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Global Tax Alert

US Final FDII regulations retain proposed regulations' structure, but reduce documentation burden, defer effective date and make important substantive changes to the computation of Section 250 deduction

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On 9 July 2020, the United States (US) Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released final regulations under Internal Revenue Code (IRC)[1] Section 250 (Treasury Decision 9901) for calculating the deduction allowed to a domestic corporation for its foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). The final regulations are scheduled for publication in the Federal Register on 15 July 2020.

Generally, the final Section 250 regulations reflect a structure similar to the proposed regulations released in March 2019 (see EY Global Tax Alert, *US Proposed Section 250 regulations provide guidance on calculating the FDII/GILTI deduction, including qualification of property and services transactions as FDDEI transactions*, dated 12 March 2019). Nevertheless, the final regulations contain a number of significant, and mostly taxpayer-favorable, changes. For example, the final regulations:

- Delay the effective date of the final regulations until tax years beginning in 2021
- Eliminate or relax, in response to taxpayer concerns, some of the more burdensome "documentation requirements" for "establishing" facts necessary to secure an FDII benefit
- Presume other necessary facts (e.g., foreign person, foreign use) in certain circumstances

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- Allow taxpayers to use any "reasonable" method to coordinate Section 250 with other sections with taxable income limitations (e.g., Sections 163(j) and 172)
- Require taxpayers to ignore carryover deductions under those sections when identifying deductions to be apportioned to gross deduction eligible income (DEI) and gross foreign-derived deduction eligible income (FDDEI)
- Relax certain provisions that defer an FDII benefit for a related-party sale that is followed by an unrelated-party sale
- Introduce new provisions applicable to narrower categories of taxpayers (e.g., "digital content" and SaaS providers, providers of advertising services, *Arms Export Control Act* sellers and renderers, and taxpayers engaging in hedging transactions)

This Alert summarizes these and other notable provisions in the final regulations.

A. Background

Section 250 generally allows a domestic corporation an annual deduction for its GILTI inclusion under Section 951A and FDII. For tax years beginning after 31 December 2017, but on or before 31 December 2025, the Section 250 deduction generally is the sum of: (i) 50% of the corporation's GILTI inclusion amount (and Section 78 "gross-up" for associated deemed-paid foreign income taxes) and (ii) 37.5% of its FDII. If the sum of the taxpayer's GILTI and FDII amounts exceeds the taxpayer's taxable income, however, the Section 250 deduction is reduced, proportionately to those two amounts.

A domestic corporation's FDII for a tax year is calculated under a complex formula. The corporation's deemed intangible income (DII) is multiplied by a fraction, the numerator of which is the corporation's foreign-derived deduction-eligible income (FDDEI) and the denominator of which is the corporation's deduction eligible income (DEI). Generally, the corporation's DEI is the excess, if any, of its gross income (excluding to certain amounts, such as its foreign branch income, and its subpart F and GILTI inclusions) over properly allocable deductions. FDEEI is the portion of DEI that is income derived from: (i) property sold to any non-US person for foreign use; or (ii) services provided to a person, or with respect to property, located outside the US. Lastly, the domestic corporation's DII is the excess, if any, of its DEI over its deemed tangible income return (DTIR), which equals 10% of the domestic corporation's qualified business asset investment (QBAI) for the year.

As such, this complex formula depends on a variety of inputs (i.e., DEI, DTIR, DII and FDDEI) that require factual determinations, many as to individual transactions (e.g., whether property sold in a particular transaction is subjected to a "foreign use"). The final regulations provide guidance on these components and, as discussed in this Alert, appear to respond favorably to many taxpayer requests for additional certainty and flexibility.

B. Effective date of the final regulations

One of the most taxpayer favorable changes is the effective date of the final regulations. The proposed regulations would have applied, when finalized, to tax years ending on or after 4 March 2019. For tax years beginning on or before 4 March 2019, the proposed regulations allowed taxpayers *not* to apply the proposed documentation rules but rather to substantiate certain facts necessary to establish FDII by using "any reasonable documentation maintained in the ordinary course of … business" (the documentation transition rule).

