Pinpoint
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TAX REFORM 2025

FOREIGN DERIVED INTANGIBLE INCOME (FDII)

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HIGHLIGHTS

- The "One Big Beautiful Bill" currently under consideration in Congress would largely preserve the FDII deduction at its current rate. As part of the Tax Cuts and Jobs Act (TCJA), Congress enacted a sweeping reform of the U.S. international tax system.
- As part of this reform, policymakers created the Foreign Derived Intangible Income (FDII) provision, which provides a crucial incentive for U.S. firms to retain intellectual property and associated profits domestically, fostering innovation and boosting export-driven growth
- As Congress considers the looming expiration of key elements of the TCJA, they should be mindful of the intricate balance tax writers struck in crafting FDII in concert with other international tax policies.
- The "One Big Beautiful Bill" currently under consideration in Congress would largely preserve the FDII deduction at its current rate.
- As the U.S. and global tax frameworks evolve, FDII remains a vital tool for preserving U.S. economic interests and maintaining leadership in a competitiv global economy.

INTRODUCTION

The Tax Cuts and Jobs Act (TCJA), enacted in December of 2017, represented the most significant rewrite of the internal revenue code since 1986. The most sweeping reforms in the TCJA relate to the taxation of foreign income. As part of these reforms, the TCJA introduced three key elements to U.S. foreign taxation intended to balance competing priorities: the need to prevent the shifting of economic activity and related profits overseas for tax reasons and the overall goal of the TCJA to improve the relative attractiveness of the U.S. for investment. One of those key elements is the Foreign Derived Intangible Income (FDII) provision. This provision provides a tax preference for income notionally derived from firms' U.S.-based intellectual or other intangible property. Importantly, the FDII provision acts in concert with other international provisions of the TCJA to incentivize the location of firm intangibles in the U.S.

The TCJA significantly reformed how the United States taxes the foreign earnings of U.S. firms. Prior to the TCJA, the U.S. imposed a variation of a worldwide international tax system, whereby U.S. taxpayers face tax liabilities for income earned abroad. One major caveat to this was that income was not subject to taxation until it was repatriated – tax could be deferred indefinitely if the income remained with overseas corporate affiliates.

TCJA & THE TAXATION OF FOREIGN INCOME

Other major U.S. trading partners, meanwhile, had adopted some form of territorial taxation through a participation exemption system. Under such a system, foreign income is either fully or partially exempted from domestic taxation either by exempting foreign-sourced dividends or capital gains from tax, or both. At the time of enactment, of the 35 members of the Organisation for Economic Co-operation and Development (OECD), 29 member nations provided some exemption for dividend income, 26 member nations offered an exemption for capital gains, and 25 member nations offered some form of exemption for both.[1]

The combination of, at the time, the second highest corporate tax rate in the world and an anachronistic tax treatment of foreign income left the United States at a significant tax disadvantage compared to other major world economies.

Dozens of firms relocated abroad for tax reasons, a process known as inversion.[2] Staunching this tide – and generally improving the tax climate for investment in the U.S. – was a key rationale for the TCJA and had been at the center of tax reform efforts in the years leading up to its enactment.

The TCJA included a significant reduction in the corporate income tax rate – from a federal statutory rate of 35 percent to 21 percent.

This policy change in and of itself rendered the U.S. a more attractive jurisdiction in which to invest, and likewise reduced incentives for firms to shift profits overseas with an associated reduction in the U.S. tax base.[3] Beyond the reduction in the corporate tax rate, the most substantial reform element of the TCJA related to changes in the taxation of foreign-source income. These changes attempt to strike a balance between improving the relative competitiveness of the U.S. tax environment and preserving the U.S. tax base.

With respect to improving competitiveness, the U.S. enacted a participation exemption system – broadly referred to as a territorial tax system. In general, under such a system the foreign earnings of U.S. firms are exempt from taxation. The specific mechanism for this system in the TCJA is a dividends received deduction (DRD), whereby qualified dividends from foreign affiliates of U.S. firms can be deducted from the domestic firm's income – effectively exempting that income from tax. Under the pre-TCJA system, this income would have faced full taxation upon repatriation. As a result of deferral, foreign affiliates of U.S. firms had built up substantial foreign earnings that remained overseas. As part of transitioning to the new, territorial system, firms were subject to a transition tax on prior overseas earnings.

Despite the shortcomings of the previous U.S. international tax regime and the global shift towards participation-exemption tax systems, territorial systems come with their own set of challenges. These systems

1 https://taxfoundation.org/research/all/federal/territorial-tax-system-oecd-review/
2 https://www.cbo.gov/system/files?file=115th-congress-2017-2018/reports/53093-inversions.pdf
3 https://taxfoundation.org/research/all/federal/benefits-of-a-corporate-tax-cut/#:~:text=The%20benefits%20of%20a%20lower,employment%2C%20and%20wages%20over%20time

require intricate rules to safeguard a nation's tax base, as they provide tax planners with incentives to shift profits to low-tax foreign jurisdictions.

