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Maximizing the FDII Deduction for U.S. Exported Property and Services: Determining Foreign Use, Grouping Expenses, Optimizing the R&D Allocations

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Maximizing the FDII Deduction for U.S. Exported Property and Services:

Determining Foreign Use,
Grouping Expenses,
Optimizing the R&D Allocations

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Ms. Fuller provides tax planning services across most industry sectors, including software & emerging digital technologies, investment management, financial services, real estate development, healthcare, pharmaceutical, construction & engineering, infrastructure, energy, and retail. She also has over two decades of experience resolving U.S. federal, state, and foreign tax controversies, including transfer pricing issues--skills Ms. Fuller first acquired when served as Attorney Advisor to the Chief Judge of the U.S. Tax Court earlier in her career for three consecutive terms.

Ms. Fuller holds an LL.M. in Tax Law from New York University School of Law, where she served as Graduate Editor of that school’s international law review and completed post-LL.M. studies in international business and comparative law; a J.D. from Seattle University; and a B.A. from the University of Washington. She is admitted to practice law in several U.S. state jurisdictions and multiple federal courts, including the U.S. Tax Court.

Ms. Fuller regularly speaks on corporate and international tax issues at conferences sponsored by various tax bar associations, and publishes in her field. She sits on several steering committees, including TaxLaw 360’s international tax advisory board, and the New York State Bar’s “Global Law Week” steering committee. She is a founding member of the New York City Bar’s Taskforce on the Independence of Lawyers and Judges, and a fellow of both the American College of Tax Counsel, and the American Bar Foundation.

Prior to becoming an attorney, Ms. Fuller was a business news reporter and an all- news radio anchor for a highly regarded NBC News affiliate in Seattle, Washington, covering regional, national, and international business, as well as geo-political developments.

Agenda (for first part of presentation)

I. Overview of FDII Deduction in IRC § 250

A. History, Policy, and Purpose; Statutory Allowance; Basic Mechanics

B. Regulatory Requirements

II. Sales of "General Property"

A. "Foreign person" requirement (and application to partnerships, disregarded entities, and branches)

B. "Foreign Use" requirement

1. "End User" tests
2. Manufacturing test and exceptions

C. Examples and Planning opportunities

III. Sales of Intangible Property

A. Changes made by Final FDII Regulations

B. General rule for determining "foreign use" of sales and other transfers of intangible property

C. Determining the "End-User" in various scenarios

D. Illustrative examples

IV. Provision of Services

A. The Relevant Statutory Provisions (and their ambiguity)

B. Definition of "FDDEI Service"

C. The five mutually exclusive Service Categories (as modified and delineated by the Final 2020 Regulations)

D. Illustrative examples

V. "Related Party" Rules: **An introductory look at the broad statutory definition**

I. Overview of Deduction for "Foreign Derived Intangible Income" (FDII) in IRC § 250

- History, Policy, and Purpose
- Statutory Allowance of FDII Deduction
- Basic Mechanics
- Regulatory Requirements

History, Policy & Purpose of the FDII Deduction in § 250

- The deduction for "foreign-derived intangible income" (FDII) in Section 250 of the U.S. Internal Revenue Code (IRC), entitled "**Foreign-derived intangible income and global intangible low-taxed income**," was enacted on December 22, 2017 as part of the Tax Cuts & Jobs Act (TCJA).
- **Ostensible Tax Policy**: Legislative history indicates § 250 was enacted as part of an attempt by Congress to transform the U.S. international tax system from one that allowed for the deferral of taxation on foreign-source income of U.S. controlled foreign subsidiaries (i.e., CFCs) unless and until that income was repatriated (or deemed repatriated by an anti-tax deferral regime like Subpart F) to a partial "territorial regime"—i.e., one where foreign-source earnings of subsidiaries can be repatriated tax free. Section 245A of the Code allows corporations taxed as C-corps to fully deduct dividends paid by their CFCs, to the extent the earnings are previously untaxed foreign-source E&P.
- A good summary of the ostensible tax policy of the FDII deduction is set forth in the Preamble to the Proposed FDII/GILTI Regulations, published in the Federal Register on March 6, 2019 at 26 CFR 1 [REG 104464-18).

Policy & Purpose of the FDII Deduction (according to Preamble of Proposed FDII Regs)

- The pre-2018 U.S. federal income tax system allowed for the indefinite tax deferral of U.S. taxation of active foreign business income—in particular, mobile income arising from the exploitation of intangible property. This system of deferral, in turn, resulted in a "lock-out effect," whereby U.S. shareholders that had allocated income to CFCs formed in low- or zero-tax jurisdictions could not repatriate such income to the U.S. without incurring significant U.S. tax.
- In order to facilitate the efficient redeployment of foreign earnings in the U.S., Congress enacted IRC § 245A in 2018--a partial participation exemption, under which certain earnings of a foreign corporation can be repatriated to a corporate U.S. shareholder without U.S. tax. However, Congress recognized that without any tax base protection measures, the participation exemption system could further incentivize taxpayers to allocate intangible income to CFCs formed in low- or zero-tax jurisdictions because the earnings related to such intangible income could then be repatriated back to the U.S. tax free under new § 245A. Accordingly, Congress enacted § 951A—the GILTI provision—at the same time it enacted § 245A, and allowed for GILTI to be taxed at a relatively low effective tax rate (via the § 250 deduction) because it recognized that many countries do not subject active foreign business income of foreign subsidiaries to current tax, and taxing GILTI at a higher rate could hurt the competitive position of U.S. corporations relative to their foreign counterparts.
- After the Act, income earned directly by a domestic corporation is subject to a 21 percent rate. Absent a deduction with respect to intangible income attributable to foreign market activity earned directly by a domestic corporation, the lower effective tax rate applicable to GILTI by reason of the § 250 deduction would perpetuate the pre-Act incentive for domestic corporations to allocate intangible income to CFCs formed in low- or zero-tax jurisdictions. Therefore, to neutralize the effect of providing a lower U.S. effective tax rate with respect to the active earnings of a CFC of a domestic corporation through a deduction for GILTI, § 250 also provides a lower effective U.S. tax rate with respect to "foreign-derived intangible income" or "FDII" earned directly by the domestic corporation through a deduction of 37.5 percent for taxable years beginning after December 31, 2017, and before January 1, 2026.
- **The result of the § 250 deduction for both GILTI and FDII is to help neutralize 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.**

