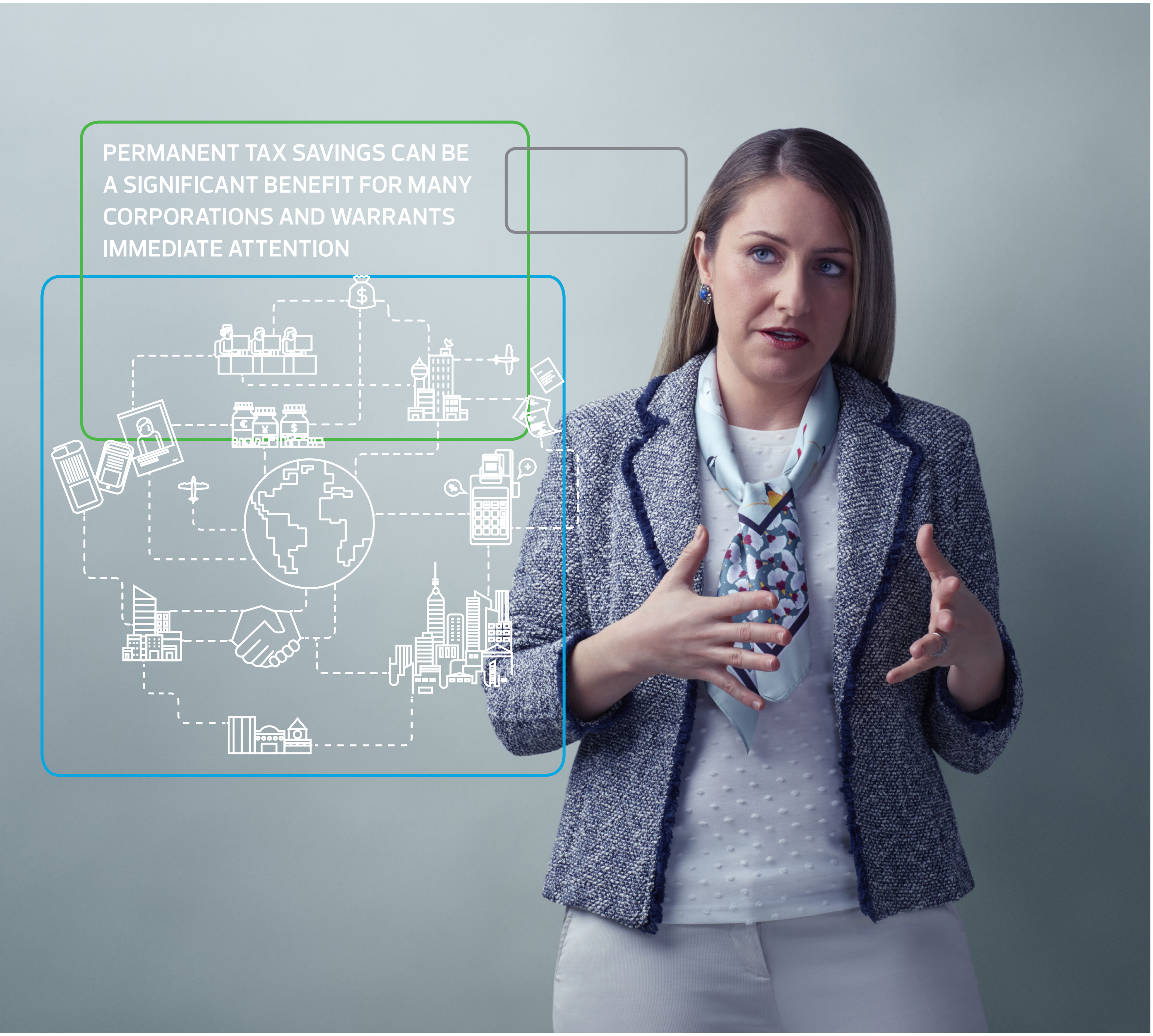
INTERNATIONAL TAX



A ROAD MAP TO NAVIGATING FOREIGN-DERIVED INTANGIBLE INCOME PROVISIONS

Tax reform's new incentive for domestic corporate exporters

THE POWER OF BEING UNDERSTOOD
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Prepared by:

Adam Chesman, Senior Director, RSM US LLP
adam.chesman@rsmus.com, +1 972 590 7312

Michael Mazzarella, Senior Manager, RSM US LLP
michael.mazzarella@rsmus.com, +1 312 634 3466

Brian Hayes, Senior Manager, RSM US LLP
brian.hayes@rsmus.com, +1 312 634 3798

INTRODUCTION

Foreign-derived intangible income (FDII) provisions allow domestic corporations to take a 37.5% deduction, provided they have sufficient total taxable income to absorb that deduction, on export sales and services income—bringing the effective tax rate on that income down to 13.125%—through the end of 2025. After 2025, the FDII deduction shrinks to 21.875% and the effective tax rate rises to 16.406%.

As noted in the preamble to the proposed regulations, the FDII deduction is intended to limit "the role that tax considerations play when a domestic corporation chooses the location of intangible income attributable to foreign-market activity, that is, whether to earn such income through its U.S.-based operations or through its CFCs" (its controlled foreign corporations).

> **Commentary:** "Foreign-derived intangible income" is something of a misnomer. The FDII deduction is not limited to income derived from a corporation's ownership of intangible property, but rather applies to any type of export sales or services income that exceeds a 10% return on tangible assets (provided various requirements are met).

While other provisions of the new tax law, such as the Global Intangible Low-Taxed Income (GILTI) provisions and the Base Erosion and Anti-abuse Tax, have often overshadowed it, the FDII deduction's permanent tax savings can be a significant benefit for many corporations and thus warrants immediate attention.

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STATUTORY OVERVIEW

Section 250(a)(2): Taxable income limitation

The FDII deduction is subject to a taxable income limitation that works in combination with the GILTI rules. If the sum of a domestic corporation's FDII plus GILTI income (including the GILTI-attributable section 78 gross-up amount) exceeds the corporation's taxable income (i.e., FDII income + GILTI income + other regular taxable income) determined without regard to section 250, the excess is allocated pro rata to reduce the corporation's FDII and GILTI income for purposes of section 250. The corresponding deductions for FDII and for GILTI are computed based on these reduced amounts.

Section 250(b): The FDII calculation

To determine its FDII deduction, a domestic corporation must first determine the total amount of its FDII. This is made through a series of complex calculations.

