tax notes international®

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Proposed FDII Regulations Bring Some Clarity

by Julia Ushakova-Stein

Julia Ushakova-Stein

Julia Ushakova-Stein is an associate with Fenwick & West LLP in Mountain View, California.

In this article, the author discusses the proposed U.S. foreign-derived intangible income regulations and highlights important areas that the regs clarify for taxpayers.

On March 4 Treasury and the IRS released the highly anticipated proposed foreign-derived intangible income regulations (REG-104464-18) under section 250. That section provides a deduction against a domestic corporation's income from foreign property sales and provision of services to foreign persons that results in an effective tax rate on that income of 13.125 percent through 2025 and 16.4 percent thereafter. FDII was enacted as part of the Tax Cuts and Jobs Act and is a corollary to the new global intangible low-taxed income regime. FDII is intended to encourage U.S. corporations to earn foreign sales and services income directly or through a foreign subsidiary — or at least make them indifferent to that structure.

The proposed FDII regulations address several questions taxpayers have been waiting to receive clarity on; some of the major topics are outlined below.

Proving Property Is for Foreign Use

The FDII deduction is available for foreign-derived deduction eligible income (FDDEI), which is income derived in connection with property sold to foreign persons for foreign use or services provided to a person or for property not in the United States. Under prop. Treas. reg. section 1.250(b)-4(d) and (e), determining whether a sale of property is for foreign use depends on whether the property sold is general or intangible. General property is defined as property other than intangible property, a security, or a commodity, although sales of securities and commodities are not FDDEI because, according to the preamble, those kinds of financial instruments are not subject to any use, consumption, or disposition outside the United States under section 250(b)(5)(A). Intangible property is defined by cross-reference to section 367(d)(4), meaning that goodwill and going concern value are captured.

Foreign Use for General Property

The sale of general property to foreign persons is for foreign use if either the property is not subject to domestic use within three years of its delivery, or the property is subject to manufacture, assembly, or other processing outside the United States before its ultimate sale. Manufacture, assembly, or other processing occurs only if the property is physically and materially changed (excluding minor assembly, packaging, or labeling) or is incorporated as a component into a second product and is no more than 20 percent of the fair market value of that product. A facts and circumstances test is used to determine whether general property has been physically and materially changed. There are special rules for transportation property, such as aircraft and motor vehicles: Foreign use is established if during the three years beginning on delivery the property is located outside the United States more than 50 percent of the time and more than 50 percent of its miles are traversed outside the United States. Although foreign use must be established either for all or none of the income from the sale of general property, apportionment between foreign and domestic use for income from the sale of general property is acceptable if use of the property cannot be traced because of the property's fungible nature (fungible mass).

For more *Tax Notes International* content, please visit www.taxnotes.com.

Foreign Use for Intangible Property

The proposed regulations provide that a sale, including a license or any transfer of property in which gain or income is recognized under section 367, of intangible property to foreign persons is for a foreign use if it generates revenue from exploitation outside the United States, with intangible property being used in development, manufacture, sale, or distribution of a product being treated as exploited at the location of the end-user when the product is sold. Unlike a sale of general property (other than a sale of a fungible mass), a seller can establish foreign use for a portion of the income from the sale of intangible property.

Whether a sale is foreign use depends on the type of payment made for the intangible property. If the consideration is in the form of periodic payments, foreign use is determined annually based on the actual revenue earned by the recipient. If the consideration is in the form of a lump sum, foreign use is determined based on the ratio of the total net present value of revenue the seller would have reasonably expected to earn from exploitation of the intangible property outside the United States to the total net present revenue the seller would have reasonably expected to earn from exploitation of the intangible property worldwide. For a lump sum payment from an unrelated party, the seller can make reasonable annual projections of the amount and location of revenue, consistent with the financial data and projections used to determine the price of the intangible property the seller would have reasonably expected to earn from exploiting the property.

Also, the preamble states that intangible property is not subject to manufacture, assembly, or processing, and, relying on the lack of discussion in the conference report (H.R. Rep. No. 115-466), it states that Treasury and the IRS do not provide a rule for intangible property analogous to the manufacturing process rule for general property.

Documentation and Knowledge Requirements

Foreign use for general and intangible property is established if the seller obtains documentation that meets the reliability requirement and does not know or have reason to know otherwise as of the date the relevant tax return is due, including extensions (FDII filing date). The reliability requirement is met if: (1) as of the FDII filing date, the seller does not have reason to know that the documentation is objectively unreliable; (2) the documentation is obtained by the FDII filing date; and (3) the documentation is obtained no earlier than one year before the sale or service.