Statutory Allowance of the § 250 Deduction

- **Section 250(a):** In the case of a domestic corporation for any taxable year, there shall be allowed as a deduction an amount equal to the sum of—
  - **(A)** 37.5 percent of the **foreign-derived intangible income** of such domestic corporation for such taxable year, plus
  - **(B)** 50 percent of—
    - **(i)** the global intangible low-taxed income amount (if any) which is included in the gross income of such domestic corporation under section 951A for such taxable year, and
    - **(ii)** the amount treated as a dividend received by such corporation under section 78 which is attributable to the amount described in clause (i).
- **FDII Deduction set to decrease in 2026:** Section 250(a)(3) provides that the FDII deduction equals 37.5%, but for tax years that begin after Dec. 31, 2025, the FDII deduction drops to 21.875%. (The deduction for GILTI will, at same time, drops from 50% to 37.5%).
- **Taxable Income Limitation**: If the sum of the Taxpayer's (TP's) GILTI and FDII amounts exceeds the TP's "taxable income," the § 250 deduction is reduced proportionately by the total excess. IRC § 250(a)(2).
  - The Final FDII Regs confirm that pre-TCJA NOLs are taken into account for purposes of determining the taxable income limitation in § 250(a)(2).
  - The Final FDII Regs also eliminate a "complex ordering rule" that appeared in the 2019 Proposed FDII Regs, which specified the interaction of § 250 with other types of deductions—e.g., § 163(j) and § 172--the determination of which is also dependent on "taxable income." Purpose of the ordering rule was to eliminate circularity. Preamble to Final Regs states that Treasury & IRS will continue to study these provisions' interaction, and that they may become the subject of a separate administrative guidance project. Until further guidance is issued, Preamble instructs Taxpayers to choose any "reasonable method" in determining the taxable income limit of § 250(a)(2) (including at Taxpayer's choice, the ordering rule described in the Proposed Regs), just so long as the chosen method is applied consistently.

Basic Mechanical Formula for Calculating the FDII Deduction

- §250(b)(1) sets forth the basic formula for FDII deduction:

  For purposes of this section—

  (1) In general

  The foreign-derived intangible income of any domestic corporation is the amount which bears the same ratio to the deemed intangible income of such corporation as—

  (A) the foreign-derived deduction eligible income of such corporation, bears to

  (B)the deduction eligible income of such corporation.

- Thus, the basic formula for calculating the § 250 FDII deduction can be expressed as follows:

$$\text{FDII} = \frac{\text{Foreign-derived deduction eligible income}}{\text{Total deduction eligible income}} \text{ X } \text{“Deemed Intangible Income”}$$

Key Definitions in the FDII Deduction Formula

- **Most key definitions are in Code § 250 itself,** and thus cannot be materially altered by regulation.
- **"Domestic corporation":** Final Reg. § 1.250(a)—1(c) defines term by reference to Code § 7701(a)—i.e., an entity created or organized in U.S. or under U.S. law as a corporation--but Preamble & Regs explicitly exclude RICs, REITS, and S-corporations. **Only U.S. corporations that are taxed as associations under Subch. C may qualify for the FDII deduction, according to IRS. (And, this includes LLCs that are taxable as "associations"—making them eligible for the FDII deduction.)**
  - **But a Section 962 Election will not help a non-corporate shareholder to qualify for FDII deduction:** Final § 250 Regs solidify the proposed rule that allows individuals (e.g., shareholders of S-Corps) who elect § 962 to be treated as a C-Corporation for certain Subpart F and GILTI purposes, including: (a) taking a 50% deduction under § 250 with respect to a § 951A GILTI inclusion; (b) qualifying for the lower 21% corporate rate, and (c) taking an indirect FTC under § 960.
    - However, the statutory framework of § 250(b), defining FDII, is clearly limited to FDII of any domestic corporation—meaning a "associations." Although § 962 was not amended in the 2017 TCJA to include a direct reference to § 951A, § 951A(f) states that GILTI inclusions under § 951A are to be treated in the same manner as inclusions under § 951(a) (i.e., Subpart F income) for purposes of, *inter alia*, § 962. **Thus, although a non-corporate shareholder may be eligible for the GILTI 50% deduction under §250, such shareholder is not eligible for the FDII deduction unless it is taxed as a domestic corporation (apart from the Sec. 962 election).** See also Legislative History of § 250.
- **"Gross <u>Deduction Eligible Income</u>" (or "Gross DEI**): means "gross income" of any domestic corporation, but determined without regard to:
  1. Subpart F inclusions, as determined under § 951(a)(1);
  2. GILTI inclusions, as determined under § 951A, including the associated "Gross Up" amount under § 78;
  3. "Financial services income," as defined in § 904(d)(2)(D);
  4. Dividends received from CFCs;
  5. Domestic "oil & gas extraction income" described in § 907(c)(1); and
  6. "Foreign Branch Income" as defined in § 904(d)(2)(J). **Note**: The Final FDII Regs conform the definition of "foreign branch income" to that that found in Reg. § 1.904-4(f)(2), which is a welcome change from the Proposed 2019 FDII Regs, which proposed to expand this excluded category..
- **Deduction Eligible Income ("DEI"):** means the excess (if any) of gross DEI over the deductions (including taxes) properly allocable to such gross income. Allocation of deductions generally follow the § 1.861 Regs.