Step 1. Compute deduction eligible income

Deduction eligible income (DEI) is gross income for the year, less certain excluded items and reduced by deductions—including taxes—properly allocable to such modified gross income. Items excluded from DEI and FDII are:

1. Subpart F income
2. GILTI inclusions
3. Financial services income
4. Dividends received from CFCs
5. Domestic oil and gas extraction income
6. Foreign branch income

Section 250 provides no guidance regarding the methodology for allocating deductions to DEI. The statutory formula may be summarized as follows:

DEI = gross income – exclusions – allocable deductions

Step 2. Compute deemed-intangible income

Deemed-intangible income (DII) is the excess of the corporation's DEI less a deemed tangible income return (DTIR). DTIR is 10% of the corporation's qualified business asset investment (QBAI). QBAI is the average of the corporation's adjusted basis in its depreciable tangible property used in a trade or business of the corporation to produce DEI. Adjusted basis is computed on a quarterly basis, using the alternative depreciation system (ADS) under section 168(g). DII can be calculated as follows:

DII = DEI – (10 percent x QBAI)

Commentary: Consider accounting methods planning to minimize the aggregate tax basis in tangible property, and thereby increasing the FDII deduction.

Step 3. Compute foreign-derived deduction eligible income

Foreign-derived deduction eligible income (FDDEI) is the foreign portion of a corporation's DEI. FDDEI includes the DEI derived from:

1. Sale of property to a foreign person that is for a foreign use
2. Services provided by the corporation to any person located outside the United States or with respect to property located outside of the United States

For purposes of determining FDII, the terms "sold," "sells" and "sale" include any lease, license, exchange or other disposition.

Determining foreign use

Foreign use means any use, consumption or disposition outside the United States. While this seems straightforward, the statute provides special rules to keep in mind when determining foreign use.

The first set of rules involves property or services provided to domestic intermediaries. Property sold to an unrelated person for further manufacture or other modification inside the United States will not be considered a foreign use even if the property is subsequently used outside the United States. Similarly, if a service is provided to an unrelated person within the United States, those services will not qualify as foreign use even if such other person uses the services in providing foreign-derived services.

Commentary: For a sale of property to qualify for the FDII deduction, the general rule is that the purchaser must be a foreign person, regardless of relationship to the seller. Use of the term "domestic" intermediaries in the statutory subheading, thus, is a bit confusing. Many tax commentators and tax practioners have interpreted the word "domestic" as referring to the location where activities are taking place, and not to the identity of the purchaser. As such, they have read the statute to mean that the foreign-use requirement will not be met if an unrelated foreign purchaser engages in manufacturing or modification activities in the United States.

The second set of special rules applies to related-party transactions. If property is sold to a related foreign party, then the property needs to either be resold or used in connection with property sold to an unrelated foreign person. Services provided to a related foreign party will be treated as foreign use only if the same, or similar, services are not provided by the related foreign party to persons located in the United States.

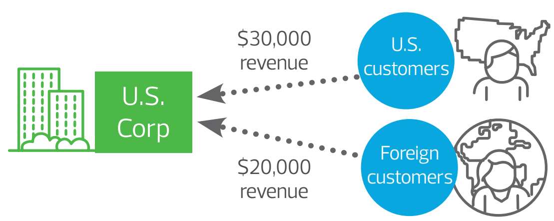
Finally, to qualify for the FDII deduction, corporations must be able to show that export property is being used outside the United States.

Step 4. Computing FDII

$$\text{FDII} = \text{Deemed-intangible income} \times \frac{\text{Foreign derived deduction eligible income}}{\text{Deduction eligible income}}$$

The corporation calculates its FDII by multiplying its DII by the ratio of its FDDEI to its DEI (referred to as the foreign-derived ratio). The formula for FDII can be expressed as the following:

Example of FDII calculation



U.S. Corp., a domestic corporation, has $50,000 of gross revenue and $20,000 of deductions allocable to the gross revenue. These are U.S. Corp.'s only items of income and deductions. Of the $50,000 of gross revenue, $20,000 is foreign-derived. U.S. Corp. also has $100,000 of QBAI.

Step 1: Compute DEI	
Gross income	50,000
Less subpart F income	–
Less GILTI inclusions	–
Less financial services income	–
Less dividends received from CFCs	–
Less domestic oil and gas extraction income	–
Less foreign branch income	–
Modified gross income	50,000
Less allocable deductions	(20,000)
DEI	30,000
Step 2: Compute DII	
QBAI	100,000
Apply routine return factor	10.00%
DTIR (QBAI x 10%)	10,000
DII (DEI – DTIR)	20,000
Step 3: Compute FDDEI	
FDDEI (20,000 – 8,000*)	12,000
Step 4: Compute FDII	
Foreign-derived ratio (12,000/30,000)	40.00%
FDII (DII x foreign-derived ratio)	8,000
FDII deduction (FDII x 37.5%)	(3,000)
Taxable income (30,000 – 3,000)	27,000
Tax rate	21.00%
Tax liability (21% x 27,000)	5,670
U.S. Corp. Effective tax rate (5,670/30,000)	18.90%

* In this example, because 40% of total gross income is foreign-derived, it is assumed that 40% of total deductions are allocable to gross FDDEI.

Effective date

The FDII provisions are effective for years beginning after Dec. 31, 2017.

PROPOSED FDII REGULATIONS

On March 4, 2019, Treasury and the IRS released proposed regulations providing much-needed guidance for determining the FDII deduction. The proposed regulations expand and clarify the computational aspects of FDII and its components, namely DEI, DTIR, DII and FDDEI. Full sections of the proposed regulations are devoted to fleshing out the meaning of foreign use, and to introducing detailed documentation rules for substantiating foreign use. Guidance is also provided for coordinating the FDII deduction calculation with the business interest limitation rules of section 163(j), and the net operating loss deduction rules under section 172. Finally, the proposed regulations provide guidance on the application of the FDII deduction to partnerships, consolidated groups and tax-exempt organizations.

Commentary: While the statute is only a few pages in length, the proposed regulation package runs for 177 pages, with more than 80 pages of preamble language, including over 20 requests for comments, 92 pages of regulatory text and nearly 40 examples.

Taxpayers eligible for the FDII deduction

The proposed regulations provide that the FDII deduction is limited to domestic corporations as defined in section 7701(a), but does not include a regulated investment company or RIC (as defined in section 851), a real estate investment trust (as defined in section 856), or an S corporation (as defined in section 1361).

Domestic corporations subject to the unrelated business income tax (UBIT) under section 511 (tax-exempt organizations) may also claim the FDII deduction, but only with respect to the items of income, gain, deduction or loss, and adjusted bases in property that are taken into account in computing UBIT.

A partnership is not eligible to claim a FDII deduction because it is not a domestic corporation. However, the proposed regulations clarify that a domestic corporate partner takes into account its distributive share of partnership DEI, FDDEI, allocable deductions, in order to calculate the partner's FDII.

Interplay of sections 163(j) and 172 with FDII

How should a domestic corporation with foreign-derived income, interest expense and a NOL compute its FDII deduction, section 163(j) interest deduction limitation and section 172(a)(2) NOL deduction limitation, when all three provisions rely, directly or indirectly, upon taxable income?