Such rules, known as "base erosion" provisions, are essential to mitigate the tendency of taxpayers, particularly large multinational firms, to move income abroad to avoid U.S. taxes. Consequently, the international provisions of the Tax Cuts and Jobs Act (TCJA) introduced several new policies, including the Base Erosion and Anti-Abuse Tax (BEAT) and the Global Intangible Low-Taxed Income (GILTI) designed to function in harmony with other international elements and the broader TCJA framework.

FDII DESIGN

The TCJA defines FDII as income derived from the sale or provision of intangible U.S. goods and services to foreign entities

From the firm's calculated FDII of $910, the firm candeduct $341.25, leaving $568.75 of FDII subject to th 21 percent corporate tax rate. Combined, the tax liability of $119.44 (rounded up) reflect a 13.125 percent effective tax on the exporting-firms foreign incomenominally attributable to its intangible property.

The calculation for FDII is as follows:

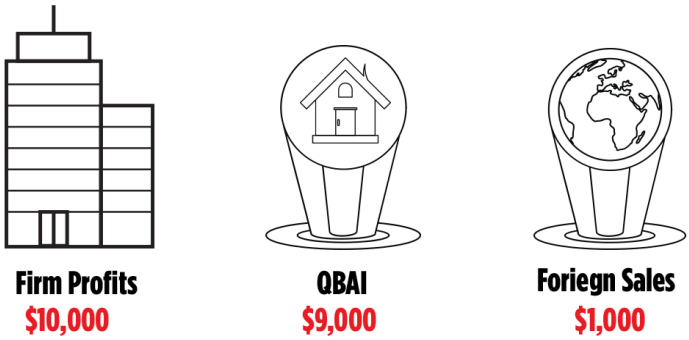
FDII = [NET INCOME – (10 PERCENT ×QBAI)] X [FOREIGN DERIVED\NET INCOME/NET INCOME]

EXAMPLE EQUATION

To illustrate, consider a hypothetical U.S. technology company with $10,000 in total profits, $1,000 of which are earned from foreign sales, and $9,000 in QBAI.

For this firm: [$10,000 - $900] x [$1,000 / $10000] = $910

Applying the 37.5 percent deduction = $910 X 37.5 percent = $341.25



Firm Profits $10,000

QBAI $9,000

Foriegn Sales $1,000

or for foreign use. Essentially, this provision is designed to capture income that U.S. companies earn abroad from their intellectual property. Intellectual property such as patents is highly mobile. In practice, this means that multinational firms have an incentive to locate intellectual property in lower-tax jurisdictions.

The FDII provision offers a 37.5 percent deduction against qualifying income earned by U.S. firms, effectively reducing the tax rate on this income to 13.125 percent, as opposed to the standard corporate tax rate of 21 percent.[4]

Starting in 2026, the FDII deduction will be reduced to 21.875 percent, thereby increasing the effective U.S. tax rate on FDII to 16.406 percent. This adjustment is a result of the budget reconciliation process used to enact the TCJA, which required limiting certain tax preferences to comply with Senate rules.

The FDII provision was crafted to incentivize U.S. multinationals to retain and generate intellectual property and the associated profits within the United States. Instead of discouraging specific activities or structures that could harm U.S. fiscal interests,

FDII aims to boost U.S. export activity. In simple terms, while GILTI and BEAT are designed to dissuade base erosion, FDII is meant to encourage the inclusion of applicable income within the U.S. tax base.[5] If the international tax provisions in the TCJA are viewed as a system of "sticks and carrots," GILTI and BEAT represent the sticks, whereas FDII serves as the carrot.

MECHANICS OF FDII

FDII allows U.S. corporations to deduct 37.5 percent (21.875 percent in 2026) of their foreign-derived intangible income, reducing the effective tax rate on such income to 13.125 percent, compared to the standard corporate tax rate of 21 percent that would otherwise apply to this income. Broadly, the calculation of FDII involves identifying the firm's net income, subtracting a deemed 10 percent return on its Qualified Business Asset Investment (QBAI), and applying the deduction to the remaining income derived from foreign sources.

To determine the amount of FDII and the relevant deduction, an eligible U.S. firm must determine several key inputs.[6] First a firm must determine it's "deduction eligible income," which is essentially its overall net income. It must also determine the share of its net income attributable to foreign sales, known as "foreign-derived deduction eligible income." Lastly, the firm must determine its "Qualified Business Asset Investment (QBAI)."

QBAI is essentially the tangible assets, such as machines and other equipment of the exporting firm. For the purposes of determining FDII, firms subtract 10 percent of QBAI from overall income to isolate income above what is essentially a deemed return on those assets. The rationale for this standard is that 10 percent represents a reasonable rate of return on a firm's tangible assets. FDII income is the excess income above that rate of return. Thus, while the provision nominally targets income on intangibles held

4 https://www.jct.gov/publications/2024/jcx-26-24/
5 https://taxfoundation.org/blog/intellectual-property-ip-tax-gilti-fdii/
6 https://www.irs.gov/pub/fatca/int_practice_units/section-250-deduction-fdii.pdf

domestically it really targets any income that can be defined as "excessive" measured relative to the U.S. firm's tangible assets.