Documentation of foreign use of general property is established if the seller obtains any one of the following:

- a written statement from the recipient that the recipient's use or intended use of the property meets the foreign use requirement;
- a binding contract with the recipient that the recipient's use or intended use of the property meets the foreign use requirement;
- documentation of shipment outside the United States — for example, the export bill of landing from the carrier or an equivalent document from the foreign customs officer; or
- documentation as provided for by the Treasury secretary.

However, for fungible mass property, the documentation requirement can be met by providing market research indicating that the property will be subject to foreign use.

Although the foreign use requirement for general property is rather burdensome in that it requires the seller to fully understand the purchaser's supply chain — an ask that many purchasers would be unwilling to accommodate, especially regarding the requirement that the property not be used domestically for three years (a rather long time) — the option to provide shipment documentation seems to alleviate this burden. The proposed regulations provide that so long as shipment documentation is obtained (typically a standard practice for most exporters), the seller will meet the foreign use requirement without having to obtain written statements from or amend its contracts with the purchaser. However, if the seller knows or has reason to know that the foreign use requirement would not be met, shipment documentation cannot be relied on.

Documentation of foreign use of intangible property in exchange for periodic payments is

For more *Tax Notes International* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

established if the seller obtains any one of the following:

- a written statement from the recipient providing the amount of annual revenue within and outside the United States for the intangible property;
- a binding contract with the recipient providing that the intangible property can be exploited solely outside the United States;
- the recipient's audited financial statements or annual reports showing the annual revenue earned inside and outside the United States from the sale of products related to the intangible property;
- any statements or documents providing reliable data used by the seller and the recipient to determine the amount of payments that must be made for the exploitation of the intangible property; or
- documentation as provided for by the Treasury secretary.

However, for a sale of intangible property to an unrelated party in exchange for periodic payments that are not contingent on revenue or profit, the seller may use the lump sum payment documentation requirements annually if the documentation requirements are otherwise unduly burdensome. Documentation of foreign use of intangible property in exchange for a lump sum payment is established if reasonable projections are provided.

Sellers will need to evaluate their contracts for sales of intangible property to verify that they are entitled to receive information that meets at least one of the documentation requirements, which is likely to be the case if the seller receives annual royalties contingent on revenue or profit and has the right to verify the calculation of those royalties. If the contracts do not cover that documentation, sellers will want to incorporate the appropriate limitations or requirements to receive the relevant financial information, which recipients might oppose. The information that likely will be the most challenging to obtain involves intangible property used in development, manufacture, sale, or distribution of a product because the seller will have to obtain information about the location of the end-user, something the foreign purchaser may not want to provide.

The documentation requirements have a de minimis exception that allows sellers who received less than $10 million in gross receipts during the prior tax year or who receive less than $5,000 in gross receipts during the current tax year from a single recipient to rely on the recipient's shipping address.

Non-U.S. Services Recipients

Income from services qualifies as FDDEI if the services are provided to a person or for property not located in the United States. The proposed regulations divide those services into four categories:

- proximate services in which the service provider (the renderer) and the recipient are in physical presence of one another when the service is performed;
- property services for tangible property that result in physical manipulation of the property such as assembly, maintenance, or repair;
- transportation services to transport people or property using an aircraft, motor vehicle, or similar mode of transport; and
- general, or all other, services.

To determine whether a service constitutes an FDDEI service, the proposed regulations look to the location of performance for proximate services, the location of the property for property services, the origin and destination of transportation services, and the location of the recipient for general services.

The proposed regulations also distinguish between general services provided to consumers, or individuals purchasing general services for personal use, and to business recipients. A consumer or business recipient's location outside the United States is established if the renderer obtains documentation that meets the reliability requirement and does not know or have reason to know otherwise as of the FDII filing date. A consumer's location is where she resides when the service is performed. A business recipient's location is the location of an office or fixed place of business where the renderer's earned gross income is allocated, with allocation occurring based on where the business recipient's, including its related parties', operations benefit from the service. As a result, the location of residence,

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes International* content, please visit www.taxnotes.com.

incorporation, or formation of a business recipient is irrelevant.

Documentation of a consumer's location can be established by obtaining a written statement of the consumer's residence, the consumer's government identification, or documentation as provided for by the secretary. Documentation of a business recipient's location can be established by obtaining a written statement specifying the locations of the business recipient's operations benefiting from the service, a binding contract specifying the location of the business recipient's operations that benefit from the service, documentation obtained in the ordinary course of the provision of the service that specifies the business recipient's operations that benefit from the service, publicly available information establishing the business recipient's operations, or documentation as provided for by the secretary that supports the renderer's allocation of income. The same de minimis exceptions discussed above exist for establishing foreign use.

How Do Related-Party Transactions Differ?