Commentary: Section 172(d)(9) states that a domestic corporation's net operating loss (NOL) for a tax year is determined without regard to the FDII deduction, and section 163(j)(8)(A)(iii) provides that a taxpayer's adjusted taxable income (ATI) is determined without regard to section 172. However, neither section 163(j) nor section 250 prescribes an ordering rule regarding the other provision.

In the preamble, the government says it considered the idea of requiring taxpayers to use simultaneous equations to address the interplay of these provisions, but ultimately landed on a five-step ordering rule for applying sections 163(j) and 172 in conjunction with section 250. These steps are as follows:

Five-step ordering rule	
Step 1	Compute tentative section 250 deduction ▪ Take into account all deductions ▪ Disregard sections 163(j), 172(a) and the 250(a)(2) taxable income limitation
Step 2	Compute disallowed interest under section 163(j) ▪ Take into account the tentative section 250 deduction ▪ Disregard section 172(a)
Step 3	Compute NOL under section 172(a) ▪ Take into account section 163(j) ▪ Disregard section 250 (including the tentative section 250 deduction)
Step 4	Compute FDII ▪ Take into account the section 163(j) deduction and the section 172(a) deduction
Step 5	Compute the FDII deduction ▪ Take into account sections 163(j), 172(a) and the 250(a)(2) taxable income limitation

Example of interplay of code sections 163(j), 172 and 250

U.S. Corp., a domestic corporation, has gross DEI and gross FDDEI of $30,000. These are U.S. Corp.'s only items of income. U.S. Corp. also has an NOL carryover of $13,000 and business interest of $10,000. All of U.S. Corp.'s interest expense is allocable to gross FDDEI and the NOL is allocable to gross FDDEI. U.S. Corp. has no other deductions, QBAI, GILTI, floor plan financing interest or business interest income for the tax year.

General computational rules

Important definitions

Dividends	As discussed in *Statutory Overview: Section 250(b): The FDII calculation*, DEI and FDDEI exclude six categories of income, including dividends received from CFCs. The proposed regulations clarify that a section 78 gross-up attributable to subpart F and GILTI inclusions is a dividend for purposes of DEI and FDDEI.
Foreign branch income	DEI and FDDEI also exclude foreign branch income. The proposed regulations define foreign branch income by cross-reference to the proposed foreign tax credit regulations. Proposed regulation section 1.904-4(f)(2), issued Nov. 28, 2018, provides that foreign branch income generally does not include gain from the sale of an interest in a disregarded entity or partnership (unless the branch owns at least 10% of the entity and is engaged in the same or a related business as the entity). The proposed regulations, however, provide that for purposes of FDII, income from the sale of a branch asset, including the sale of an interest in a disregarded entity or partnership (but not a corporation) is considered foreign branch income and is excluded from DEI and FDDEI.
Foreign-derived ratio	Recall that a corporation's FDII is defined as its DII multiplied by the corporation's foreign-derived ratio. The foreign-derived ratio is the ratio of the corporation's FDDEI to its DEI. The proposed regulations clarify that the foreign-derived ratio cannot exceed one.

Commentary: The preamble acknowledges that, as a result of expense apportionment or attribution of cost of goods sold, a domestic corporation's FDDEI could be greater than its DEI. For example, a domestic corporation could have $90 of DEI and $100 of FDDEI, with losses attributable to domestic market sales accounting for the $10 difference between DEI and FDDEI. However, the regulation writers believe that it would be inconsistent with the statute to treat a domestic corporation as having a foreign-derived ratio in excess of one, and therefore pronounce that the foreign-derived ratio cannot exceed one.

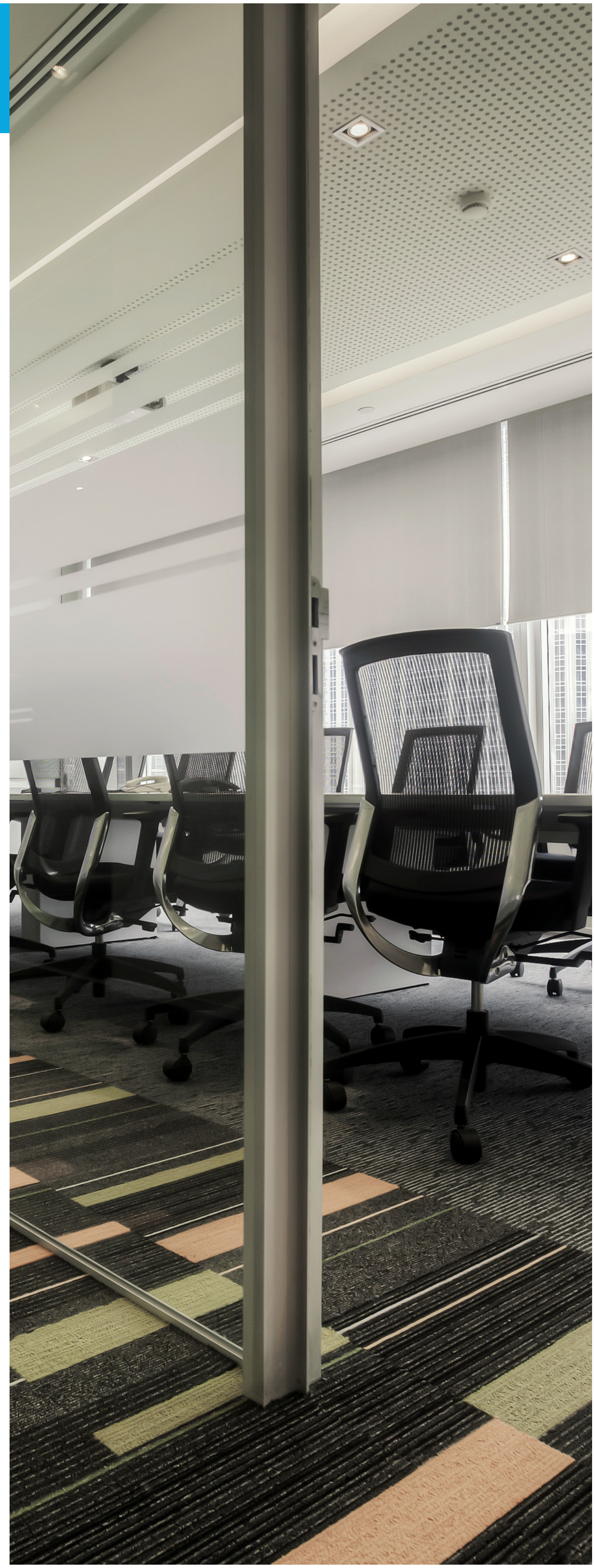
Costs of goods sold

The proposed regulations provide that costs of goods sold must be attributed to gross income under any reasonable method for purposes of calculating gross DEI and gross FDDEI. This attribution is required even for costs of goods sold associated with activities undertaken in prior tax years. Further, the proposed regulations prohibit a domestic corporation from segregating costs of goods sold into component costs and disproportionately attributing them to gross receipts not included in gross DEI or gross FDDEI. This concept is similar to the rule in regulation section 1.199-4(b)(2)(iii)(A), which may provide helpful guidance for this purpose.