Key Definitions in FDII Formula
(continued)

- **Gross Foreign-Derived Deduction Eligible Income" (or "Gross FDDEI"):** means, with respect to any taxable year, the taxpayer's *gross* Deduction Eligible Income ("DEI") which is derived in connection with: (A) property sold by the taxpayer to any person who is not a U.S. person, and which is Tp establishes is for a foreign use; or (B) Services provided by the taxpayer to any person, or with respect to property, not located in the U.S. (Loosely paraphrasing IRC § 250(b)(4)).

- **Foreign-derived deduction eligible income (FDDEI)**: means Gross Foreign-Derived Deduction Eligible Income, less deductions properly allocable to the foreign-derived DEI.

- **"Deemed Intangible Income":** means excess (if any) of "deduction eligible income" of the domestic corp over the "deemed tangible income return." IRC § 205(b)(2)(A).

- **"Deemed Tangible Income Return":** means any amount equal to 10% of the corp's QBAI ("qualified business asset investment, defined in § 951A(d)), determined by substituting DEI for "tested income" and without regard to whether the corp is a CFC.

Basic mechanics of FDII Formula - Importance of allocation of expenses

- Calculation of FDII under the Final Regs is a multi-step process that begins with the concepts of "Gross Deduction Eligible Income" ("Gross DEI") and "Gross Foreign-Derived Deduction Eligible Income" ("Gross FDDEI").
- Gross DEI does not include all gross income; rather, six specific categories are excluded (see above).
- Gross FDDEI is a subset gross DEI, in that FDDEI includes only DEI that is "foreign derived" as defined, whereas Gross DEI is essentially total DEI. (This is somewhat analogous to the ratio used in calculating the foreign tax credit limitation and limits within FTC baskets—i.e., foreign-source income relative to worldwide income).
- After calculating the gross amounts, deductions of the domestic corporation are allocated against the gross items to arrive at DEI and FDDEI—which are "net" amounts (i.e., net of Cost-of-goods Sold when applicable, and net of any allocable expenses).
- "Net" FDDEI may be greater than "Net" DEI, or vice versa. When both amounts are positive, and DEI is greater than DTIR, the domestic corporation will be allowed a §250 deduction for FDII (subject to the taxable income limitation of §250(a)(2)).
- If net DEI is zero or negative for the tax year, the domestic corporation will not be allowed an FDII deduction.
- If a domestic corporation's (net) FDDEI exceeds its (net) DEI and would otherwise result in a "foreign-derived ratio" exceeding one (*e.g.*, due to losses attributable to domestic market sales), the Regulations provide that the ratio of FDDEI to DEI cannot exceed one.
- Not surprisingly, because deductions can increase or decrease the numerator of the "foreign-derived ratio" relative to the denominator, the mechanical rules need to be applied carefully, and the characterization and sourcing of items of expense (as U.S. or foreign), and their allocation and apportionment, along with COGS calculation (if applicable), are all important considerations that can make a big difference in maximizing the ultimate FDII deduction.
- See below for details regarding allocation and apportionment of deductions in the context of the "foreign derived ratio."

KEY = “Foreign-Derived Deduction Eligible Income”

- Increasing the “foreign-derived deduction eligible income” (in the numerator) of the foreign derived ration is the obvious “key” to maximizing the FDII deduction. (Thus, planning should be aimed at increasing “FDDEI Sales” and FDDEI Services”—the two components of gross FDDEI.
- **Section 250(b)(4)** states that the term “foreign-derived deduction eligible income” means, with respect to any taxpayer for any taxable year, any deduction eligible income of such taxpayer which is derived in connection with—

(A) **property**—

(i) which is sold by the taxpayer to any person who is **not a United States person**, and

(ii) which the taxpayer establishes to the satisfaction of the Secretary is for a **foreign use**, or

(B) **services** provided by the taxpayer which the taxpayer establishes to the satisfaction of the Secretary are provided to any person, **or with respect to property**, **not located within the United States**.

[Emphasis added]

Overview of Changes made by the Final FDII Regs

- In general, the Final FDII Regulations, released in July 9, 2020, retain the structure and many of the rules in the Proposed FDII Regs (released March 2019).
- However, the Final FDII Regs alter the Proposed Regs in some important respects. For example, the Final FDII Regulations:
  - <u>Significantly reduce the documentation burden</u> by adding presumptions (and eliminating the submission of certain documentation required in the Proposed Regs);
  - Defer the promised retroactive effective date--making the Final Regulations mandatorily applicable in 2021, and allowing taxpayer choose to apply either the Proposed or the Final Regs in pre-2021 years, so long as they are consistently applied;
  - Allow taxpayers to use any “reasonable” method to coordinate § 250 with other sections with taxable income limitations (e.g., §§ 163(j) and 172)
  - Require taxpayers to ignore carryover deductions under those sections when identifying deductions to be apportioned to gross deduction eligible income (DEI) and gross foreign-derived deduction eligible income (FDDEI)
  - Expand the “manufacturing” method of establishing “foreign use” in sales of general property by (a) adding an alternative substantive facts & circumstances test, and changing the no-more-than-20%-of-value component prerequisite into a safe harbor as a method of proving foreign manufacturing.
  - Conform the branch rules to those found in the foreign tax credit regulations at Reg. § 1.904-4(f)(2).
  - Relax certain provisions that defer an FDII benefit for a related-party sale that is followed by an unrelated-party sale.
  - Add new provisions applicable to categories of taxpayers (e.g., “digital content” and Software-as-a-Service (SaaS) providers, providers of advertising services, Arms Export Control Act sellers and renderers, and taxpayers engaging in hedging transactions).