Sale of Property Between Related Parties

Under prop. Treas. reg. section 1.250(b)-6(b) and (c), sale of general property to a foreign related party is an FDDEI sale only if the transaction falls into one of two buckets. First, the foreign related party must resell the property or include it as a component of other property sold to a foreign party unrelated to the domestic seller for foreign use on or before the FDII filing date in a transaction that would otherwise be an FDDEI sale. If an unrelated-party transaction occurs after the FDII filing date, an amended return must be filed to claim a FDII deduction. Second, as of the FDII filing date, the seller in the related-party sale must reasonably expect that the property will be used in connection with a subsequent sale or provision of service by the related party to an unrelated foreign party; the unrelated-party transaction would otherwise be an FDEII sale or service without regard to the documentation requirements; and more than 80 percent of the revenue earned by the foreign related party for the general property will be from the unrelated-party transactions.

The proposed section 250 regulations provide that all of a seller's foreign related parties are treated as a single foreign related party, which allows any subsequent transactions between foreign related parties before the ultimate unrelated-party transaction to be disregarded.

The additional related-party sale rules in prop. Treas. reg. section 1.250(b)-6 do not apply to sales of intangible property. The preamble states that because sales of intangible property are for a foreign use only if the property generates revenue from exploitation outside the United States, additional related-party rules for those sales are unnecessary.

Provision of Services Between Related Parties

The provision of a service to a foreign related party qualifies as an FDDEI service only if the service is not substantially similar to services provided by the related party to persons in the United States. That rule is meant to prevent round-tripping by circling a service to a U.S. recipient through a foreign affiliate to obtain a FDII benefit.

The preamble provides that the special related-party rules apply only to the provision of general services to business recipients because other types of services present minimal risk of round-tripping. That result is logical because for proximate, property, and transportation services, the location of the recipient or property is generally determined based on the place of performance, and a related-party consumer can never provide services that are substantially similar because they are by definition individuals who purchase the services for personal use.

Under prop. Treas. reg. section 1.250(b)-6(d), services are substantially similar only if the service provided to the related party is used by that party to provide a service to a person in the United States and either: (1) at least 60 percent of the benefits of the original service provided by the U.S. renderer to the related party are ultimately to persons in the United States (the benefit test); or (2) at least 60 percent of the price paid by persons in the United States for services provided by the related party is attributable to the original service provided by the U.S. renderer to the related party (the price test). If related-party services are substantially similar, the proposed regulations provide that gross income can be prorated based on the location of the unrelated parties.

For more Tax Notes International content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

How Are Bundled Transactions Treated?

A transaction that includes both sales and service components is categorized as a sale or service based on its overall predominant character. As a result, taxpayers will have to consider their foreign transactions and determine if contracts or invoicing for transactions should be split to capture sales and services separately, especially if that will make it easier to meet the FDII requirements, including for documentation.

Antiabuse Rules

The proposed regulations include antiavoidance rules for calculating a domestic corporation's qualified business asset investment. Under those rules, a transfer of specified tangible property by a domestic corporation to a related party is disregarded if the domestic corporation or another party in its consolidated group leases the same or substantially similar property from any related party at any time one year before or after the transfer, and the transfer and lease occur for a principal purpose of reducing the domestic corporation's deemed tangible income return. A transfer and lease are treated as per se occurring for a principal purpose of reducing a domestic corporation's deemed tangible income return if they occur within the same six-month period. The antiavoidance rule applies to a transaction with an unrelated party if the transaction is part of a structured arrangement.

The proposed regulations also include an antiabuse rule that requires specific transactions that generate losses to be deemed FDDEI transactions and thus be included in a domestic corporation's calculation of FDDEI. That antiabuse rule applies when the domestic corporation knows or has reason to know that property is sold to a foreign person for a foreign use or a general service is provided to a person located outside the United States, the transaction reduces the domestic corporation's FDDEI, and the domestic corporation does not meet the relevant documentation requirements. This rule prevents taxpayers from intentionally failing the documentation requirements for transactions that generate losses that would reduce their FDDEI.

Effective Dates

The proposed regulations apply to domestic corporations with tax years ending on or after March 4, 2019. As a result, taxpayers with calendar tax years do not have to apply them to their 2018 tax years. Because the rules apply to transactions that occurred before their publication, Treasury and the IRS provided a transition rule for FDII documentation requirements for tax years beginning on or before March 4, 2019. Under that rule, taxpayers may use any reasonable documentation maintained in the ordinary course of 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. Thus, calendar-year taxpayers, for example, may rely on the transition rule for all of 2019 as they incorporate the requirements of the proposed FDII regulations into their contracts and documentation practices. ■

For more *Tax Notes International* content, please visit www.taxnotes.com.