Commentary: With regard to the six categories of income not included in gross DEI and gross FDDEI, costs of goods sold would probably be attributable only to domestic oil and gas extraction income and foreign branch income.

Allocation and apportionment of deductions

In determining DEI and FDDEI, the proposed regulations provide that a domestic corporation must first determine gross DEI and gross FDDEI, and then allocate and apportion expenses under regulation sections 1.861-8 through 1.861-14T and 1.861-17 to arrive at DEI and FDDEI. However, in order to avoid circularity, in applying those rules for purposes of determining DEI and FDDEI, the FDII deduction is not treated as giving rise to exempt income or assets (which is important for multinational corporations that must calculate a foreign tax credit limitation). In addition, research and development expenditures are allocated and apportioned using regulation section 1.861-17 but without considering regulation section 1.861-17(b)'s exclusive geographic apportionment rule.



Determination of QBAI

Consistent with the statute, the proposed regulations provide that a domestic corporation's QBAI for FDII is equal to its average adjusted tax basis in specified tangible property as of the close of each quarter of the tax year. Specified tangible property is any tangible property used in the production of gross DEI. Tangible property includes property for which depreciation deductions are eligible under section 168. Adjusted basis is determined using ADS under section 168(g).

To the extent the taxpayer has property used in the production of DEI and non-DEI, the portion of the adjusted basis included in calculating QBAI is determined by multiplying the average adjusted basis in the property by the dual-use ratio. The dual-use ratio is the ratio of gross DEI produced by the property over the total gross income produced by the property for the tax year. If the property does not produce directly identifiable income, then the dual-use ratio is the gross DEI of the domestic corporation over the total gross income of the domestic corporation for the tax year.

If the domestic corporation holds an interest in a partnership, the domestic corporation's QBAI is increased by its share of the partnership's adjusted basis in partnership specified tangible property.

There are special rules related to intercompany transactions in a consolidated group:

QBAI anti-abuse rule

If a domestic corporation transfers specified tangible property to a related party and leases the same or substantially similar property from any related party, then for purposes of computing the QBAI of the domestic corporation, the corporation will be treated as owning the transferred property from the later of the beginning of the term of the lease date or the date of the transfer of the property, until the earlier of the end of the term of the lease or the end of the recovery period of the property. If a similar transfer takes place with an unrelated party and is deemed a structured arrangement, the transfer will be treated as if it was made to a related party.

Aggregate approach for determining FDII

The proposed regulations clarify that FDII is determined on an aggregate basis—rather than on a transaction-by-transaction basis—for all transactions that meet the FDII description.

FDDEI transactions

The proposed regulations define FDDEI transactions as either an FDDEI sale or an FDDEI service. To the extent a transaction has both sale and service components, the transaction is classified with reference to the overall predominant character of the transaction for purposes of determining whether the transaction is subject to treatment as an FDDEI sale or FDDEI service. For example, the sale of equipment that includes incidental support services at no additional cost would be classified as a sale of property rather than as a service transaction.

QUICK GUIDE TO FDDEI TRANSACTIONS

FDDEI sales	FDDEI services
Property sold by the taxpayer to a foreign person for a foreign use (including leases, licenses, exchanges and other dispositions, but not including sales of securities and specified commodities)	Services provided by the taxpayer to any person not located in the United States, or with respect to property, not located in the United States
Broken into sales of general property and intangible property	Broken into proximate services, property services, transportation services and general services
Sales to domestic intermediaries do not qualify	Services provided to domestic intermediaries do not qualify
Sales to foreign related parties can qualify if ultimately sold to or used to provide services to an unrelated, foreign person	Services provided to a related party outside the United States can qualify if not substantially similar to services performed by the related party provided to persons in the United States
Documentation requirements apply to all FDDEI sales	Documentation requirements apply to general services, but not proximate, property or transportation services

Qualifying FDDEI sales

A qualifying FDDEI sale is a sale of property to a foreign person for foreign use. Consistent with the statute, the proposed regulations define the term sale to include a lease, license, exchange or disposition of property. The proposed regulations make clear that the term sale also includes any transfer of property in which gain or income is recognized under section 367, including a transfer of intangible property subject to section 367(d).

The proposed regulations define a foreign person as a person that is not a U.S. person, which includes a foreign government or international organization for purposes of the proposed regulations.

> **Commentary:** A U.S. person is defined in section 7701(a)(30). However, to prevent the possible inconsistent treatment of sales to entities in a U.S. territory (qualifying as a FDDEI sale) and sales to individuals in a U.S. territory (not qualifying as a FDDEI sale), the proposed regulations exclude bona fide residents of a U.S. territory from the definition of U.S. person.

Whether the sale of property is for a foreign use depends on whether the property sold is general property or intangible property.

> **Commentary:** Unlike the IC-DISC rules, for a sales transaction to qualify for FDDEI there is no content test requiring the property sold have a certain percentage of domestic content.

General property

General property is any property other than intangible property, a security or a commodity. A sale of general property will be considered for a foreign use if (i) the property is not subject to a domestic use within three years of the date of delivery, or (ii) the property is subject to manufacture, assembly, or other processing outside the United States prior to any domestic use. To the extent property is subject to any use, consumption, or disposition within the United States, or to the extent property is manufactured, assembled or otherwise processed within the United States, the property is considered to have undergone a domestic use.

> **Commentary:** Although the statute does not provide clear guidance on foreign use, the proposed regulations are generally consistent with legislative history. Footnote 1522 of the [conference report to the Tax Cuts and Jobs Ac (TCJA)] says if "property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use."

Property is considered as having been subject to manufacture, assembly or other processing if the product is physically and materially changed or incorporated as a component into a second product. This determination is based on all relevant facts and circumstances. However, minor assembly, packaging or labeling should not constitute a physical and material change.

General property is treated as a component of a second product to the extent the fair market value of such property when delivered is no more than 20% of the fair market value of the second product, determined at completion. All general property sold to a recipient by a seller and incorporated into a second product is treated as a single item of property for this purpose.

In the case of certain transportation property (aircraft, railroad rolling stock, vessels, motor vehicles or other similar property), the property is only sold for a foreign use if, for the three-year period from the date of delivery, the property is located outside the United States more than 50% of the time and more than 50% of the miles travelled are outside the United States. For this purpose, transportation property is deemed to be in the United States at all times when it is engaged in transport within any two points in the United States unless the transport is uninterrupted international air travel.

To the extent the sale of a fungible mass property cannot be reasonably traced to the location of use, a seller may establish that a portion of the fungible mass is for a foreign use via documentation, including market research, statistical sampling, economic modeling and other similar methods. If these methods establish that more than 90% of the fungible mass is for a foreign use, then the entire fungible mass is for a foreign use. If the seller is unable to establish 10% or more of the sale as for a foreign use, then none of the fungible mass will be considered for a foreign use.