II. Sales of "General Property"

- Meaning of "sold" and "sale"
- "Foreign person" requirement
- Categories of "general property"
- "Foreign Use" requirement
  - End User Tests
  - Foreign Manufacturing Tests and Exception
- Examples

"FDDEI Transactions"

- Obviously, given the "foreign derived ratio" in the statutory formula for determining the FDII deduction, maximizing the deduction involves efforts to increase the numerator of the fraction—i.e., gross Foreign-Derived Deduction Eligible Income (FDDEI).
- A U.S. corporation's gross FDDEI equals the portion of the corporation's gross DEI that is derived from its "FDDEI transactions," which are comprised of the U.S. corporation's:

  (1) "FDDEI sales" of property and

  (2) "FDDEI services". See IRC § 250(b)(4) (defining "FDDEI"); Final Reg. §1.250(b)(3) (defining Scope, Key Definitions, and various operating rules pertaining to "FDDEI Transactions").

- **Final Regulation's Definition of "FDDEI Sale":** means "a sale of **general property** or **intangible property** to a recipient that is a **foreign person** and that is for a **foreign use**. * * * A sale of any property other than general property or intangible property is not an FDDEI sale." Final § Reg. 1.250(b)-4(b).

“Sale” and “General Property”

- **“<u>Sale</u>” defined very broadly in both Code & Regs:**
  - **IRC § 250(b)(5)(E):** “For purposes of this subsection [defining FDDEI] “the terms “sold”, “sells”, and “sale” shall include any lease, license, exchange, or other disposition.”
  - **Final Regs** include same definition, but also include a transfer of property resulting in gain or an income inclusion under § 367.
- **“<u>General Property</u>” is defined as any property <u>other than</u>:**
  - “intangible property” (defined expansively in § 367(d));
  - stock or a security (as defined in § 475(c)(2));
  - an interest in a partnership, trust, or estate; or
  - a commodity described in § 475(e)(2)(A) that is not a physical commodity. The final FDII Regs provide that the sale of a commodity pursuant to a forward or option contract is treated as a sale of general property only to the extent that a taxpayer physically settled the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances. Reg. § 1.250(b)– 3(b)(10).
- **Practice point:** A sale of a “disregarded entity” (“DE” or “foreign branch”) under the <u>Final</u> FDII Regs is now treated as a sale of the DE/branch’s underlying assets, meaning that each asset deemed sold must be analyzed to see if the “foreign use” requirement and other requirements are satisfied to qualify as an FDDEI sale. Thus, the a sale of a DE/branch could be advantageous over the sale of a partnership interest since the latter is neither “general property” nor “intangible property” and thus cannot qualify as an FDDEI sale, generating gross FDDEI.

Qualifying the property recipient as a "Foreign Person"

- The meaning of "foreign person" is relevant to sale of general property because such sales **must often be to a "foreign person" in order to qualify for the FDII deduction.**
- **Old Rule in 2019 Proposed Regs:** Proposed Regs treated a recipient of property as a "foreign person" only if the Seller-Taxpayer obtained specific documents evincing the recipient's status as a "foreign person" and did not know or have any reason to know that the recipient was not a foreign person. Specifically, Seller-Taxpayer was required to submit a written statement from recipient proving his/her/its foreign "residence," such a valid foreign ID card in the case of individual recipients, or documents establishing that a recipient <u>entity</u> is organized under foreign law, etc. It is unclear how the various countries' disparate definitions of tax "residence" align with this requirement of proof of "foreign person" (e.g., many countries use the concept of "seat" or "place of effective management and control" to establish the residence of companies for tax and company law purposes).
- **Final FDII Regulations relax the specific documentation requirements and create "presumptions" of "foreign person" status, subject to the "no-reason-to-know-otherwise" exception.**
- Specifically, Final Reg. § 1.250(b)-4)c) provides that the sale of property is presumed to be to a recipient that is a foreign person for purposes of qualifying as an "FDDEI sale" in the following cases:

   i. The sale is a "foreign retail sale" (as defined);

   ii. Sales of general property "delivered" to the recipient or end user (e.g., by commercial freight carrier) to a <u>shipping address</u> outside the U.S.;

   iii. Other sales of general property so long as the <u>billing address</u> of the recipient is outside the United States; and

   iv. In the case of a sale of <u>intangible property</u>, the <u>billing address</u> of the recipient is outside the United States.

Exception to Presumptions of "Foreign Person" Status

- However, these presumption in the Final FDII Regulations do not apply if the seller knows or has reason to know that the sale is **<u>not</u>** to a foreign person.
    - A seller has reason to know that a sale is not to a foreign person if the information received as part of the sales process contains information that indicates that the recipient is not a foreign person <u>and the seller fails to obtain evidence establishing that the recipient is in fact a foreign person</u>.
    - Information indicating a recipient is not a foreign person includes, but is not limited to, a U.S. phone number, billing address, shipping address, or place of residence; and, with respect to an entity, evidence that the entity is incorporated, formed, or managed in the U.S.
- Although a Seller-Taxpayer cannot have "actual knowledge" that the recipient is not a foreign person, absent actual knowledge, the Seller-Taxpayer can "rebut" evidence (in good faith) that the recipient may not be a foreign person with documentary evidence to the contrary (i.e., with evidence that the recipient is a foreign person). Final Reg. § 1.250(b)-4(c).
- Presumably, Seller-Taxpayer cannot be "willfully blind" as to the recipient's non-foreign status.

"Foreign Use" Requirement for Sales of General Property: The <u>Proposed</u> Regs.

- **Proposed Regs – (Old "general rule" for establishing "foreign use"):** A sale of general property meets the "foreign use" standard if either:
  1. The property is not subject to "domestic use" within 3 years of its delivery date; **OR**
  2. The property is subject to "manufacture, assembly or other processing" outside the U.S. ***<u>before</u>*** any "domestic use" occurs.