The final regulations generally apply only to tax years beginning on or after 1 January 2021. Taxpayers may, however, apply the final regulations to prior (pre-2021) tax years — provided they apply the final regulations in their entirety. In addition, taxpayers that apply the final regulations to pre-2021 tax years are relieved from applying in those years some of the more burdensome documentation requirements that remain in the final regulations.

Alternatively, taxpayers may "rely on" the proposed regulations "in their entirety" for pre-2021 tax years. A taxpayer opting to do so may apply the documentation transition rule to all pre-2021 tax years — not just those beginning on or before 4 March 2019 (as had been proposed).

For tax years beginning before 1 January 2021, taxpayers have the option of applying either the final regulations in their entirety, with the exception of certain documentation requirements, or the proposed regulations in their entirety, including the documentation transition rule. Taxpayers should evaluate the substantive provisions of both sets of regulations, as well as the regulations' documentation requirements, to determine which regulations are more favorable given their specific circumstances. Taxpayers should also consider whether a desired position for a pre-2021 tax year may be taken based solely on a reasonable interpretation of Section 250 itself.

C. Overview of documentation & reliability requirements

A taxpayer that sells property (including a lease or license) or renders a service must establish certain facts to claim an FDII benefit. The proposed and final regulations set out rules governing the documentation that a "seller" (of property) or "renderer" (of services) must collect to establish those facts. Both sets of rules contain standards regarding the reliability of the documentation, including the circumstances in which a taxpayer has "reason to know" that certain documentation is *not* reliable. In response to taxpayer concerns about the documentation requirements in the proposed regulations, the final regulations ease these requirements (including the reliability standards) in several important respects.

For certain specific transactions, the final regulations specify the documentation needed to substantiate the following facts necessary for income to qualify as FDDEI:

1. Whether a sale of "general" property for resale or for additional manufacturing is for a foreign use
2. Whether a sale of intangible property is for a foreign use
3. Whether general services provided to a business recipient benefits the operations of the recipient outside the US — such that the recipient is deemed to be located outside the US when the services are rendered

To substantiate these facts, the final regulations permit taxpayers to rely on "credible evidence" obtained in the ordinary course of business. Alternatively, a taxpayer can self-certify with a written statement and corroborative evidence. In all cases, however, the taxpayer must obtain the documentation by the due date (including extensions) for the income tax return for the tax year of the relevant transaction (the FDII filing date) and must provide the documentation to the IRS within 30 days upon request.

For other transactions, the final regulations eliminate the proposed requirement that a taxpayer obtain specific documentation to substantiate the following facts:

1. Whether a recipient of property is a foreign person
2. Whether certain sales of general property to an end-user (e.g., a person who ultimately uses or consumes the property) are for a foreign use
3. Whether general services performed for a consumer are provided to a location outside the US

Instead, the final regulations specify certain facts (e.g., a foreign shipping or billing address) that must be established for a presumption to apply or for income to otherwise qualify as FDDEI. More generally, the Preamble states that the general recordkeeping requirements under Section 6001 continue to apply in such cases.

The final regulations adopt a reliability standard, requiring that a seller or renderer of services not know or have reason to know that documentation is unreliable or incorrect as of the FDII filing date. In a welcome change, however, the final regulations limit the circumstances in which the "reliability" of documentation is conditioned on the taxpayer's neither knowing nor having "reason to know" (i.e., constructive knowledge) that the documentation is unreliable.

The relaxation of the documentation requirements depends on, among other things, the form of the taxpayer's qualifying transaction. When specific documentation requirements apply, FDII benefits are available only if the requirements are satisfied. Taxpayers should map out their transaction's business flows against the final regulations to determine whether qualifying documentation is readily available. If it is not, taxpayers should evaluate whether they could obtain a more favorable result by modifying their systems, documenting their transactions differently or perhaps restructuring their business flows.