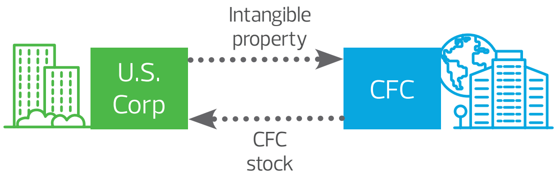
Intangible property

Intangible property is defined by cross-reference to section 367(d)(4) and includes patents, trademarks and franchises. A sale of intangible property will be considered for a foreign use if the seller generates revenue from exploitation of the intangible property outside the United States. If the sale of intangible property provides rights to exploit the property both within and without the United States, the revenue generated from such property is considered for a foreign use in proportion to the revenue generated from exploitation outside the United States over the total revenue generated from the intangible property. When periodic payments are received, the extent of foreign use is determined annually based on the actual revenue earned in the tax year in which the periodic payment is received. When property is sold for a lump sum, the extent to which the sale is for a foreign use is determined based on the ratio of the total net present value of revenue expected from the exploitation outside the United States over the total net present value expected from the exploitation of the intangible property.

Example of deemed sale under code sections 367(d)

Outbound transfers of intangible property in general

Under section 367(d), an outbound transfer of intangible property by a U.S. person to a foreign corporation pursuant to sections 351 or 361 is treated as a deemed sale of the property in exchange for a continuing deemed annual royalty. The deemed royalty is characterized as ordinary income over the useful life of the property, not to exceed 20 years. The appropriate charge for the deemed royalty is determined in accordance with the provisions of section 482. If within the intangible's useful life, the foreign corporation subsequently disposes of the property to an unrelated party, then the U.S. transferor recognizes gain equal to the difference between the fair market value of the property and its adjusted basis.



U.S. Corp., a domestic corporation, develops a patent and transfers the patent to its Cayman Islands subsidiary, CFC, in a section 351 transaction. CFC uses the patent to produce product A in the Cayman Islands. Under these circumstances, U.S. Corp. is treated as having sold the patent to CFC. Under section 367(d), U.S. Corp. is required to recognize ordinary income annually over the useful life of the patent on deemed royalty payments from CFC. In the current tax year, CFC earns $10,000 of revenue from sales of product A. Based on CFC's sales records for the tax year, $3,000 of its revenue is earned from sales of product A to customers in the United States, and $7,000 of its revenue is earned from sales of product A to customers outside the United States.

Based on CFC's sales records, U.S. Corp. has obtained documentation that 70% ($7,000/$10,000) of the revenue generated by the intangible property is outside the United States in the tax year. Accordingly, for the tax year, 70% of U.S. Corp.'s income inclusion under section 367(d) is included in U.S. Corp.'s gross FDDEI.

Qualifying FDDEI services

The proposed regulations introduce four categories of qualifying FDDEI services: proximate services, property services, transportation services and general services. Each category contains a different foreign use test.

Proximate services

A service, other than a property or transportation service, substantially all of which is performed in the physical presence of the recipient or, in the case of a business recipient, in the presence of its employees. Onsite training, consulting and auditing are examples of a proximate service. More than 80% of the service provider's time must be spent in the physical presence of the recipient for it to be considered substantially all. A proximate service is a FDDEI service if it takes place outside of the United States but may qualify in part if it takes place partly within the United States.

Property services

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 foreign location of the property and results in physical manipulation of the property. Physical manipulation of the property includes assembly, maintenance or repair. Like a proximate service, more than 80% of the service provider's time must be spent at or near the location of the property for it to be considered substantially all.

Other services related to the property, but not provided at the location, are not considered property services. For example, an architectural service not performed at the location will be evaluated as a general service.

Transportation services

A service to transport a person or property using any mode of transportation. The proposed regulations provide that the origin and destination of the service will determine whether the service was provided outside of the United States. If both origin and destination of the service are located outside of the United States, then the entire amount of gross income qualifies as foreign. If either the origin or the destination of the transportation service is outside of the United States, then only 50% of the service qualifies.

General services

A service other than a proximate, property or transportation service. The proposed regulations further separate general services provided to consumers and business recipients. As one may expect, consumer services are services provided to individuals for personal consumption. A business recipient is defined as any recipient other than a consumer.

For both consumer and business services, the recipient must be located outside of the United States. For consumers, the test of foreign use depends on where the consumer resides when the service is provided. For business recipients, the test of foreign use depends on the location of the business recipient's operations and the operations of any related party of the recipient that received a benefit as a result of the service.

The proposed regulations go on to state that a business recipient is treated only as having operations in a location where it maintains an office or fixed place of business. The location of residence, incorporation or formation of a business recipient is not relevant.

When a service provides a benefit for a recipient's business as a whole, or where reliable information about which related operations specifically receive a benefit is unavailable, the proposed regulations deem the benefit relates to all of the business recipient's operations. The service provider must then allocate its gross income between the operations that receive a benefit that are located within and outside of the United States. Any reasonable method may be used and the principles of regulation section 1.482-9(k) apply to determine whether a method is reasonable.

Domestic intermediary rule

The proposed regulations do not contain specific rules corresponding to the domestic intermediary rule of the statute. However, the preamble makes clear that a sale of property to a U.S. person and a sale of property to a foreign person for further manufacture in the United States is not a FDDEI sale, regardless of the ultimate use of the property by the recipient.

Commentary: In the case of a back-to-back sale—domestic corporation sells to an unrelated domestic intermediary, which then on-sells to a foreign purchaser—the first sale does not qualify for the FDII deduction; the second sale retains eligibility.

With respect to the provision of services, the preamble states that a service provided to a person, or with respect to property, located within the United States is not a FDDEI service, regardless of the ultimate use of the service by the recipient.

Related-party transactions

A sale of property or rendering of services to a related foreign party may qualify as a FDDEI transaction if certain additional requirements are satisfied.

Related party defined

The proposed regulations define a related party as any member of a modified affiliated group that includes such person. A modified affiliated group is defined as an affiliated group as provided in section 1504(a) by substituting more than 50% for at least 80% each place it appears, and without regard to section 1504(b)(2) and (3) (which refer to insurance companies subject to tax under section 801 and foreign corporations). A modified affiliated group also includes any person other than a corporation that is controlled by one or more members of a modified affiliated group or that controls such a member.

Related-party sales

A sale of general property to a foreign related party qualifies as a FDDEI sale if the following conditions are met:

1. The sale of the property otherwise qualifies as a FDDEI sale (e.g., sale of general property to a foreign person for a foreign use)
2. The related party sells the property to a foreign unrelated party or uses the property to provide a service to a foreign unrelated party
3. The unrelated party transaction occurs on or before the due date of the return (including extensions)

There are not specific rules related to the sale of intangible property to a foreign related party. The existing rules for determining the foreign use of intangible property should be applied when determining whether such a transaction qualifies as a FDDEI sale.