- In general, under the Proposed Regs, "domestic use" of the property occurs if the property is subject to *<u>any</u>* use, consumption, or disposition within the U.S., or the property is subject to manufacture, assembly, or other processing within the U.S.
- Under the Proposed Regs, general property is subject to "manufacturing, assembly or processing" only if it meets one of two tests—either:

  (a) there is a "physical & material change" to the property; OR

  (b) the property is incorporated as a "component" into a second product ("component test").

  - The "material change" test in the Proposed Regs is not met if only *<u>minor</u>* assembly, packaging, or labeling of the product occurs.
  - In general, under the Proposed Regulations, property is not a "component" for purposes of the manufacturing test unless the taxpayer can show that the fair market value (FMV) of the general property, when delivered to the manufacturer, constitutes no more than 20% of the FMV of the second product.

"Foreign Use" Requirement for Sales of General Property: Final Reg. § 1.250(b)-4(d)

- The Final 2020 FDII Regulations substantially change the 2019 Proposed Regulations for determining whether sales of general property satisfy the "foreign use" requirement.

  Final Reg. § 1.250-(b)-4(d): A sale of general property will satisfy the "foreign use" requirement if either the Seller-Taxpayer can satisfy one of two basic tests (set forth in Reg. § 1.250(b)-4(d)(ii) and (iii)), each with their own particular requirements. For sales of general property, the "foreign use" requirement is generally satisfied if either:

  - The sale (whether by direct delivery, through resale at a foreign retail store, or via a computer download of digital content) is to an "end-user" located outside the United States (see --4(d)(ii));

  OR

  - The sale is to a foreign unrelated party that subjects the property to manufacture, assembly or other processing outside the United States, and such manufacturing, assembly, or other processing outside the U.S. is properly substantiated (see -4(d)(iii)).

- **Overall Exception to the new "general rule" for foreign use:** If Seller sells the general property to a recipient (other than a related party) for manufacturing within the U.S., such property is not sold for "foreign use" even if the requirements of the two-part disjunctive general rule—i.e., -4(d)(ii) or (iii)– are satisfied. (The Final Regs now state this exception in –4(d)(iv), but such rule is already explicit in Code § 250(b)(5)(B(i), which provides:
  - "If a taxpayer sells property to another person (other than a related party) for further manufacture or other modification within the United States, such property shall not be treated as sold for foreign use even if such other person subsequently used such property for foreign use."

"Foreign Use" for Sales of General Property: Final Reg. § 1.250(b)-4(d) (Continued)

- **Final Regs eliminate the broad "3-year-no-domestic use" limitation of the Prop Regs.** Unlike the Proposals, the Final Regs do not require Seller to ***not*** know, or to ***have no reason*** to know, that there will be a domestic use of the property within three years of its delivery. This change allows for the possibility of some domestic use of the property after a qualifying sale to an end user. It also removes the implication that the seller must "track" the property's use for three years following the sale. (This potential tracking burden may have been a reason why the IRS chose to not adopt this proposed rule as final.)

- **"End-User Tests" in Final Reg. 1.250(b)-4(d)(1)(ii):** Similar to the "foreign person" presumptions, the Final Regs set forth scenarios in which the sale of general property will generally be presumed to be for foreign use. "Foreign use" is presumed if:

  A. The sale is to an end-user receiving delivery outside the US (e.g., from a freight carrier). (But no "foreign use" if the sale is made with a principal purpose of having the property transported to the U.S. for ultimate use.);

  B. The sale is of general property already located outside the U.S. at the time of sale (e.g., foreign retail sales);

  C. The sale is made in contemplation of its resale to an end-user outside U.S. (E.g., general property sold to a distributor or reseller for ultimate sale to an end-user located outside the U.S.);

  D. The sale is an electronic transfer of digital content that is downloaded, installed, received or accessed by an end-user outside the United States; OR

  E. The sale involves international transportation property that is registered outside the United States. (But if such transportation property is not going to be used for leasing (i.e., for hire) or for compensation, then it must also be both registered outside, and primarily stored outside, the United States.)

“Foreign Use” for Sales of General Property:
The “Foreign Manufacturing” Test
Final Reg. § 1.250(b)-4(d)(1)(iii)

- Under the Final FDII Regs, the second way to establish that sales of general property are for “foreign use” (i.e., apart from the end-user tests & presumptions) is to meet the foreign manufacturing test. The Final Regs substantially altered this test, relative to that found in the Proposed Regs.
- **The new “Foreign Manufacturing Test” is in Final Reg. §1.250(b)-4(d)(1)(iii):** A sale of general property is for foreign use if the sale is to a foreign unrelated party that subjects the property to manufacture, assembly, or other processing outside the U.S., *and such manufacturing, assembly, or other processing is properly substantiated.*
  - Like the Proposals, the Final Regs make clear that there are only 2 ways (or tests) to satisfy the foreign manufacturing test (although Final Regs tweak these). **Either the general property must be:**

    (1) “physically and materially changed” (as defined; “material change test”)

    OR

    (1) incorporated as a component into another product (as described in Regs; “the component test”).

"Foreign Use" for Sales of General Property: The "Foreign Manufacturing" Test

What does "physically and materially changed" mean?

- Final Regs provide a flexible facts-and circumstances test in Reg. § 1.250(b)-4(d)(1)(iii)(B):

  General Rule: The determination of whether general property is subject to a physical and material change is made based on all the **relevant facts and circumstances.** General property is subject to a physical and material change if it is **substantially transformed** and **distinguishable from** and **cannot be readily returned to its original state.**

- See Examples 1 and 2 involving the insertion of batteries in computers and tablets of Final Reg. § 1.250(b)-4(d)(1)(iv) below. (See next 3 slides.)

