5x5 series: Insights and actions

FDII issues and potential opportunities

Foreign Derived Intangible Income (FDII) is a category of income for US corporations that was introduced under the TCJA. The section 250 deduction provides an effective tax rate of 13.125% on US income derived from both sales of general property or intangible property to foreign parties for foreign use and the provision of a service to a foreign person, or with respect to property not located within the US , in order to support the policy goals of increasing exports of US goods and services and encouraging US companies to locate more intangible assets in the US. Subsequent regulations and legislative proposals present a complex series of issues for US corporations to analyze, but the analysis is an investment that may reveal the potential to reduce cash taxes.

5 insights you should know

1. Certain transactions are subject to specific substantiation requirements in order to qualify for a FDII deduction. Taxpayers who do not substantiate their deduction are not entitled to a FDII deduction (zero deduction).
2. New section 174 rules provide that R&E expenditures must be capitalized or amortized for tax years beginning after 12/31/2021, in contrast to previous rules which allowed taxpayers to adopt a method to either currently deduct or capitalize/amortize R&E expenditures.
3. Some supply chain structures produce income that is taxed at the US rate of 21%, while others produce income that may qualify as FDDEI (which may be taxed at a lower rate).
4. When higher future tax rates are contemplated, one way to reduce cash taxes is to accelerate income in the current tax rate environment or defer deductions to a future, higher-rate tax environment.
5. The final FDII regulations require that a corporation's deductions are allocated and apportioned to gross DEI and gross FDDEI under the rules of §§ 1.861-8 through 1.861-14T and 1.861-17 by treating section 250(b) as an operative section described in § 1.861-8(f).

5 actions to take now

1. **Establish systems and processes.** Transactions occurring on or after 1/1/2021 must be properly substantiated; therefore, taxpayers should have systems and processes in place to extract or collect the data as part of the compliance process
2. **Analyze impact of mandatory capitalization of section 174 costs.** Consider when it's appropriate to recharacterize SG&A and/or R&E expenses to reduce expense apportionment and identify whether the corresponding FDII deduction impact is positive or negative.
3. **Analyze supply chain structure.** Modifying contracts or the supply chain structure, in alignment with business objectives, may qualify some income for FDDEI treatment and save cash tax.
4. **Accelerate FDII qualifying income with FDII-eligible prepayments.** Prepaying FDII-eligible income at the current 21% tax rate: consider the effect of certain prepaid income on expense allocation and apportionment, particularly with the prospect of increasing tax rates.
5. **Analyze expense allocation and apportionment methodologies.** Consider completing a detailed review of expense allocation and apportionment methodologies and ensure consistency with other calculations, including FTC calculations. Analyze R&E allocation and apportionment methodology to ensure conformance with complex guidance in § 1.861-17.

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