the biggest change to tax policy since the Tax Reform Act of 1986. The TCJA is already having a profound impact on U.S. corporations and individual taxpayers. The jury is still out about whether the sweeping tax reform package will supercharge the economy with "rocket fuel" as President Trump has claimed. That said, if you or your company invests overseas or does business overseas, then you should pay attention to some of the international tax provisions embedded in the new rules that rarely make headlines.

Take, for instance, Foreign Derived Intangible Income. FDII effectively creates a new preferential tax rate for qualified income that's derived by domestic corporations when they serve foreign markets.

What Is FDII?

FDII is a new category of income that is exclusively applicable to domestic corporations that are taxed as C corporations. On its most basic level, FDII is a new regime to encourage domestic exports to foreign markets – whether that is tangible products, services, or the licensing of IP. The name "FDII" is a bit of a misnomer since it applies to any type of income, including income from sales of tangible property, above a 10 percent return on fixed assets.

Under the new rules, a corporation pays an effective rate of 13.125 percent (down from the flat 21 percent corporate rate) on its qualified FDII arising from serving foreign markets. The reduced rate is achieved through a deduction allowed on FDII.

Policy Perspective

The tax reform bill was designed to boost the U.S. domestic economy and to encourage business activity in the U.S. Taking a high level look at the new rules, we see the corporate rate has dropped a whopping 14 percentage points to 21 percent rate from 35 percent. By contrast, the top individual rate has dropped only 2.6 percentage points to 37 percent from 39.6 percent.

Lawmakers and supporters of the bill are clearly hoping that businesses will increase their investments and activity in the U.S. to provide a boost for American workers. In addition to a significant drop in the corporate rate, there are a variety of incentives within the TCJA to boost investment and production in the U.S. For example, to incentivize investment in U.S. business assets, there is now a 100 percent first-year bonus depreciation allowance for qualified property.

The TCJA uses a "carrot and stick" approach to encourage companies to keep business activity and intangible property in the U.S. The **carrot**, of course, is FDII which incentivizes American companies to keep operations in the U.S. that could otherwise be centered overseas. The **stick** is Global Intangible Low Taxed Income (GILTI) which penalizes companies that move their intangibles or operations overseas – particularly when those intangibles or operations are shifted to low-tax jurisdictions, such as Ireland.

Calculating FDII

Calculating FDII and the related deduction can seem unnecessarily complex. To make the computation manageable (and to avoid making expensive mistakes), we recommend a step by step approach (see table below):

		INCLUDES	NOTES
STEP 1	Determine deduction eligible income.	Gross income of the corporation less certain excluded items reduced by properly allocable deductions.	Excluded items may include Subpart F, GILTI, financial services income, dividends from a CFC, oil and gas extraction income, and foreign branch income.
STEP 2	Determine foreign derived deduction eligible income.	Income derived from property sold to a non-U.S. person that is for a foreign use **and** Income derived from services provided by the taxpayer to non-U.S. persons or with respect to property located outside of the U.S.	Foreign use defined as any use, consumption, or disposition outside of the U.S. A sale includes a lease, license, exchange, or other disposition.

STEP 3	Calculate deemed intangible income.	a) Deemed intangible income which equals deduction eligible income in excess of a 10 percent return on the corporation's qualified business asset investment. b) Qualified business asset investment which equals the adjusted bases of tangible property used in a trade or business of a type with respect to which a deduction is allowable under section 167.	
STEP 4	Calculate Foreign Derived Intangible Income (FDII).	FDII which equals deemed intangible income multiplied by the ratio of foreign derived deduction eligible income over deduction eligible income.	

The corporation's deduction = 37.5% of FDII for tax years beginning before 2025 + 21.875% of FDII for tax years beginning after 2025.

Beneficiaries of the new FDII rules

FDII is particularly appealing to those in industries that do not require significant fixed assets. Those industries include: Service providers, technology platforms, software companies, medical device companies, industrials with patents, and entertainment companies to name a few.

Mid-sized businesses and startups clearly have the flexibility to structure themselves for FDII and to take advantage of it. However, it's harder for most large, U.S-based multinational companies to take advantage of FDII because in their structures, intangible property is often based offshore. For example, Apple made headlines because of its "double Irish" tax structure that helped the company achieve an extremely low corporate tax rate in Ireland.