POLICY CONSIDERATIONS

The Foreign-Derived Intangible Income (FDII) provision was designed to align the U.S. international tax system with global trends while promoting domestic economic interests. Similar to "patent box" regimes employed by other major economies, FDII offers a lower tax rate on high-return income nominally derived from U.S.-held intellectual property (IP). [7] This structure incentivizes companies to retain valuable IP within the United States, bolstering domestic innovation and stimulating economic growth. By encouraging export-driven intangible income, FDII not only strengthens the U.S. economy but also creates a competitive edge for American firms in the global market. Moreover, it operates as a critical counterbalance to other provisions introduced under the Tax Cuts and Jobs Act (TCJA), such as the Global Intangible Low-Taxed Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT), which aim to prevent profit shifting and discourage base erosion practices by multinational corporations.[8]

FDII & 2025

Under current law, the FDII provision is permanent, though the applicable deduction will be reduced in 2026. Nevertheless, while the provision is fixed in law, similar to most business and international provisions of the TCJA, its permanence does not guarantee immunity from change. That Congress must address the looming expiration of most of the individual title of the TCJA does not isolate the business provisions from potential changes. The fluidity of the applicable rate under current law underscores the tendency of Congress to modify provisions like FDII and GILTI to address evolving budgetary demands.

Congress is currently considering making the current FDII rate permanent with relatively minor changes. It is worth noting that there has been a bipartisan support for preserving or even expanding the FDII deduction. Under the proposed Growing and Preserving Innovation in America Act, sponsored by Representative Randy Feenstra (R-IA) and Representative Joe Morelle (D-NY), the FDII deduction would be increased from 37.5 percent to 50 percent. The bill's sponsors noted the significance of the provision in supporting businesses and incentives to invest in their districts.[9]

Nevertheless, the former administration and the current Congressional minority have generally opposed the direction of U.S. international tax policy since 2017. The Biden administration, for example, proposed eliminating FDII. Specifically, the administration's prior budgets proposed replacing the FDII deduction with an unspecified R&D subsidy.[10] Similarly, Democratic initiatives have sought to eliminate or reduce the scope of the FDII deduction, though no such proposal has advanced in Congress. Importantly, analyses have shown that such proposals would, contrary to advocates' claims, worsen incentives to invest in the U.S. [11]

The new Trump administration has

7 https://taxfoundation.org/research/all/federal/impact-gilti-fdii-beat/
8 https://taxfoundation.org/blog/international-tax-proposals-profit-shifting/
9 https://feenstra.house.gov/media/press-releases/feenstra-morelle-introduce-legislation-spur-investment-and-economic-growth

signaled a material departure from the past administration's tax policies. Perhaps most conspicuously, the Trump administration has announced a withdrawal and repudiation of the global tax agreement facilitated through the OECD.[12] This multinational effort led to the development of two key tax policies known as Pillar One and Pillar Two. The first relates the taxing rights of the digital economy, while the second Pillar established a global minimum tax regime. Major U.S. trading partners are substantially implementing key elements of the Pillar Two, notwithstanding U.S. involvement going forward.

Even with U.S. participation, the Pillar Two policy introduced substantial uncertainty into international taxation. With the U.S. signaling a withdrawal from this effort, the outlook for the international tax landscape has been obscured further still. Protecting the U.S. tax base and preserving core U.S. tax policy prerogatives in the face of ongoing implementation around the world of Pillar Two will be a key challenge for the new Trump administration. The 2017 tax law introduced the most sweeping reform of U.S. international tax policy. But as the global tax landscapes continues to shift, so too will U.S. international tax policies.

CONCLUSION

The FDII provision of the TCJA represents a significant shift in U.S. international tax policy, offering a strategic incentive for U.S. firms to keep their intellectual property and associated profits within the country. Like all of the TCJA, the provision will face renewed Congressional scrutiny as policymakers grapple with the extension on current tax policies. Policymakers should be mindful of the intricate balance tax writers struck in crafting FDII in concert with other international tax policies. FDII is an important component of the broader effort to enhance U.S. competitiveness in the global economy.

The House-passed "One Big Beautiful Bill," would largely preserve the current rate under the FDII provision. As modified, the House would take the current rate to 13.335 percent, up from 13.125 percent, but materially lower than the 16.406 percent otherwise set in law.[13] The Senate's version would extend the provision at a 14 percent effective rate; again higher than current policy but lower than what current law would prescribe.[14]

10 https://taxfoundation.org/blog/international-tax-proposals-profit-shifting/
11 https://taxfoundation.org/blog/ways-means-proposal-profit-shifting/
12 https://www.whitehouse.gov/presidential-actions/2025/01/the-organization-for-economic-co-operation-and-development-oecd-global-tax-deal-global-tax-deal/
13 https://taxnews.ey.com/news/2025-1143-us-house-approves-tax-reconciliation-bill-with-minor-rate-changes-in-international-tax-provisions
14 https://www.finance.senate.gov/imo/media/doc/finance_committee_section-by-section_title_vii3.pdf

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