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EAGERLY ANTICIPATED PROPOSED FOREIGN DERIVED INTANGIBLE INCOME (FDII) REGULATIONS PROVIDE TAXPAYERS WITH GUIDANCE

SUMMARY

Effective for tax years beginning after December 31, 2017, corporate taxpayers that engage in certain qualifying transactions may recognize substantial tax savings from the Foreign Derived Intangible Income (FDII) deduction. To qualify for the deduction, taxpayers must sell, lease, license, exchange or dispose of property, including tangible and intangible property, to a non-U.S. party for foreign use. Taxpayers that provide certain services may qualify for the FDII deduction as well. When fully maximized, the FDII deduction can reduce a taxpayer's effective tax rate by almost 8 percent.

SUMMARY

On March 4, 2019, the IRS and Treasury released proposed regulations (REG-104464-18) providing guidance for determining the Foreign Derived Intangible Income (FDII) deduction. The proposed regulations address a variety of issues, including specifics as to the types of transactions that qualify for the deduction, computational rules, and documentation requirements necessary to substantiate qualification for the benefit. Further, the regulations also provide several simplifying de minimis rules to streamline certain aspects of the computation for qualifying taxpayers, as well ordering rules to assist taxpayers with computing the FDII deduction in connection with the Section 163(j) interest expense limitation and the net operating loss deduction under Section 172. The regulations are proposed to generally apply to taxable years ending on or after the date of filing in the Federal Register. Taxpayers however, may rely on certain sections of the proposed regulations for taxable years ending before the date of filing in the Federal Register.

Note that the regulations also address the 50 percent deduction for Global Intangible Low Tax Income (GILTI), which, like the FDII deduction, is generally applicable for corporate taxpayers only. However, individuals that make a Section 962 election may take into account the Section 250 deduction with respect to GILTI and the Section 78 gross-up attributable to GILTI.

TAXPAYERS ELIGIBLE FOR THE DEDUCTION

The proposed regulations provide that the FDII deduction is available to any domestic corporation as defined in Section 7701(a), but does not include a regulated investment company, a real estate investment trust, or an S corporation. A domestic corporation that is subject to the unrelated business income tax under Section 511 may also claim the deduction, but only with respect to the corporation's items of income, gain, deduction, etc. that are taken into account in computing its unrelated business taxable income. Further, the regulations clarify that a domestic corporate partner of a partnership takes into account its distributive share of the partnership's income and assets for purposes of determining the corporation's FDII deduction. Thus, a partnership with one or more direct or indirect partners that are domestic corporations must furnish to each partner on or with such partner's Schedule K-1 each partner's share of information necessary to compute the FDII deduction.

QUALIFYING SALE OF PROPERTY

As noted above, taxpayers may be eligible for the FDII deduction if they sell, lease, license, exchange or otherwise dispose of property to a non-U.S. party for foreign use. The proposed regulations provide different sets of rules for determining whether the foreign use requirement is met depending on whether the property transferred is "general property" or

"intangible property." General property is property other than intangible property, a security or a commodity. To meet the foreign use requirement for general property, the regulations provide that the property cannot be subject to domestic use within three years of delivery of the property, or must be further manufactured, assembled or processed outside the United States before any domestic use occurs. General property is subject to manufacturing, assembly or other processing only if it meets either of the following two tests: (1) there is a physical and material change to the property (above and beyond minor assembly, packaging or labeling), or (2) the property is incorporated as a component into a second product.

For purposes of Section 250, intangible property is defined by cross-reference to Section 367(d)(4), which includes patents, copyrights, trademarks, and franchises. Under the proposed regulations, a sale of intangible property meets the foreign use requirement if the revenue from exploiting the intangible property is earned outside the United States.

