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The Foreign Derived Intangible Income (FDII) Deduction: Why It Belongs on the Chopping Block

Both the Made in America Tax Plan[1] and the No Tax Breaks for Outsourcing Act[2] (H.R.1785, S.714) call for the elimination of the Foreign-Derived Intangible Income (FDII) tax break introduced in 2017 by the Tax Cuts and Jobs Act (TCJA). Eliminating this provision would be a big revenue raiser: the U.S. Treasury and Joint Committee on Taxation expect an increase between $124 billion and $224 billion respectively in revenue over ten years.[3]

The FDII was crafted to promote US research and development and preempt potential abuse of the TCJA reforms to minimize corporate tax liability.[4] The TCJA introduced a spread between the tax rates paid by US multinational corporations' foreign subsidiaries (the GILTI rate of 13.125 percent)[5] and the domestic rate of 21 percent. That created an incentive to use accounting tricks to move intellectual property offshore, or worse, move actual research and development activities offshore. US multinationals could sell their intangible assets (like patents and brands) at deflated prices to their own subsidiaries in tax havens, which would then charge royalties at inflated prices to other subsidiaries throughout the world. That would shift profits to tax havens and lower tax bills for multinational corporations. To address that problem, the TCJA also created the FDII deduction, which reduces the tax rate on intellectual property-intensive exports of goods and services to 13.125 percent. The FDII is meant to level the playing field between the export-oriented domestic operations of US multinationals and their foreign operations.[6]

In practice, however, the FDII fails to promote research and development; it perversely incentivizes the offshoring of US jobs and profits; it discriminates against producers serving the domestic market; and it under review for violating international law. There is a better way.

1. FDII is a poor incentive for research and development.

Although FDII was created in the name of innovation, it is not tied to actual spending on research and development in the United States. The FDII formula approximates innovation as the profits in excess of a 10 percent return on tangible assets like buildings and machinery. Such super-profits may reflect past

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[1] https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf

[2] https://thefactcoalition.org/fact-sheet-taming-the-offshoring-of-jobs-and-profits-the-case-for-equalizing-rates/

[3] The lower estimate is extracted from the FY2022 federal budget (Treasury Department, May 2021, https://bit.ly/2STRszU). The higher one is from the Joint Committee on Taxation's scoring of a bill that contains similar provisions, the Corporate Tax Dodging Prevention Act, https://bit.ly/3vdzm9V.

[4] For a good description of FDII, see https://tpc.io/3ycSOFo.

[5] The GILTI rate is 10.5%, but GILTI allows a credit for foreign taxes of only 80%. Considering foreign taxes, the GILTI rate is thus 13.125%.

[6] The FDII deduction is also available to US exporters that do not have foreign operations.

spending on research and development – carried out in the United States or abroad – but also other things like brand value or the exploitation of a monopoly niche that government has failed to close. The FDII deduction is to a large extent a tax break on windfall income.

2. FDII perversely incentivizes jobs offshoring.

As the FDII deduction is based on profits in excess of a 10 percent return on domestic tangible assets, the fewer tangible assets a US corporation has, the greater the tax break it gets. That constitutes a perverse incentive to decrease investment in tangible assets in the United States and the jobs that go with them.

3. FDII favors exports and is therefore discriminatory

The FDII deduction introduces a distortion in the economy that puts the thumb on the scales for exporters at the expense of producers for the domestic market. Take Amazon and T-Mobile, for example, both headquartered in Washington state. Amazon is a global company that benefits significantly from FDII, through which the corporation lowered its 2020 effective tax rate from 13.4 percent to 11.8 percent according to its financial statements. By contrast, T-Mobile, like other major US telecom companies, serves mainly the domestic market and benefits little from FDII. Its effective tax rate was 22.3 percent in 2020. (T-Mobile's financial statements do not show any benefit from FDII, probably because it is small.) Both companies are innovative and directly compete in some market segments – indeed Amazon reportedly considered buying a business from T-Mobile in 2019.[7] There is no economic justification as to why the tax code should favor exporters like Amazon over producers serving the domestic market like T-Mobile.

Likewise, the FDII deduction has ruffled the feathers of international partners. FDII is currently under peer review as a "harmful tax practice" by the Organization for Economic Cooperation and Development (OECD). Harmful tax practices are tax haven-grade schemes designed to steal other countries' tax revenues. The United States is bound by an international agreement to abandon harmful tax practices. FDII is the only provision in the US tax code that is under such scrutiny.

Even if it passes the OECD test, FDII may also be challenged as an illegal export subsidy under World Trade Organization (WTO) rules. Foreign countries may eventually have the right to apply retaliatory tariffs against US exports to make up for the increase in exports linked to FDII.

4. The No Tax Breaks for Outsourcing Act offers a better way

The No Tax Breaks for Outsourcing Act (H.R.1785, S.714) resolves the root cause of the problem that FDII was meant to address: by equalizing the domestic and GILTI rates, this bill would entirely remove the incentive to artificially move intellectual property offshore, or worse, American jobs.

[7] https://reut.rs/3hqdv9M

The Made in America Tax Plan proposed by the Biden Administration would repeal the FDII deduction and use the revenue for new research and development incentives. It would also reduce, but not entirely eliminate, the spread between the domestic and GILTI rates. Some incentive to artificially offshore intellectual property would remain.

Another framework proposed by Senate Finance Committee Chair Wyden (D-OR), Senator Brown (D-OH), and Senator Warner (D-VA) would preserve FDII to prevent the artificial offshoring of intellectual property.[8] But it would modify it such as to eliminate the incentive to offshore tangible assets and to introduce a link between FDII and actual research and development activities in the United States. Nevertheless, it would preserve the discriminatory link to exports.

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[8] https://www.finance.senate.gov/imo/media/doc/040121%20Overhauling%20International%20Taxation.pdf