If the unrelated party transaction occurs after the due date of the return (including extensions), a taxpayer may file an amended return for the tax year in which the related-party sale occurs claiming the sale as a FDDEI sale for purposes of determining its FDII attributes for the year. For these purposes, all foreign related parties of the seller are treated as if they were a single foreign related party, and thus if one foreign related-party sells the property to a second foreign related party, the transaction is disregarded and an ultimate sale from the second foreign related party to a foreign unrelated party is required.

Related-party services

Related-party services are only considered FDDEI services if the related-party service is not substantially similar to a service provided by the related party to a person located within the United States. If 60% or more of the related party's services are rendered to persons located in the United States or 60% or more of the price paid by persons within the United States to the related party are attributable to the related-party service, they will be deemed to be substantially similar services. If the 60% benefit test is failed, the entire transaction is disqualified from FDDEI treatment; however, if the 60% price test is failed, only a portion of the income is disqualified in proportion to the amount that benefitted persons located in the United States.

The proposed regulations provide an example where a foreign related party enters into an agreement with a domestic corporation to have design services provided to the foreign related party. The foreign related party will use those design services to provide architectural services to exclusively benefit a customer's U.S. operations. In this case, the services provided by the domestic corporation to the foreign related party will be treated as substantially similar and will not qualify as a FDDEI service.

Application to certain taxpayers

Consolidated groups

The proposed regulations provide that the FDII deduction for a member of a consolidated group be determined by reference to the relevant items of all members of the same consolidated group. The proposed regulations provide for the aggregation of the consolidated group's DEI, FDDEI, DTIR and GILTI for all members. These aggregate numbers and the group's consolidated taxable income are used to calculate an overall deduction for the group, and then the overall deduction is allocated to the members of the group.

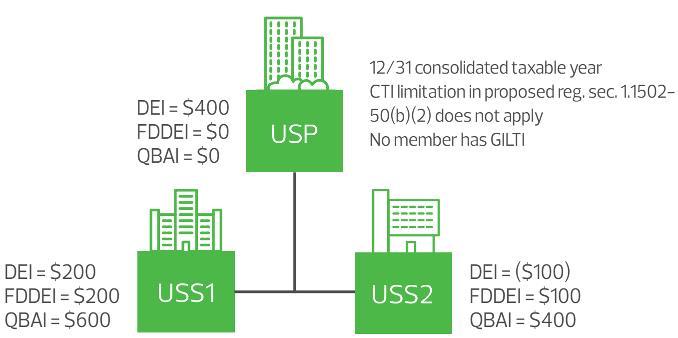
The proposed regulations address two issues relating to intercompany transactions.

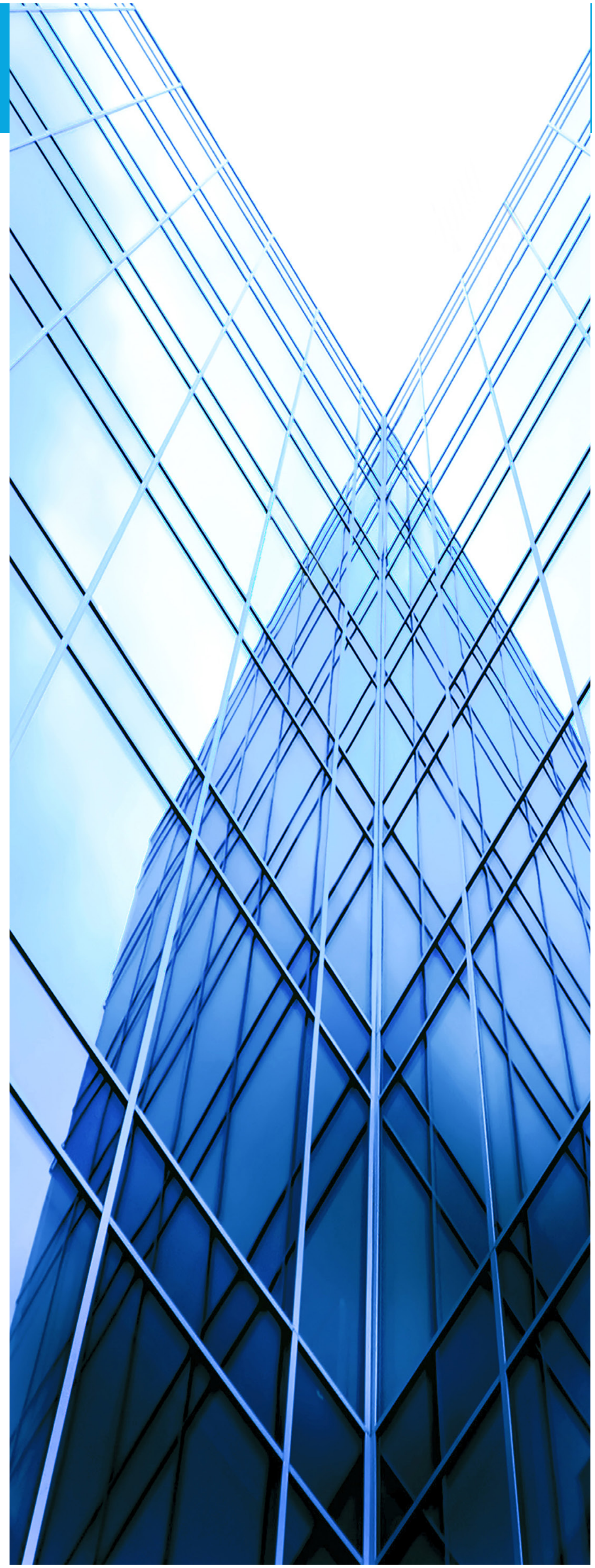
1. The proposed regulations add an example to regulation section 1.1502-13 demonstrating the applicability of the attribute redetermination rule of regulation section 1.1502-13(c)(1)(i). This example applies the intercompany transaction rules to clearly reflect consolidated taxable income.
2. The proposed regulations provide that, for purposes of determining a member's QBAI, the basis of specified tangible property will not be affected by an intercompany transaction. Accordingly, an intercompany transaction cannot result in the increase or decrease of a consolidated group's aggregate amount of DTIR or, in turn, aggregate amount of deduction.

Consolidated group member basis

The proposed regulations indicate that an adjustment to the parent's basis in its investment in a subsidiary member of a consolidated group should be made as if the FDII deduction is treated as tax-exempt income under regulation section 1.1502-32(b)(3)(ii)(B).