D. Computing the FDII deduction — General observations

i. Taxable income limitation and coordination rules with other IRC sections

As discussed previously, a US corporation's FDII deduction may be limited by its taxable income, determined without regard to the FDII deduction. Other deductions under the Code are also limited by reference to the taxpayer's taxable income, e.g., Sections 163(j), 172 and 1503(d). The proposed regulations contained an ordering rule under which the Section 250 deduction was computed after taking other such deductions into account. The final regulations remove this provision and reserve on the interaction of the Section 250 deduction with other deductions that are determined by reference to taxable income. The Preamble to the final regulations states that Treasury is considering a separate guidance project to address the interaction of Sections 163(j), 172, 250(a)(2) and other IRC provisions that refer to taxable income.

Until such guidance is issued, taxpayers may choose any reasonable method for coordinating the computation of such deductions (which could include the ordering rule in the proposed regulations or the use of simultaneous equations) if the method is applied consistently for all tax years beginning on or after 1 January 2021.

Taxpayers may benefit from modelling alternative approaches to coordinating the computation of the deductions.

ii. Allocation and apportionment of deductions

a. Limitation and carryover of deductions under other IRC Sections

In a change that might be very significant for many taxpayers, the final regulations require the deductions to be apportioned to gross DEI and gross FDDEI without regard to the limitations in Sections 163(j), 170(b)(2), 246(b) and 250. In contrast, the Preamble focuses primarily on the deduction in one tax year of a carryover deduction attributable to another tax year, with the intended result that the carryover deduction is not taken into account when calculating FDII. Based on the literal terms of the final regulations, however, it appears that deductions taken into account for FDII purposes in a given year may be greater (in limitation years) or less (in carryover years) than the deductions taken into account for taxable income purposes, as illustrated in the following example.

Example. In 2021, a US corporation earns US$1000 of gross income that consists of $800 of gross DEI (of which $500 is gross FDDEI) and $200 of gross non-DEI. The US corporation's only potential deduction is $400 of interest expense, of which only $300 is deductible in 2021 due to Section 163(j). The final regulations appear to indicate that the full $400 of interest expense is taken into account in determining net DEI (and net FDDEI) of the US corporation in 2021 (i.e., the Section 163(j) limitation is ignored). Furthermore, assume that the US corporation may deduct the $100 of excess interest expense in 2022 under Section 163(j). None of this $100 interest expense deduction is taken into account in determining the net DEI (and net FDDEI) of the US corporation in 2022. Thus, while the Section 163(j) limitation applies for purposes of determining the amount of the interest expense allowed as a deduction in computing taxable income in 2021 and 2022 ($300 and $100, respectively), it appears that the entire $400 expense is taken into account in 2021 for purposes of allocating and apportioning the expense in determining the FDII deduction in each of those years.

The carryover deductions continue to apply for purposes of computing a taxpayer's Section 250(a)(2) taxable income limitation. As a result, the deductions may reduce a taxpayer's FDII and GILTI deductions under the Section 250(a)(2) taxable income limitation.

b. R&E expenses

The final regulations apply the rules of Treas. Reg. Sections 1.861-8 through 1.861-14T and 1.861-17 to allocate and apportion deductions against gross DEI, gross FDDEI and gross non-DEI to arrive at DEI and FDDEI. In a change from the proposed regulations, the final regulations apply the exclusive geographic apportionment rule of Treas. Reg. Section 1.861-17(b) for purposes of apportioning R&E expenses to gross DEI and gross FDDEI.

It is unclear how the exclusive apportionment rule of Treas. Reg. Section 1.861-17 will apply for purposes of FDII. Under the rule, 50% of R&E expense is apportioned to groupings of gross income "arising from the geographical source where the research activities were performed." Depending on the facts, FDDEI and residual DEI (RDEI) may both arise from sources in the US. The Preamble to the final regulations states that Treasury and the IRS will "consider the issues raised regarding the application of exclusive apportionment for purposes of [IRC] Section 250 as part of finalizing the 2019 FTC proposed regulations." It may be that the Preamble is referring to the sourcing question.

iii. Foreign branch income

As described previously, DEI does not include foreign branch income, as defined for purposes of Section 904(d). The proposed regulations would have expanded the definition of foreign branch income for purposes of Section 250 to include income from the sale of a disregarded entity or a partnership interest. The final regulations do not adopt this provision and instead conform to the definition of foreign branch income under Section 904(d).