QUALIFYING PROVISION OF SERVICES

Qualifying transactions for FDII also include services provided by a domestic corporation to any person, or with respect to property, not located within the United States. The proposed regulations specify that whether the service is considered provided to a person, or with respect to property, located outside the United States, depends on the type of service provided, and in certain instances, the type of recipient of the service. In particular, the proposed regulations provide four categories of services:

- **Transportation Service** – A service to transport a person or property using any mode of transportation (such as an airplane). The proposed regulations provide that if both the origin and destination of a transportation service are outside the United States, then the service qualifies for the FDII deduction. Otherwise, if either the origin or the destination of the transportation service is outside the United States, but not both, then only 50 percent of the service qualifies for FDII.
- **Property Service** – A service, other than a transportation service, provided with respect to tangible property, but only if "substantially all" of the service is performed at the location of the property outside the United States and results in physical manipulation of the property (e.g., warranty repair work). The "substantially all" requirement is met if more than 80 percent of the time providing the service is spent at or near the location of the property.
- **Proximate Service** – Defined as a service, other than a property service or a transportation service, substantially all of which is performed in the physical presence of the recipient or in the case of a business recipient, its employees (e.g., training services performed on-site). The recipient of a proximate service is treated as located where the service is performed.
- **General Service** – A residual category of services defined as a service other than the three categories above. The proposed regulations distinguish between general services provided to consumers and general services provided to business recipients. For general services provided to a consumer, such services qualify if the consumer resides outside the United States when the service is provided. In contrast, for general services provided to a business recipient, the proposed regulations determine the location of the business recipient based on the location of the business recipient's operations, and the operations of any related party of the recipient that receive a benefit for such services; thus, the location of residence, incorporation, or formation of a business recipient is irrelevant.

RELATED PARTY RULES

The proposed regulations also include rules related to related party transactions. First, a sale of general property to a foreign related party can qualify as a Foreign Derived Deduction Eligible Income (FDDEI) transaction if the foreign related party resells the purchased property to an unrelated foreign party for foreign use on or before the tax return filing date. If the foreign related party does not resell the property purchased from the domestic corporation and instead uses the property to produce other property or provide services to an unrelated party, the related party sale can qualify if the domestic corporation reasonably expects that as of the tax return filing date, more than 80 percent of the revenue earned by the foreign related party from the use of the property in all transactions will be earned from unrelated party transactions that are FDDEI transactions (determined without regard to the documentation requirements in §1.250(b)-4 or §1.250(b)-5).

In order for a general service provided to a related foreign party to qualify, the proposed regulations provide that the service cannot be substantially

similar to a service provided by the related party to persons located within the United States. A service is "substantially similar" if the domestic corporation's service is used by the related party to provide a service to a person located within the United States and either the "benefit test" or the "price test" is satisfied. The benefit test is satisfied if 60 percent or more of the benefits conferred by the related party service are to persons located within the United States. The price test is satisfied if 60 percent or more of the price that persons located within the United States pay for the service provided by the related party is attributable to the domestic corporation's service.

COMPUTATIONAL CONSIDERATIONS

For purposes of computing FDII, the regulations specify that once a taxpayer determines gross qualifying income (e.g., gross FDDEI), it must allocate cost of goods sold and other deductions to qualifying income. Cost of goods sold can be allocated to gross receipts under any reasonable method. Deductions must be allocated and apportioned to qualifying income under the rules of Treas. Reg. Sections 1.861-8 through 1.861-14T and 1.861-17, consistent with the old Section 199 expense allocation rules for computing qualified production activities income. Unlike the Section 199 regulations, however, the proposed FDII regulations do not offer the option of using simplified expense allocation methods for small taxpayers; thus, it appears that all taxpayers eligible for the FDII deduction must allocate expenses under general Section 861 principles.

The regulations further provide that in the context of a consolidated group, taxpayers must aggregate members' components of FDII and compare such amounts to the consolidated group's consolidated taxable income amounts to calculate an overall deduction amount for the group. The consolidated deduction is then allocated among the members on the basis of their respective contributions to the consolidated group's aggregate amounts.

Like GILTI, taxpayers subject to the FDII rules must compute their "qualified business asset investment," which is defined as the taxpayer's average aggregate adjusted bases at the close of each quarter in tangible depreciable property used in the domestic corporation's trade or business to produce deduction eligible income. The adjusted basis in the tangible property is determined by using the alternative depreciation system (ADS) under Section 168(g) and by allocating the depreciation deduction with respect to such property for the domestic corporation's taxable year ratably to each day during the period in the taxable year to which such depreciation relates. For property placed in service before December 22, 2017, the adjusted basis is computed as if the taxpayer had used ADS from the date that the property was placed in service.