Example of consolidated FDII deduction





U.S. Parent (USP) is the common parent of an affiliated group of U.S. corporations that join in filing a U.S. consolidated return. USP owns all of the outstanding stock of U.S. Subsidiary 1 (USS1) and U.S. Subsidiary 2 (USS2). The USP group is on a calendar year-end. In 2018, USP has DEI $400, FDDEI of $0, and QBAI of $0; USS1 has DEI of $200, FDDEI of $200, and QBAI of $600; and USS2 has DEI of ($100), FDDEI of $100, and QBAI of $400. These are the USP group's only items of income and deductions. The consolidated taxable income (CTI) limitation in proposed regulation section 1.1502-50(b)(2) does not apply (because the group has sufficient consolidated taxable income). No member of the USP group has GILTI.

Step 1: Compute consolidated DEI	
Consolidated DEI ($400 + $200 + ($100))	500
Step 2: Compute consolidated DII	
Consolidated QBAI ($0 + $600 + $400)	1,000
Apply routine return factor	10.00%
Consolidated DTIR (QBAI x 10%)	100
Consolidated DII (DEI – DTIR)	400
Step 3: Compute consolidated FDDEI	
Consolidated FDDEI ($0 + $200 + $100)	300
Step 4: Compute consolidated FDII	
Consolidated foreign-derived ratio (300/500)	60.00%
Consolidated FDII (DII x foreign-derived ratio)	240
Consolidated FDII deduction (FDII x 37.5%)	90

Member's FDII deduction attributable to consolidated FDII
Under proposed consolidated return regulations, the USP group's consolidated FDII deduction is allocated among the group's members based on each member's respective proportionate contribution to the consolidated group's aggregate amounts of FDDEI as follows:

- USP: $90 x (FDDEI $0/consolidated FDDEI $300) = 0
- USS1: $90 x (FDDEI $200/consolidated FDDEI $300) = $60
- USS2: $90 x (FDDEI $100/consolidated FDDEI $300) = $30

Partnerships with corporate partners

The proposed regulations provide that a domestic corporate partner of a partnership takes into account its distributive share of a partnership's gross DEI, gross FDDEI and deductions in order to calculate such corporate partner's FDII. When determining a corporate partner's DTIR, a domestic corporate partner's QBAI is also increased by its share of the partnership's adjusted basis in its specified tangible property.

Because the FDII deduction is ultimately determined at the corporate partner's level based on an aggregation of all its attributes, a partnership with one or more direct or indirect partners that are domestic corporations must furnish such partners with a Schedule K-1 that includes the partner's share of the following items:

- Gross DEI
- Gross FDDEI
- Deductions definitely related to the partnership's gross DEI
- Deductions definitely related to the partnership's gross FDDEI
- Partnership QBAI

Partnership basis
Because the FDII deduction is computed and allowed only at the domestic corporation level, it is not considered to exempt any income from tax for purposes of computing partnership income. Therefore, no adjustment should be made to the domestic corporation's basis in its partnership interest related to a FDII deduction.

Military sales

The proposed regulations provide rules for applying section 250 to foreign military sales and services. Foreign military sales or services to the U.S. government under the Arms Export Control Act that are ultimately for the benefit of a foreign government are treated as a sale of property or provision of services to a foreign person.

The Arms Export Control Act authorizes the president to control the import and export of defense articles and services by issuing a license to an individual or organization that wishes to export defense articles or services. Otherwise, exportation of these items is not permitted.

Documentation rules

The proposed regulations introduce documentation requirements to establish that a sale or service qualifies as a FDDEI transaction. Due to the distinction between types of qualifying FDDEI transactions (such as property, general services, proximate services, property services and transportation services), the documentation requirements vary depending on the nature of such transactions.

> **Commentary:** Taxpayers are not required to follow the documentation requirements outlined below for tax years beginning on or before March 4, 2019. Instead, the proposed regulations allow taxpayers to use any reasonable documentation maintained in the ordinary course of business that establishes the recipient is a foreign person, the property is for a foreign use or that a recipient of a general service is located outside the United States. This reasonable documentation includes the types allowable for the special rules for small businesses and small transactions, even if the taxpayer would not otherwise qualify.

Reliability of documentation

In general, any documentation supporting any type of FDDEI transaction must meet certain reliability requirements. The seller or renderer (i.e., a person who provides services to a recipient) must obtain the documentation by the due date of the return (including extensions), the documentation must be obtained no earlier than one year before the sale or service, and the seller or renderer must not know, or have reason to know, that the documentation is incorrect or unreliable.

> **Commentary:** The proposed regulations do not define the terms "know" and "reason to know." However, the preamble provides that a seller or renderer is treated as knowing or having reason to know that documentation is unreliable or incorrect if a reasonably prudent person in the position of the seller or renderer would question the accuracy or reliability of the documentation.

Sales of property

For sales of property to qualify as a FDDEI transaction, a seller must establish that the sale of property was to a foreign person for a foreign use. The sale may be of general property or intangible property.

QUICK GUIDE TO DOCUMENTATION REQUIREMENTS FOR FDDEI SALES

Foreign person	▪ A written statement by recipients attesting to their foreign status ▪ Documentation of organization under laws of the foreign jurisdiction ▪ Valid identification used by a foreign government for individuals ▪ Documentation filed with a foreign government evidencing the organization or residency of the entity in a foreign country ▪ Other documentation as prescribed
Foreign use (general property)	▪ A written statement by the recipient attesting to the foreign use ▪ Contractual language providing that the sale is for a foreign use ▪ Documentation of shipment to a location outside the United States ▪ Other documentation as prescribed ▪ Special rules for fungible mass property
Foreign use (intangible property)	▪ A written statement of annual revenue from sales generated from foreign exploitation of intangible property and from worldwide sales ▪ Contractual language providing that the intangible property can only be exploited outside the United States ▪ Audited financial statements showing revenue earned within and outside the United States from products using the intangible property ▪ Documents used by the seller and recipient to determine amounts due from exploitation of intangible property, if they provide reliable data on revenue earned within and outside the United States ▪ Other documentation as prescribed ▪ Special rules for lump-sum payments

Foreign person
A seller must document the status of a recipient as a foreign person by obtaining one or more of the types of documentation noted in the table above with respect to such person.

For small businesses that receive less than $10 million in gross receipts during the prior tax year, a special rule applies that allows them to establish the status of a recipient as a foreign person if the seller's shipping address for the recipient is outside the United States. If the seller's prior tax year was less than 12 months, the gross receipts must be annualized to determine if the special rule applies. A similar rule applies for sellers that receive less than $5,000 in gross receipts during a tax year from a particular recipient.

Foreign use (general property)
In addition to documenting the foreign status of the recipient, the seller must also document that the general property sold was for a foreign use. A seller must document the foreign use of the property sold by obtaining one or more of the types of documentation noted in the table above with respect to the sale.

When determining whether property was sold for a foreign use, similar rules apply for small businesses and small transactions as described above for the determination of a recipient's status as a foreign person.

Foreign use (intangible property)
When the property sold is intangible property subject to periodic payments (such as a license of such property), special documentation rules apply to determine the foreign use. In these situations, the seller must obtain one or more of the types of documentation noted in the table above with respect to the sale.