E. FDDEI transactions

A US corporation's gross FDDEI equals the portion of the US corporation's gross DEI that is derived from the US corporation's "FDDEI transactions," which are comprised of the corporation's FDDEI sales and FDDEI services.

i. FDDEI sales

Different qualification rules apply for sales of general property (generally tangible property) and sales of intangible property as defined in Section 367(d)(4) (intangible property

sales). Regardless of the property type, however, the sale must be made to a foreign person for foreign use to qualify as an FDDEI sale.

a. Foreign person

The final regulations reduce uncertainty in the determination of whether a sale of property qualifies as an FDDEI transaction by presuming that a sale is made to a foreign person in the following cases:

1. Foreign retail sales
2. Sales of general property delivered (e.g., by a freight carrier) to a shipping address outside the US
3. Other sales of general property for which the billing address of the recipient is outside the US
4. Intangible property sales for which the billing address of the recipient is outside the US

b. Foreign use of general property

The proposed regulations provided that the sale of general property is for a foreign use (i) if the property is not subject to domestic use within three years of delivery or (ii) the property is subject to manufacture, assembly or other processing outside the US before a domestic use occurs.

The final regulations modify the definition of foreign use for general property by eliminating references to domestic use and instead defining foreign use as the sale (or eventual sale) of property to end-users outside the US or the sale of the property to a person that subjects the property to manufacture, assembly or other processing outside the US. An end-user of general property is the person that ultimately uses or consumes the property or a person that acquires property in a foreign retail sale. A person acquiring property for resale is not an end-user.

The broad limitation in the proposed regulations on any domestic use within three years has been replaced in the final regulations with a rule denying foreign use if general property is sold to an unrelated party for manufacture, assembly or other processing in the US, even if the requirements for foreign use are subsequently satisfied. This should substantially reduce uncertainty about whether a sale of general property is for a foreign use.

Similar to the presumptions for foreign-person status, the final regulations list scenarios in which sales of general property are presumed to be for foreign use:

1. Sales to end-users receiving delivery outside the US (e.g., from a freight carrier)
2. Sales of general property already located outside the US (e.g., foreign retail sales)
3. General property sold to a distributor or reseller for ultimate sale to an end-user outside the US
4. Electronic transfers of digital content that is downloaded, installed, received or accessed by an end-user outside the US
5. Sales of international transportation property that is registered outside the US, and, if not used for compensation or hire, is primarily stored outside the US

General property is treated as subject to manufacturing, assembly or other processing if: (i) the property is physically and materially changed, or (ii) the property is incorporated as a component into a second product and the fair market value of the property sold by the taxpayer is 20% or less of the fair market value of the second product (the component test). The final regulations clarify that general property is subject to a physical and material change if it is substantially transformed and is distinguishable from, and cannot be readily returned to, its original state. The final regulations also add that property is considered to be incorporated into another product if the activities to incorporate the property are substantial in nature and generally considered to constitute manufacturing, assembly or processing under all the facts and circumstances.

c. Foreign use of intangible property

The final regulations determine foreign use of intangible property by whether revenue from the intangible is earned from end-users located outside the US. However, the final regulations provide detailed guidance for making this determination when intangible property is: (i) embedded in general property or used in connection with the sale of such property (location of the end-user of the property determines foreign use); (ii) used to provide services (location of the recipient of the service determines foreign use); and (iii) used in research and development (location of the end-user of the secondary IP determines foreign use). A sale of intangible property to an unrelated foreign party is considered to be for a foreign use, however, if the intangible consists of a manufacturing method or process used outside the US.

ii. FDDEI services

The final regulations contain different rules for determining whether the following five types of services are FDDEI transactions:

1. Proximate services: a service (other than a property or transportation service) provided to a recipient, if substantially all of the service is performed in the physical presence of the recipient
2. Property services: a service (other than a proximate or transportation service) provided with respect to tangible property, if substantially all the service is provided at the location of the property and the service results in the physical manipulation of the property
3. Transportation services: a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle or any similar mode of transportation
4. General services provided to consumers: a service that is provided to a consumer and does not fall into one of the other categories
5. General services provided to business recipients: a service that is provided to a business recipient and does not fall into one of the other categories

a. General services provided to a customer

In certain circumstances, the final regulations permit a taxpayer to treat a consumer to whom a general service is provided as located at the consumer's billing address. For an electronically supplied service, however, the consumer generally is deemed to be at the location of the device used to receive the service.

