FDII

Key Points

- Established in the TCJA, Foreign Derived Intangible Income (FDII) defines certain foreign earnings as eligible for a special reduced tax rate.
- The purpose of FDII is to incentivize companies to keep or bring back highly mobile intangible assets.
- FDII serves as one part of the system enacted in the TCJA to make the tax code more competitive.
- GILTI and FDII work in tandem to ensure the tax rate on profits earned from intangible assets remains close across companies, regardless if the assets are held in the U.S. or abroad.
- Because the lower tax on FDII is tied to the corporate tax rate, proposals to increase the corporate rate will directly impact FDII.

Foreign Derived Intangible Income (FDII) is a new definition of earnings for U.S. companies developed in the Tax Cuts and Jobs Act (TCJA). It is designed to serve as a benefit for companies that hold intellectual property (IP) in the U.S. and have foreign sales by reducing the tax on profits from those sales. The purpose of the FDII benefit is to encourage domestic companies to hold or bring IP to the U.S. and keep those profits here by providing a lower tax rate of 13.125 percent on those profits.

The structure of FDII is similar to Global Intangible Low Tax Income (GILTI), incorporating many of the same components used to calculate the tax on GILTI to determine the benefit of FDII. The two policies are considered mirror images, GILTI ensuring companies pay some amount of tax and FDII reducing taxes on similar income.

FDII is equal to foreign-derived profits in excess of "normal" returns to investments. This is defined as 10 percent of assets known as Qualified Business Asset Investment (QBAI). Foreign-derived income is the share of a corporation's U.S. income related to the export of goods or services based on IP held in the U.S. QBAI for purposes of the FDII is equal to the value of tangible assets used in earning foreign-derived income. For example, a company may own a factory in the United

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States and export widgets to Germany. This company's foreign-derived income would be the income from the sale of those widgets overseas, and the U.S. factory would be counted as QBAI for the purposes of FDII.

Companies are allowed to deduct 37.5 percent of their FDII against their taxable income. This brings the effective rate on each dollar of FDII to 13.125 percent.

Suppose a company earned $10,000 in total income in the United States and 10 percent was earned by exporting goods overseas ($1,000). This company has $9,000 in QBAI related to its export activities. This implies that the company's FDII is $100: $1,000 in foreign derived income minus 10 percent of QBAI ($900). This company would then be allowed to deduct 37.5 percent of its FDII ($37.50) against its taxable income. The result is taxable FDII of $62.50 and a tax liability of $13.125, an effective tax rate on FDII of 13.125 percent.

Total U.S. Income	$10,000
Export Share of Income	10%
QBAI	$9,000
FDII	
Foreign Derived Income	$1,000
Minus	
QBAI Exemption (10% of QBAI)	$900
Equals	
FDII	$100
Taxable FDII (FDII minus 37.5% deduction)	$62.5
FDII Liability	$13.125

For intangible earnings, the combination of the lower corporate tax rate, territorial treatment, and FDII serves to provide a tax benefit to companies that hold their intangible assets in the U.S. The new system contrasts with the previous system of worldwide taxation, deferral, and a high corporate tax rate that incentivized companies to place their intangible assets in offshore low-tax jurisdictions.

FDII and GILTI are designed to provide a backstop to the participation exemption that forms the basis of the territorial tax system enacted by the TCJA as well as reduce incentives for companies to move IP overseas. This idea is illustrated by the tax rates on GILTI and FDII. The tax rates on IP located abroad and therefore subject to the GILTI regime range from 10.5 percent to 13.125 percent. The tax rate on IP located in the U.S. and benefiting from FDII treatment is 13.125 percent. In theory, companies should face about the same tax rate on profits from IP, regardless of where that IP is located.

Because tax rates on both FDII and GILTI are tied to the U.S. corporate rate, raising the corporate rate would increase the tax rates on both. This would mean the tax burden on domestic income connected to IP and exports would rise alongside the tax burden on foreign earnings.

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