“Foreign Use” for Sales of General Property:
The “Foreign Manufacturing” Test
How is the “component test” applied?

- With respect to the second of the two sanctioned methods of proving foreign manufacturing took place, the Final Regs substantially change the “component test” (found in the Proposed Regs) by, among other things:
  1) adding a facts-and-circumstances test and
  2) demoting the 20% test from a prerequisite (in the Proposed Regs) to a “safe harbor” in the Final Regs.
- **Facts-and-Circumstances Test:** “General property is a component incorporated into another product if the incorporation of the general property into another product **involves activities that are substantial in nature and generally considered to constitute the manufacture**, assembly, or processing of property **based on all the relevant facts and circumstances**. However, general property is not considered a component incorporated into another product if it is subject only to packaging, repackaging, labeling, or minor assembly operations.” Reg. § 1.250(b)-4(d)(3)(C) (emphasis added).
- **20%-of-Finished-Goods FMV Safe Harbor:** “**[G]**eneral property is treated as a component if the seller expects, using reliable estimates, that the fair market value of the property when it is delivered to the recipient will constitute no more than 20 percent of the fair market value of the finished good into which the general property is directly or indirectly incorporated when the finished good is sold to end users.”
  - If the property could be incorporated into a number of different finished goods, a reliable estimate of the fair market value of the finished good may include the average fair market value of a representative range of such goods.
  - **Anti-Abuse Rule?** “For purposes of the 20-percent rule, all general property that is sold by the seller and incorporated into the finished good is treated as a single item of property if the seller sells the property to the recipient and the seller knows or has reason to know that the components will be incorporated into a single item of property (for example, where multiple components are sold as a kit).” NOTE: This appears to be an anti-abuse rule designed to **prevent attempts to disaggregate integrated components so as to qualify for the 20% safe harbor.**

"Foreign Use" for Sales of General Property: The "Foreign Manufacturing" Test Example 1 at Reg. §1.250(b)-4(d)(1)(v)

Facts: DC, a US corporation, sells batteries for $18x to unrelated Foreign Person (FP). DC expects that FP will insert the batteries into tablets as part of the process of assembling tablets outside the US. While the tablets are manufactured in a way that end users would not easily be able to remove the batteries, the batteries could be removed from the tablets and would resemble their original state following the removal. The finished tablets will be sold to end users within and outside the US. DC's batteries are used in two types of tablets, Tablet A and Tablet B. Based on an economic analysis, DC determines that the fair market value (FMV) of Tablet A is $90x and the fair market value of Tablet B is $110x. FP informs DC that the number of sales of Tablet A is approximately equal to the number of sales of Tablet B.

Analysis: Because the batteries could be removed from the tablets and be returned to their original state, the insertion of the batteries into the tablets *does not constitute a physical and material change.* However, the average FMV of a representative range of tablets that incorporate the batteries is $100x (i.e., average of $90x and $110x for Tablets A & B), and $18x is less than 20 percent of $100x.

Result: Because the batteries meet the 20% Safe Harbor, they are considered components of the tablets and treated as subject to manufacture, assembly, or other processing outside the United States. **** *As a result, notwithstanding that some tablets incorporating the batteries may be sold to an end user in the US, DC's sale of batteries [i.e., ALL of them] are considered for a foreign use. Accordingly, DC's sale of batteries to FP is for a foreign use * * * and the sale is an FDDEI sale.*

"Foreign Use" for Sales of General Property: The "Foreign Manufacturing" Test

Example 2 at Reg. §1.250(b)-4(d)(1)(v)

Alternative Facts: Assume the same facts as in Example 1 above, except that FP purchases the batteries from DC for $25x, and that FP purchased other components of tablets from other parties. Further assume FP has a substantial investment in machinery and tools that are used to assemble tablets.

Different Analysis but Same Result: Although the 20% safe harbor is not met (because the FMV of the batteries > 20% of the finished tablets), the batteries meet the "components test" for manufacturing because the batteries are used by FP in activities that are **substantial in nature and generally considered to constitute the manufacture**, assembly or other processing of property. As a result, DC's sale of property to FP is still for a "foreign use" * * *and the sale is an FDDEI sale.

Comment: The addition of a fact-and-circumstances -based substantive test (i.e., to show that FP's activities regarding the property are the type that are generally considered to be manufacturing) is a very welcome change to the component-part test (and one practitioners argued for during the comment period). Under the Proposed Regs, the mandatory 20% -of- final FMV threshold often prevented high-value component parts from being treated as manufactured outside of the U.S. even when the product underwent substantial manufacturing and was incorporated in a finished good different and distinguishable from the components (e.g., chips incorporated into computers).

III. Sales of Intangible Property

- Changes made by Final FDII Regulations
- General rule for determining “foreign use” of sales and other transfers of intangible property
- Determining the “End-User” in various scenarios
- Illustrative examples

How the Final Regulations determine "Foreign Use" for Intangible Property "Sales" (An Overview)

- **How the Proposed Regs determined "foreign use" for sales of Intangibles:** The Proposed Regs provide that a sale (including a license) of intellectual property (IP) is for a foreign use to the extent revenue is earned from exploiting the IP outside the United States. With respect to IP used in the development, manufacture, sale, or distribution of a "product," the IP is treated as exploited at the location of the "end user" when the product is sold to that end user. The Proposed Regs further provide that a sale of IP includes a deemed sale in exchange for deemed royalty payments under IRC § 367(d).

- **Final Reg. § 1.250(b)-4(d)(2):** The 2020 Final Regs retain the proposed general rule that a sale of IP is for a "foreign use" *only to the extent it is "exploited" outside the United States*, but they also significantly ***modify the proposed rules governing when this standard is satisfied*, and how it can be substantiated by the Seller.**

    - Determination of "foreign use" under the Final Regs is based on the ***portion of the revenue earned using the IP from "end users" located outside the United States***. And, determining the "location" of the "end user" depends on the type of IP transaction involved—specifically whether the IP:

        (1) is ***embedded in or used in connection with*** a sale of general property,

        (2) is used in providing a **service**,

        (3) consists of a ***manufacturing method or process***, or

        (4) is used in ***research and development***.