b. General services provided to a business recipient

The final regulations continue to identify the location of a business recipient of a general service as the location(s) of the recipient's office or other fixed place of business. The location where advertising services are provided, however, is the location(s) where the advertisements are viewed by individuals; the location where electronically supplied services are provided is the location(s) where the recipient's employees and agents access the service.

c. Property services

A property service is generally considered to be provided outside the US (an FDDEI service) only if the property is located outside the US for the duration of the period the service is performed. The final regulations, however, provide an important exception to this rule for property that is temporarily located in the US for the purpose of receiving the property service. Specifically, a property service is deemed to be provided for tangible property located outside the US if the following conditions are met: (i) the property is temporarily located in the US for the purpose of receiving the property service, (ii) the property is primarily hangered, docked, stored or used outside the US after the service's completion, (iii) the property is not used to generate revenue in the US at any point during the service, and (iv) the property is owned by a foreign person that resides or primarily operates outside the US.

iii. Related-party transactions

Special rules apply to transactions with related parties, whether to sales or services, as discussed next.

a. Related-party sales

The sale of property to a foreign related party is treated as for a foreign use under the statute when the foreign related party (i) resells the property to an unrelated foreign party for foreign use, or (ii) uses the property in connection with the sale of other property or provision of services to an unrelated foreign party for a foreign use.

The final regulations treat the original sale to a related party (the related-party sale) as an FDDEI sale in the year it occurs if the unrelated party sale occurs in such year or will occur in the future in the ordinary course of business. The final regulations also eliminate the requirement under the proposed regulations to file an amended return to claim an FDII benefit for an unrelated party sale occurring after the FDII filing date.

When the foreign related party uses the purchased property in connection with the sale of other property or provision of services, the amount of the related party sale treated as an FDDEI sale is proportionate to the amount of revenue reasonably expected to be earned from all qualifying unrelated party transactions relative to the total revenue expected to be earned from all transactions. (In contrast, the proposed regulations would have required more than 80% of the revenue earned by the foreign related party to be from qualifying FDDEI transactions with unrelated parties.)

The final regulations treat all related parties — both foreign and US — as a single foreign related party for purposes of determining whether an unrelated party sale has occurred.

The inclusion of related US parties properly takes account of supply-chains involving an intermediate sale to one or more US related parties before the eventual sale to an unrelated foreign party.

The final regulations do not apply the related-party sales rules to sales of intangible property, because a sale of intangible property is an FDDEI transaction only to the extent the intangible property is used outside the US.

b. Related-party services

A related-party service is an FDDEI service only if the service is not substantially similar to a service that is or will be provided by the related person to a person located in the US. The final regulations clarify that services provided to a related party that only indirectly benefit the related party's service recipients are not "substantially similar" to the services provided by the related party. The Preamble to the final regulations, citing Treas. Reg. Section 1.482-9(l)(3)(ii), notes that this is generally the case when the related party's service recipients would not be willing to pay for the related-party service.

iv. Other transactions

a. Sales of copyrighted articles and digital content

To clarify that the rules applicable to sales of intangible property do not apply to a limited-use license of a "copyrighted article," the final regulations define "intangible property" to exclude a copyrighted article. Absent further change, however, the rule for determining foreign use that would apply to a sale of a copyrighted article (i.e., the rule that applies to general property) arguably would not be suitable for such a sale because it focuses on the physical transfer of property to the end-user. Accordingly, the final regulations also include a rule specific to a sale of general property that is transferred electronically and primarily contains "digital content" — i.e., copyrighted articles (including books, movies and music) in digital format. Such a sale is for a foreign use if the end-user "downloads, installs, receives, or accesses" the digital content on the end-user's device outside the US. In certain circumstances, when such information is unavailable, foreign use may be determined by the end-user's billing address.

b. Sales of interest in partnership or disregarded entity

Treasury rejected requests to apply a look-through approach to determine the extent to which a sale of a partnership interest qualifies as an FDDEI sale. Consequently, sales of partnership interests will not qualify as FDDEI sales, regardless of whether a direct sale of partnership property would qualify.

