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FOREIGN-DERIVED INTANGIBLE INCOME

The Tax Cuts and Jobs Act (TCJA) enacted a new provision that effectively establishes a new preferential tax rate for income derived by domestic corporations serving foreign markets. This provision is called the deduction for foreign-derived intangible income (FDII). The FDII deduction applies broadly to a variety of transactions entered into by U.S. corporations. These rules are designed to entice U.S. multinationals to relocate foreign operations back to the United States and increase new investment in U.S. operations. On July 15, 2020 the IRS and Treasury released final FDII regulations applicable for taxable years beginning on or after Jan, 1, 2021 (with some exceptions). However, taxpayers may apply the final regulations for taxable years beginning on or after Jan. 1, 2018, provided they apply the regulations in their entirety.

This is a welcome change for domestic corporations because these businesses can now further reduce their effective tax rate to 13.125% (rather than 21%) on income derived from qualifying foreign sales and service activity. However, the FDII benefit may contravene some of the obligations the United States has under its trade agreements. In addition, other countries may challenge FDII in court; those legal challenges could take years, if they ever occur at all. In the meantime, taxpayers should consider whether FDII planning is appropriate for them.

Qualifying activity and FDII deduction

The FDII deduction is computed using a complex, multistep process. Part of this process requires companies to perform a detailed transaction analysis to identify areas of business operations and opportunities that may qualify for this new tax incentive. In general, a corporation will need to determine the foreign portion of its deduction-eligible income. This includes income generated from the sale of property to any foreign person for foreign use, consumption or other disposition which is not within the United States. For FDII purposes, a sale can include leasing and licensing activity. In addition, qualifying services provided to persons outside the United States, or with respect to property located outside the United States, are also eligible for FDII benefits. Related-party sales and services may qualify for FDII purposes but are subject to additional requirements and scrutiny.

A corporation also needs to determine its deemed intangible income, which is essentially the corporation's taxable income less a deemed rate of return on its tangible depreciable business assets. This is measured by taking the excess of the corporation's deduction eligible income (if any) over 10% of its qualified business asset investment (QBAI). QBAI is the quarterly average of the corporation's adjusted tax basis of its depreciable tangible business assets using straight-line depreciation.

Based upon the foreign portion of the corporation's deduction-eligible income, a ratio is computed and applied to the corporation's deemed intangible income to derive its FDII. A corporation's FDII is 37.5% deductible, subject to income limitations, which produces an effective tax rate of 13.125% on qualifying foreign income.

Qualified taxpayers

The FDII deduction is available for domestic corporations taxed as C corporations, including U.S. subsidiaries of foreign-based multinationals. In addition, a domestic corporate partner of a partnership is able to take into account its distributive share of the qualified partnership income and QBAI in calculating its FDII.

Currently, regulated investment companies, real estate investment trusts, S corporations, partnerships, individuals and foreign corporations with U.S. trade or businesses are not eligible for the FDII deduction.

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Substantiation rules

In order for domestic corporations to substantiate their FDII-eligible transactions, the final regulations provide substantiation rules that are flexible with respect to the types of corroborating evidence that may be used to support foreign status, foreign use and location of the recipient's business operations.

These rules vary depending on the transaction type and taxpayers may need to make significant efforts to determine whether the regulatory requirement is met. For certain transactions, the final regulations specify the documentation needed to substantiate the facts necessary for the income to qualify. If no specific substantiation is required, the taxpayer claiming a deduction will still hold the burden of clearly showing the right to the claimed deduction.

Opportunities and risks

It is key to work with an advisor who understands your business, goals and tax structure, as well as the complexities of the TCJA. Computing FDII requires a significant amount of information and is a complex calculation. However, understanding the impact FDII may have on your organization may allow you to maximize planning opportunities and minimize risk. At RSM, we can assist with navigating you through this new tax incentive by providing services such as the following:

- Assessing FDII impact on your current tax structure and operations
- Navigating through documentation requirements to support FDII-eligible operations
- Calculating components of the FDII computation to be furnished by partnerships to direct and indirect corporate partners
- Reassessing transfer pricing strategies
- Performing a value-chain analysis
- Assessing FDII impact in an overall entity selection evaluation (e.g., pass-through versus C corporation)
- Winding down foreign subsidiaries or foreign branches
- Onshoring of intellectual property

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