How the Final Regulations determine "Foreign Use" for Intangible Property "Sales" The "General Rule"

- **Gen. Rule for "foreign use" for sale of intangibles is at Reg. §1.250(b)-4(d)(2):**
  - A sale of rights to exploit intangible property solely outside the U.S. **is for a foreign use.**
  - A sale of rights to exploit intangible property solely within the U.S. is **not for a foreign use.**
  - A sale of rights to exploit intangible property worldwide is **partially for a foreign use and partially not for a foreign use**. Whether intangible property is exploited within versus outside the U.S. is determined based on revenue earned from "end users" and whether **their location** at the time the revenue was earned. Thus, a sale of rights to exploit intangible property both within and outside the U.S. is for a foreign use **in proportion to the revenue earned from end users located outside the U.S. over the total revenue earned from the exploitation of the IP**.
  - A sale of intangible property will be treated as an FDDEI sale **only if** the certain substantiation requirements are met (i.e., set forth in Reg. § 1.250(b)-4(d)(3)(iv).

How the Final Regulations determine "Foreign Use" for Intangible Property "Sales"

Specific Rules for Determining the "End User"

- For purposes of determining whether the sale of intellectual property (IP) is for "foreign use" (and thus an "FDDEI sale"), the Final Regs provide specific rules for determining the "end user" in different scenarios involving the sale or license of IP. Here are the categories set forth in the Final Regulations, and illustrated in 13 helpful examples. (See Final Reg. § 1.250(b)-4(d)(2)(i)—(iv)).

    - **IP embedded or used in connection with sale of "general property":** The location of the end- user of the general property determines the end user of the embedded IP (or the IP used in connection with a sale of general property). The revenue earned from an end user of general property outside the U.S. is the proportional metric used to determine what portion of payments for the IP is for foreign use.

    - **IP used in providing a service:** Location of recipient of the services determines whether there is "foreign use" of the associated IP. A sale of IP used to provide a service by the recipient of the IP is for a "foreign use" to the same extent that the provision of the services would qualify as an FDDEI service.

    - **IP used in R&D to create other intangible property:** Location of end-user of the secondary IP is also the end-user of the "primary IP" (i.e., the IP being sold), and determines its foreign use. Preamble clarifies that if the secondary IP qualifies for the "foreign manufacturing" criterion for foreign use or as "manufacturing process IP" then those rules apply for determining whether the secondary IP is foreign use. (And this can lead to some somewhat surprising, but taxpayer-friendly, results. See Ex. 9, Reg. §1.250(b)-4(d)(2)(iv)).

“Foreign Use” for Intangible Property “Sales”

Specific Rules for Determining the “End User”

- **IP used in manufacturing:** The Final Regs provide a very taxpayer friendly flat rule that a sale of a **“manufacturing method or process”** for use in manufacturing outside the United States is for a foreign use. This new rule was adopted in response to practitioner comments asking that the foreign manufacturing test for “foreign use” for general property be extended to include sales of IP used in manufacturing.
  - Under the rule, if a “manufacturing method or process” is sold or licensed to a foreign unrelated party for use outside the U.S., the foreign unrelated party is treated as an end user located outside the U.S. for purposes of the foreign use determination, ***even if the manufactured product ultimately is sold to persons in the United States*** (“process IP exception”).

- **Limitations on the “process IP exception”:**

  1) A **“manufacturing method or process”** is narrowly defined as “a sequence of actions or steps constituting an overall method or process that is used to manufacture a product or produce a particular manufacturing result, which may be in the form of a patent or knowhow.”

  2) The exception does not apply to the sale or license of typical “make-sell rights” to a foreign unrelated party.

  3) Nor does the process IP exception apply to a sale or license of IP to a related person;

  4) The exception does not apply to a sale or license of IP to a foreign unrelated party for manufacture on behalf of the seller pursuant to a contract or toll manufacturing arrangement.

  5) The exception does not apply if the seller knows or has reason to know that the manufacturing method or process will be used in the United States.

"Foreign Use" for Intangible Property "Sales" Examples

Example 8 : Deemed sale in exchange for contingent payments under IRC § 367(d). See Ex. 8 at Reg. § 1.250(b)-4(d)(2)(iv).

FACTS: DC owns 100% of the stock of FP, a foreign "related party" with respect to DC. FP manufactures and sells product A. For the taxable year, DC contributes to FP exclusive worldwide rights to patents, trademarks, know-how, customer lists, and goodwill and going concern value (collectively, intangible property) related to product A in an exchange meeting the requirements of IRC § 351.

Under § 367(d), DC is required to report an annual income inclusion on its Federal income tax return based on the productivity, use, or disposition of the contributed IP. DC includes a percentage of FP's revenue in its gross income under § 367(d) each year. In the current taxable year, FP earns \$1,000x of revenue from sales of product A. Based on reliable sales records kept by FP for the taxable year, \$300x of FP's revenue is earned from sales of product A to customers within the USA, and \$700x of its revenue is earned from sales of product A to customers outside the USA.

ANALYSIS: DC's deemed sale of the IP to FP in exchange for payments contingent upon the productivity, use, or disposition of the IP related to product A under § 367(d) is a "sale" for purposes of § 250 and the accompanying Final FDII Regulations issued under § 250. See Reg. § 1.250(b)–3(b)(16). Accordingly, based on FP's sales records for the taxable year, 70% of DC's deemed sale to FP is for a foreign use, and 70% of DC's income inclusion under § 367(d) derived with respect to such portion is included in DC's gross FDDEI for the taxable year

“Foreign Use” for Intangible Property “Sales”

Examples (continued)

Example 1: License of worldwide rights with actual revenue data from recipient.
(See Ex. 1 at Reg. § 1.250(b)-4(d)(2)(iv)).