If the terms of the sale of intangible property include a lump-sum payment, the seller must establish the extent to which the sale of intangible property is for a foreign use by providing documentation containing reasonable projections of the amount and location of revenue that the seller would have reasonably expected to earn from exploiting the intangible property.

Provision of services

As discussed in detail above, the proposed regulations divide the provision of services into several different categories. The documentation requirements related to such services vary depending on the category of service to which a FDDEI transaction belongs.

QUICK GUIDE TO DOCUMENTATION REQUIREMENTS FOR FDDEI SERVICES

General services (consumer)	▪ A written statement indicating the consumer resides outside the United States when the service is provided ▪ Valid identification used by a foreign government ▪ Other documentation as prescribed
General services (business recipient)	▪ A written statement specifying the location of business operations that benefit from the services ▪ Contractual language or other documentation obtained in the ordinary course of business that specifies the location of the business operations that benefit from the service ▪ Publicly available information that establishes the locations of the business operations of the recipient ▪ Other documentation as required
Proximate, property and transportation services	▪ No specific documentation requirements

General services provided to consumers
For the provision of general services to consumers (meaning individuals who purchase general services for personal use), the service renderer must establish that the service was provided to a consumer located outside the United States at the time the service is provided. In order to establish this, the renderer must obtain one or more of the types of documentation noted in the table above for general services (consumer).

For small businesses that receive less than $10 million in gross receipts during the prior tax year, a special rule applies that allows them to establish the consumer of the service provided was located outside the United States if the billing address for the consumer is outside the United States. If the seller's prior tax year was less than 12 months, the gross receipts must be annualized to determine if the special rule applies. A similar rule applies for sellers that receive less than $5,000 in gross receipts during a tax year from a particular recipient.

General services provided to business recipients
For the provision of general services to business recipients (meaning any person other than a consumer, as described above), the service renderer must establish that the service was provided to a business recipient located outside the United States. In order to establish this, the renderer must obtain one or more of the types of documentation noted in the table above for general services (business recipients).

When determining whether services were rendered to a business recipient located outside the United States, similar rules apply for small businesses and small transactions as described above for the determination of a consumer's status as a foreign person.

Proximate services, property services, and transportation services
The proposed regulations do not require specific documentation with respect to proximate services, property services or transportation services. These services qualify as FDDEI transactions if they meet the various requirements for a FDDEI service under proposed regulation section 1.250(b)-5(f), (g) and (h) respectively.

Treatment of certain loss transactions
Some corporations may be motivated to intentionally fail the FDII documentation requirements for a FDDEI loss. These corporations might assume that if the loss is not properly documented, they can avoid taking it into account. Ignoring the loss would effectively increase their FDDEI and, consequently, the FDII deduction.

Corporations, however, are not allowed to intentionally fail the documentation requirements for FDDEI loss transactions. The proposed regulations provide that an improperly documented transaction is taken into account in the FDDEI calculation if: (i) it would reduce FDDEI, and (ii) the seller or renderer knows or has reason to know that it is a foreign transaction.

Commentary: Section 250 is intended to be an aggregate calculation based on all of the gross income derived in connection with FDDEI sales and FDDEI services. Therefore, the proposed regulations indicate that it would be inappropriate to permit taxpayers to elect to exclude losses by simply not meeting the documentation requirements. However, the special loss transaction rule does not apply to FDDEI transactions that are classified as proximate services, property services or transportation services.

Example of loss transactions
U.S. Corp., a domestic corporation, manufactures products A and B in the United States. U.S. Corp. sells product A for $200 and product B for $800. U.S. Corp.'s costs of goods sold is $450. U.S. Corp. attributes $250 of costs of goods sold to product A and $200 of costs of goods sold to product B. U.S. Corp. knows or has reason to know that all of its product A and product B sales are to foreign persons for a foreign use. U.S. Corp. establishes that its product B sales are to foreign persons for a foreign use but does not obtain documentation establishing that any product A sales are to foreign persons for a foreign use. U.S. Corp. has no other items of income, loss, or deduction.

	Product A	Product B	Total
Gross receipts	$200	$800	$1,000
Costs of goods sold	$250	$200	$450
Gross income (loss)	($50)	$600	$550

By not treating product A sales as FDDEI sales, the amount of U.S. Corp.'s FDDEI would increase by $50 relative to its FDDEI if product A sales were treated as FDDEI sales. Because U.S. Corp. knows or has reason to know that product A sales are to foreign persons for a foreign use, product A sales are deemed FDDEI sales and thus the $50 loss is included in U.S. Corp.'s gross FDDEI.

Reporting requirements

Any domestic corporation must prepare an annual return on form 8993, section 250 deduction for FDII and GILTI. This form must be filed with the income tax return on or before the due date (including extensions) for the return.

In addition, filers of Forms 5471, 5472 or 8865 must report certain information relating to their transactions with foreign business entities or related parties.

As mentioned in section *Partnerships with corporate partners*, certain domestic partnerships with direct or indirect domestic corporation partners must report certain information to such partners as part of the Schedules K-1 for the tax year.

Applicability dates

The proposed regulations generally apply for tax years ending on or after March 4, 2019. For tax years beginning before March 4, 2019, taxpayers are not required to follow the documentation requirements in the proposed regulations. Instead, taxpayers may use any reasonable documentation maintained in the ordinary course of business to establish that a person is a foreign person, property is for a foreign use, or a recipient is located outside the United States, in lieu of the documentation requirements.

The preamble states that taxpayers may rely on the proposed regulations for tax years ending before May 4, 2019, which includes 2018 for calendar-year taxpayers.

FDII offers an opportunity to significantly reduce the effective tax rate on at least a portion of a domestic corporation's taxable income for the year, producing a permanent tax benefit. Given the value of the FDII deduction, companies and their tax advisors should spend time understanding the rules to determine how to apply them to their specific facts.

Taxpayers should also keep in mind that the permanency of FDII may be in question. FDII may be subject to challenges by the World Trade Organization and other groups as an impermissible export subsidy. However, it typically takes three to five years to resolve such disputes, therefore FDII benefits should be viable for at least the immediate future.

GLOSSARY

ADS:	Alternative depreciation system
ATI:	Taxpayer's adjusted taxable income
BEAT:	Base erosion and anti-abuse tax
CFC:	Controlled foreign corporation
CTI:	Consolidated taxable income
DEI:	Deduction eligible income
DTIR:	Deemed tangible income return
FDDI:	Foreign-derived intangible income
FDDEI:	Foreign-derived deduction eligible income
GILTI:	Global intangible low-taxed income
NOL:	Net operating loss
QBAI:	Qualified business asset investment
RIC:	Regulated investment company
TCJA:	Tax Cuts and Jobs Act of 2017
UBIT:	Unrelated business income tax

+1 800 274 3978
rsmus.com

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