

## **Despite Criticism, the Deduction for Foreign-Derived Intangible Income (“FDII”) Is a Reasonable and Effective Policy to Promote U.S. Competitiveness and Innovation**

The Tax Cuts and Jobs Act of 2017 (“TCJA”) introduced a new deduction for foreign-derived intangible income (“FDII”), which provides a reduced rate of tax on certain income earned from the sale of goods or provision of services to foreign markets. It is designed to encourage U.S. firms to keep the income and jobs associated with intangible assets (such as patents, trademarks, and copyrights) in the United States, so they are not attracted overseas by patent boxes and other tax incentives offered by other countries.

However, critics assert that FDII is a wasteful handout for big tech, creates an incentive to shift jobs and investment overseas, is an illegal export subsidy, is a poor driver of research and development (“R&D”), and is futile if other countries adopt the OECD-designed global minimum tax (so-called “Pillar Two”).<sup>1</sup> These assertions are incorrect.

**MYTH 1: FDII is a wasteful handout for big tech.**

**FACT: The manufacturing sector is the largest beneficiary of FDII.**

According to the Internal Revenue Service (“IRS”), about 4,000 companies claimed approximately \$52 billion in deductions for FDII in 2018.<sup>2</sup> The manufacturing sector was the largest beneficiary, responsible for nearly 65 percent of total FDII deductions, followed by information (13.6 percent) and wholesale trade (8.0 percent).<sup>3</sup>

**MYTH 2: FDII creates an incentive to shift jobs and investment overseas.**

**FACT: FDII creates an incentive to retain jobs and investment in the United States.**

Another criticism of the FDII deduction is that it creates an incentive for U.S. corporations to shift jobs and investment overseas because the benefit is limited to income in excess of a 10-percent rate of return on domestic tangible assets (i.e., income deemed to be due to intangible assets). Researchers find no evidence that firms decrease their U.S. investment in response to the FDII regime.<sup>4</sup>

The FDII deduction creates an incentive for U.S. corporations to serve foreign markets with intangible assets and associated employment in the United States. Encouraged by the deduction for FDII, many companies repatriated significant amounts of intellectual property (“IP”) from abroad. According to the Joint Committee on Taxation, income qualifying for FDII more than doubled from \$190 billion in 2017 to \$386 billion in 2021, consistent with corporations both repatriating IP and developing new IP in the United States.<sup>5</sup> Foreign gross income from rents, royalties, and license fees increased from \$136 billion in 2017 to \$336 billion in 2021 (the most recent year for which data are available).<sup>6</sup>

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<sup>1</sup> FACT Coalition, “Congress Should Repeal a Wasteful Tax Break for Big Tech,” June 10, 2024.

<https://thefactcoalition.org/fact-sheet-congress-should-repeal-a-wasteful-tax-break-for-big-tech/>

<sup>2</sup> Internal Revenue Service, Statistics of Income Division, Section 250 Deduction Study, July 2021.

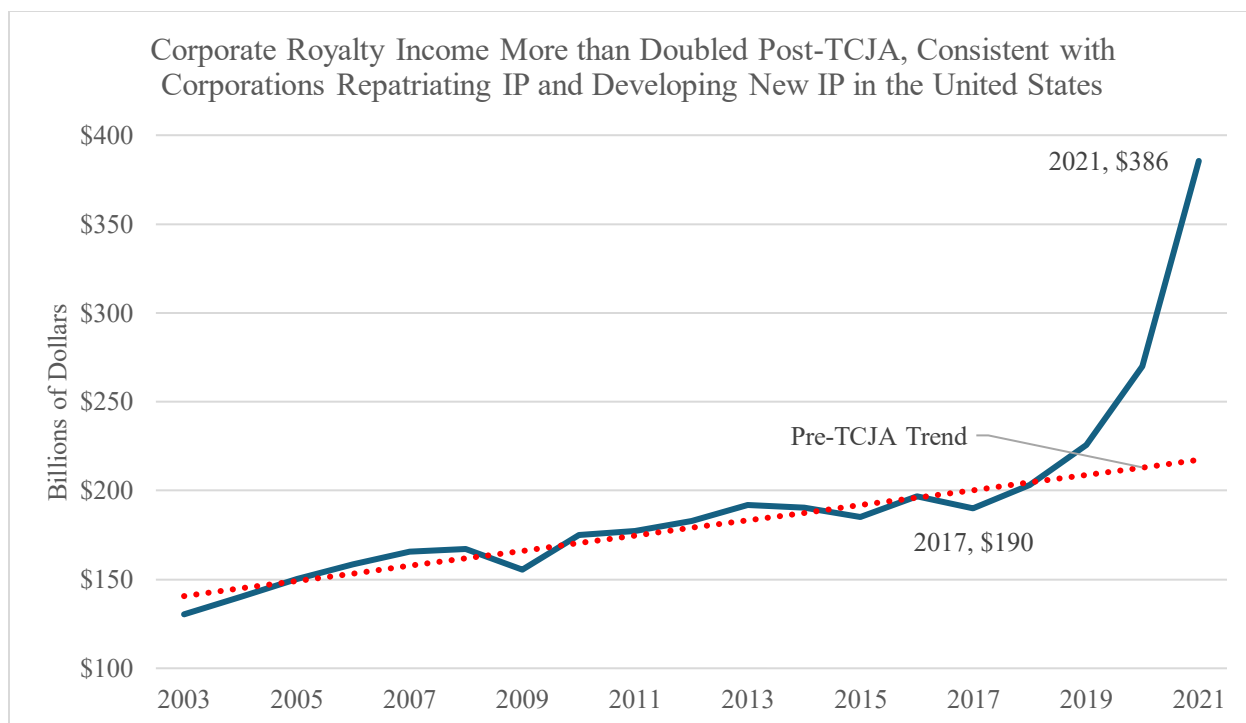
<https://www.irs.gov/pub/irs-soi/18it01fdii.xlsx> and <https://www.irs.gov/pub/irs-soi/18it02fdii.xlsx>