Additionally, the regulations provide helpful ordering rules for taxpayers subject to the interest expense limitation under Section 163(j) and the NOL deduction under Section 172(a). In particular, the regulations provide that a domestic corporation's taxable income for purposes of applying the taxable income limitation is determined after all the corporation's other deductions are taken into account. Accordingly, a taxpayer that is subject to Section 163(j) must first compute a "tentative" or hypothetical amount of its FDII deduction without regard to any carryforwards or disallowances under Section 163(j), any NOL deductions under Section 172(a), or the taxable income limitation under Section 250(a)(2). This "tentative" FDII deduction amount is used for purposes of determining taxable income for purposes of the Section 163(j) expense limitation but without regard to the amount of any NOL deduction under section 172(a).

Next, the corporation computes the amount of its net operating loss deduction taking into account the amount of business interest allowed under Section 163(j) and the taxable income limitation of section 172(a)(2), but without regard to the amount of any FDII deduction.

Fourth, the taxpayer computes the amount of its FDII, taking into account the amount of its business interest allowed after application of section 163(j) and the amount of its net operating loss deduction under section 172(a). Fifth, the corporation computes the amount of its FDII deduction, after the application of the taxable income limitation of section 250(a)(2), taking into account the amount of interest expense as determined under Section 163(j) and the amount of its NOL deduction under Section 172(a).

DOCUMENTATION REQUIREMENTS

The proposed regulations require a domestic corporation to gather documentation sufficient to support the qualification FDII-eligible transactions. For instance, with respect to the sale of property, the taxpayer must obtain documentation that establishes the recipient's status as a foreign person. This can include documentation that establishes that the entity is organized or created under the laws of a foreign jurisdiction, or a written statement by the recipient that the recipient is a foreign person. Additionally, taxpayers must also establish that the property meets the foreign use requirement, which can include documentation of

shipment of the property to a location outside the United States (e.g., a copy of the export bill of lading) or written statement from the recipient that the recipient's use or intended use of the property is for a foreign use. Similarly, with respect to the provision of general services, the taxpayer must obtain documentation sufficient to establish the location of a business recipient's operations that benefit from the service.

For the documentation to be relied upon, the taxpayer must obtain the documentation by the FDII filing date, no earlier than one year before the date of the sale or service, and the taxpayer must not know or have reason to know that the documentation is incorrect or unreliable. The proposed regulations further provide simplifying conventions with respect to the documentation requirements for small taxpayers with gross receipts less than $10 million or small transactions, defined as less than $5,000 in gross receipts from a single recipient.

For taxable years beginning on or before the date the regulations are filed in the Federal Register, taxpayers may use any reasonable documentation maintained in the ordinary course of the taxpayer's business that establishes that a recipient is a foreign person, property is for a foreign use, or a recipient of a general service is located outside the United States, as applicable, in lieu of the documentation required in proposed Treas. Reg. Sections 1.250(b)-4(c)(2), (d)(3), and (e)(3) and 1.250(b)-5(d)(3) and (e)(3), provided that such documentation meets the reliability requirements described in proposed Treas. Reg. Section 1.250(b)-3(d).

INSIGHTS

The proposed FDII regulations provide much-needed clarity for taxpayers seeking to assess whether they qualify for the benefit and how the deduction is required to be computed. Given the complexities associated with the rules, including the documentation requirements, computing depreciation under ADS, and the qualitative and quantitative analyses necessary determine to whether a benefit exists, taxpayers should begin assessing the potential impact of these proposed regulations as soon as possible to ensure that adequate time is set aside to gather the required data necessary to compute and substantiate the deduction. Additionally, partnerships with direct or indirect domestic corporation partners must immediately assess whether any FDII-related disclosures will be necessary as part of the preparation of the Schedule K-1s.

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