Conversely, as a result of modifications to the definition of foreign branch income (discussed previously), all or a portion of the income from the sale of a disregarded entity may qualify as FDDEI if the disregarded entity's property satisfies the requirements and the transaction does not otherwise give rise to foreign branch income. Thus, taxpayers operating through a flow-through entity (partnership or disregarded entity) should consider the FDII impact of future dispositions on their chosen structure.

c. Military sales

Under the final regulations, a sale or provision of services to the US Government under the *Arms Export Control Act* is an FDDEI sale or FDDEI service if it is for resale or on-service by the US government to a foreign government. The final regulations eliminate the following requirements: (i) the US government's military sale to the foreign government must be on commercial terms, and (ii) the contract terms between the taxpayer and the US Government must specify that the purchase is for resale a foreign government.

d. Hedging transactions

Generally, sales of financial instruments do not give rise to FDDEI. The final regulations contain a special rule for certain hedging transactions under which income or loss from such hedges are associated with the underlying transaction for purposes of determining the amount of FDDEI attributable to sales of general property.

F. Application to consolidated groups

The final regulations require members of a consolidated group to (i) determine the Section 250 deduction by reference to the relevant items and attributes of all group members, (ii) redetermine attributes under Treas. Reg. Section 1.1502-13(c) to compute each member's FDDEI, and (iii) treat income that is offset by the Section 250 deduction as tax-exempt income for purposes of basis adjustments in member stock.

The final regulations include one material change: for purposes of computing the "buying" member's QBAI from an intercompany sale of "specified tangible property," the member now may only defer reflecting the gain or loss recognized from the sale in the property's basis "until the

time that such gain or loss is no longer deferred [by the "selling" member] under Treas. Reg. Section 1.1502-13." According to the Preamble, the change is intended to ensure that, consistent with single entity principles, an adjustment to asset basis that is associated with an intercompany item is reflected when that intercompany item has been taken into account. Basis is adjusted for this purpose regardless of the application of deferral rules other than Treas. Reg. Section 1.1502-13(c) (e.g., Section 267(f)).

Consistent with most other provisions, the provisions in the final regulations relating to consolidated groups apply to consolidated return years beginning on or after 1 January 2021. Taxpayers choosing to apply the other provisions in the final regulations to earlier years must also apply consolidated group provisions to those earlier years. (A similar rule applies to taxpayers choosing to apply the proposed regulations in lieu of the final regulations.)

G. Conclusion

Most taxpayers will find the final Section 250 regulations — as compared to the proposed regulations — to be quite favorable. In particular, the final regulations adopt sensible rules for taxpayers to document their FDDEI sales and services.

The final regulations are more accommodating in other respects as well. Most importantly, the effective date of the final regulations has been postponed to tax years beginning on or after 1 January 2021, giving taxpayers more time to develop systems or other procedures to meet the substantiation requirement; for tax years before that effective date, taxpayers may apply, at their option, the final or the proposed regulations (subject to consistency requirements). Treasury and the IRS should be commended for reacting favorably to taxpayer concerns about those requirements. Taxpayers should also consider whether a desired position for a pre-2021 tax year may be taken based solely on a reasonable interpretation of Section 250 itself.

Pleased or disappointed, nearly every taxpayer should now react swiftly to the final regulations. For tax years beginning before 1 January 2021, taxpayers should consider which set of regulations would be more favorable — or less burdensome — to them. Looking forward, taxpayers ought to model the effect of various reasonable methods to coordinate the taxable income limitations of Sections 250(a)(2), 163(j), 172 and others. Moreover, taxpayers should evaluate the new documentation requirements and substantive provisions against their facts and begin the process of re-assessing their operating models, intercompany flows, and pricing policies and consider whether changes should be made to take full advantage of the benefits under Section 250.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986 and related regulations.

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