<sup>3</sup> Nuria McGrath, Chloe Gagin, and Jeffrey Yan, “Global Intangible Low-Taxed Income and the Section 250 Deduction, Tax Year 2018,” *Statistics of Income Bulletin*, Fall 2021, pp. 32-38.

<sup>4</sup> Jing Jing Huang, Benjamin Osswald, and Ryan Wilson, “The Effect of U.S. Tax Reform on U.S. R&D-Intensive Multinational Companies,” June 2023, Table 5, available at SSRN: <https://ssrn.com/abstract=4468276>.

<sup>5</sup> Paul Landefeld, “Modeling International Tax Proposals at the Joint Committee on Taxation,” International Tax Policy Forum – Georgetown University Law conference presentation, Washington, DC, April 5, 2024.

<sup>6</sup> Internal Revenue Service, Statistics of Income Division, *Corporate Foreign Tax Credit*, October 2024.



Source: Joint Committee on Taxation.

**MYTH 3: FDII is an illegal export subsidy.**

**FACT: FDII is not a prohibited export subsidy in violation of World Trade Organization (“WTO”) rules.**

The WTO rules only prohibit subsidies that are contingent on the export of goods; however, FDII includes royalties and services income.<sup>7</sup>

Moreover, FDII was enacted at the same time and is complementary to the global intangible low-taxed income (“GILTI”) regime, which imposes a minimum tax on the income of foreign subsidiaries of U.S. companies. As the effective tax rate on both GILTI and FDII is 13.125 percent, the two regimes in tandem seek to neutralize the effect of taxes on the location of intangible assets of U.S. companies.

Finally, to date, no country has filed a complaint with the WTO alleging that FDII violates U.S. trade commitments.

**MYTH 4: FDII is a poor driver of research and development (“R&D”).**

**FACT: FDII encourages U.S. firms hire more R&D workers in the United States.**

Critics argue that FDII is a poor driver of R&D because it does not require U.S. firms to invest in or perform any R&D activities to qualify for the deduction. However, this criticism fails to recognize the link between intangible assets and R&D. Intangible assets are the result of R&D investments, and they generate income from foreign sales and services. By reducing the tax on this income, FDII encourages U.S. firms to retain and exploit their intangible assets in the United States, rather than shifting them to

<sup>7</sup> Grant D. Aldonas, “The WTO Consistency of the Deduction for FDII,” *Tax Notes*, February 25, 2019.

low-tax jurisdictions. This in turn creates a positive feedback loop that stimulates more R&D investments and innovation in the United States.

Researchers find that the FDII tax incentive helps stimulate the hiring of new R&D personnel in the United States.<sup>8</sup> In particular, FDII encourages 23.4-percent growth in the number of U.S. inventors that appear for the first time in the U.S. patent database. The average firm with 21 domestic patent inventors would have an increase of nearly five domestic inventors as a result of FDII. These new patents they create represent newly developed intellectual property in the United States that companies may use around the world.

**MYTH 5: FDII is futile in a Pillar Two world.**

**FACT: FDII protects primary taxing rights, which increases in importance in a Pillar Two world.**

Critics argue that the FDII tax rate of 13.125 percent will be undercut in a world in which countries adopt 15-percent global minimum taxes pursuant to the so-called “Pillar Two” agreement by the OECD. However, while the federal effective tax rate on FDII currently is 13.125 percent rate, including average state and local corporate income taxes, the current combined tax rate on FDII is already 16.1 percent.<sup>9</sup> Thus the argument about the FDII benefit being undercut by a hypothetical future world with a 15-percent effective tax rate is misplaced.

In fact, in a world with broad adoption of Pillar Two taxes, the FDII regime becomes even more critical for protecting the U.S. tax base. Under Pillar Two, qualified domestic minimum top-up tax (“QDMTT”) imposed by foreign governments on the income of U.S. companies is creditable against U.S. tax. Without an incentive to return and keep IP in the United States, U.S. revenues of foreign source income will decline. A regime like FDII that attracts IP income to the United States preserves U.S. taxing rights and protects the U.S. fisc.

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<sup>8</sup> Jing Jing Huang, Benjamin Osswald, and Ryan Wilson, “The Effect of U.S. Tax Reform on U.S. R&D-Intensive Multinational Companies,” June 2023, Table 4, available at SSRN: <https://ssrn.com/abstract=4468276>.

<sup>9</sup> The 2023 weighted average state corporate income tax rate is 6.04 percent per the OECD, and state corporate income taxes are deductible in computing federal corporate income tax. Assuming all states allow the FDII deduction and accounting for deductibility at the federal level, the effective state tax rate on FDII currently is 2.98 percent  $(1-.375)*(6.04)*(1-.21)$ . The combined federal and state effective tax rate on FDII is scheduled to increase to 20.13 percent  $(21+6.04*(1-.21)*(1-.21875))$  after 2025.