While companies may still try to reduce their tax rates by using hybrid instruments or by shifting profits between borders, these schemes are increasingly under attack. For example, the double Irish structure was eliminated after facing significant pressure from the European (EU) and the Organization for Economic Cooperation and Development's BEPS project (Base Erosion and Profit Shifting). In the EU, BEPS continues to be implemented and the EU's ATAD (Anti-Tax Avoidance Directive) and ATAD 2 will further limit companies' ability to strip profits with hybrid instruments. In the U.S., the TCJA introduced GILTI, which at a high level, treats any income from a Controlled Foreign Corporation, above a 10-percent return on qualified business asset investment, as a deemed dividend back to the corporation's U.S. owner on an annual basis.

Those changes, along with the FDII incentive, should materially affect the planning for companies looking to expand overseas or to export goods or services from the U.S. The new tax landscape may also cause even the largest U.S. multinationals to reconsider how their operations are structured.

Transactions impacted by the new rules

According to a recent poll conducted by a Big Four accounting firm, there are for major types of international business transactions likely to be impacted by the new FDII rules:

1. Direct sales to foreign customers.
2. Provision of services to property or persons located abroad.
3. Sales to related foreign parties followed by ultimate sales to foreign customers.
4. Royalties from licensed properties.

Determining foreign use

"Foreign use" is defined as any use, consumption, or disposition outside of the U.S. On the surface, this is fairly straightforward, but there are a few special rules to keep in mind when determining this component of the new rules.

The first set of rules applies to unrelated parties in the U.S. At a high level, property sold or services provided to a domestic intermediary will ***not*** qualify as foreign use. Thus, property that is further manufactured or modified in the U.S. and sold to an unrelated person, is not treated as foreign use even if it is subsequently considered foreign use property. Along the same lines, if a service is provided to an unrelated person within the U.S., those services will not qualify as foreign use.

The second set of rules applies to related parties outside of the U.S. If property is sold to a related party who is not a U.S. person, then the property needs to be resold or used by that related party to or for another unrelated person who is not a U.S. person. Services provided to a related foreign party will only be treated as foreign use if the same, or similar, services are not provided by that related party to persons located in the U.S.

Real world examples

1. **Subscription-based real estate site.** This company operates a subscription-based website that has proprietary information about real estate markets, property values, rents, etc. – i.e. different analytic information. This company has a European subsidiary in the Netherlands that holds the IP rights for its platform in all non-U.S. markets. The company did some analysis after tax reform was passed to determine the best way to operate going forward. Until now, the company would have

been better off keeping some operations overseas. But now, thanks to FDII and the new lower corporate tax rate, it will be better off staying entirely in the U.S. and operating from the U.S.

2. **Agricultural processor.** This U.S.-based company processes and sells bulk products including corn oil and tallow. Some of its sales are made to foreign buyers, so the company is considered an exporter. The company's owners are planning to convert from an S-Corporation to a C-Corporation in order to take advantage of the new lower corporate tax rate and FDII deduction.

Conclusion

The TCJA has dramatically changed the tax planning and structuring landscape. FDII is a key part of the TJCA's policy and introduces an incentive for domestic corporations to keep their operations and intangible property in the U.S. even when serving foreign markets. The preferential tax rate of 13.125 percent on FDII is attractive and even the 21 percent default U.S. corporate tax rate is competitive on a global scale. Companies that are doing business overseas, or that serve foreign clients, should review their operations carefully to analyze the impact of the TCJA and structure appropriately going forward.

If you or a colleague has questions about the impact of the TJCA or FDII on your business or investment, please don't hesitate to contact me at 714-361-7685 or John.Samtoy@hcvt.com

About the Author

John Samtoy is a Principal in the Irvine, CA office of HCVT. John specializes in international tax consulting and compliance services and serves high net worth individuals, closely held businesses, and private equity clients across a variety of industries. John has experience serving multinational clients immigrating to and doing business in the U.S. as well as U.S. clients working and establishing operations overseas.