THE POWER OF BEING UNDERSTOOD

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. The new provision is described as a deduction for foreign-derived intangible income (FDII). The FDII deduction is broad in application and applies to a variety of transactions. This is generally because these rules are designed to entice U.S. multinationals to relocate foreign operations back to the U.S. and increase new investment in U.S. operations. This is a welcome change for domestic corporations because these businesses can now further reduce their effective tax rate to 13.125 percent (rather than 21 percent) 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, but 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, multi-step 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 generally 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 U.S., or with respect to property located outside the U.S., 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 percent 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 percent deductible, subject to income limitations, which produces an effective tax rate of 13.125 percent 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. 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.

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
- Winding down foreign subsidiaries or foreign branches
- Assessing FDII impact in an overall entity selection evaluation (e.g. pass-through versus C corporation)
- Reassessing transfer pricing strategies
- Onshoring of intellectual property
- Performing a value-chain analysis

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