- **FACTS:** Domestic corporation (DC) licenses to unrelated foreign person (FP) worldwide rights to the copyright to composition “A” in exchange for annual royalties of 60% of revenue from FP’s sales of the composition. FP sells composition A to customers through digital downloads from servers. In the taxable year, FP earns $100x in revenue from sales of copies of composition A to customers, of which $60x is from customers located in the USA, and the remaining $40x is from customers located outside the USA. FP provides DC with reliable records showing the revenue earned in the taxable year from total worldwide sales of composition A to establish the royalties paid to DC. The records provided to DC also show revenue earned from sales to customers located within the USA.

- **ANALYSIS:** FP is not the “end user” of the copyright to composition A because the copyright is used in the sale of general property (i.e., the sale of the copyrighted article) to customers. Rather, the customers that purchase a copy of composition A from FP are the end users because they are the recipients of the general property. Based on the actual revenue earned by FP from sales of composition A, 40% of the revenue generated by the copyright during the taxable year is earned outside the USA and is thus for “foreign use.” Accordingly, that 40% portion of DC’s license to FP is an “FDDEI sale.” Thus, 40% of the $60x royalty (or $24x) is for “foreign use” and properly included in DC’s gross FDDEI for the taxable year.

“Foreign Use” for Intangible Property “Sales” Examples (continued)

Example 2: Fixed annual payments for worldwide rights *without actual revenue data from recipient*

(See Ex. 2 at Reg. § 1.250(b)-4(d)(2)(iv)).

FACTS: **Same facts as in Example 1 except that** FP pays DC a fixed annual payment of $60x each year for the worldwide rights to the copyright to composition A, and does not provide DC with data showing how much revenue FP earned from sales of composition A, even after DC requests that FP provide it with such information. DC also is unable to determine how much revenue FP earned from sales of composition A to customers within the USA from the data it has with respect to FP and publicly available data with respect to FP.

However, DC’s economic analysis of the revenue DC expected it could earn annually from use of composition A as part of determining the annual payments DC would receive from FP from the license of composition A supports a determination that 40% of sales of composition A during the tax year would be to customers located outside the USA. During an examination of DC’s return for the taxable year, DC provides the IRS with data explaining the economic analysis, inputs, and results from its valuation of composition A used in determining the amount of annual payments agreed to by DC and FP.

ANALYSIS: As in Example 1, the customers that purchase copies of composition A from FP are the end users. DC is allowed to use reliable economic analysis to estimate revenue earned by FP from the use of the copyright to composition A because DC was unable to obtain the data—i.e. the actual revenue earned by FP--after reasonable efforts to obtain it. Based on DC’s economic analysis, a portion of DC’s license to FP is for a foreign use and thus an FDDEI sale. Same FDDEI inclusion result as in Example 1.

“Foreign Use” for Intangible Property “Sales” Examples (continued)

Example 3: Fixed annual payments for worldwide rights *without actual revenue data from recipient* (See Ex. 3 at Reg. § 1.250(b)-4(d)(2)(iv)).

FACTS: **Same facts as in Example 1 except that** FP pays DC a fixed annual payment of $60x each year for the worldwide rights to the copyright to composition A, and does not provide DC with data showing how much revenue FP earned from sales of composition A, even after DC requests that FP provide it with such information. DC also is unable to determine how much revenue FP earned from sales of composition A to customers within the USA from the data it has with respect to FP and publicly available data with respect to FP.

However, DC's economic analysis of the revenue DC expected it could earn annually from use of composition A as part of determining the annual payments DC would receive from FP from the license of composition A supports a determination that 40% of sales of composition A during the tax year would be to customers located outside the USA. During an examination of DC's return for the taxable year, DC provides the IRS with data explaining the economic analysis, inputs, and results from its valuation of composition A used in determining the amount of annual payments agreed to by DC and FP.

ANALYSIS: As in Example 1, the customers that purchase copies of composition A from FP are the end users. DC is allowed to use reliable economic analysis to estimate revenue earned by FP from the use of the copyright to composition A because DC was unable to obtain the data—i.e. the actual revenue earned by FP--after reasonable efforts to obtain it. Based on DC's economic analysis, a portion of DC's license to FP is for a foreign use and thus an FDDEI sale. Same FDDEI inclusion result as in Example 1.

“Foreign Use” for Intangible Property “Sales” Examples (continued)

Example 6: License of intangible property that includes a patented manufacturing method or process protected in the U.S. and other countries, with a foreign unrelated party.
See Final Reg. § 1.250(b)-4(d)(2)(iv), Ex. 6.

FACTS: DC owns worldwide rights to patents, know-how, and a trademark and trade name for product Z. The patents consist of: a patent covering the right to make, use, and sell product Z, and a patent covering the rights to make, use, and sell a composition of substances used in certain components of product Z, and a third patent covering the right to use a manufacturing process consisting of a series of manufacturing steps to manufacture product Z, and to sell the product Z that FP manufactures using that manufacturing method or process. (The know-how consists entirely of manufacturing know-how used to implement the manufacturing steps that comprise the manufacturing method or process.)

DC licenses the worldwide rights to the patents, know-how, and the trademark and tradename for product Z to FP in exchange for annual royalties of 60% of revenue from sales of product Z.

FP manufactures product Z in country X and sells product Z to DC2, a domestic corporation and unrelated party to DC and FP, for resale to customers located within the USA.

FP also sells product Z to FP2, a foreign unrelated party with respect to DC and FP, for resale to customers located outside the USA. During the taxable year, FP sells to DC2 $140x of product Z. Also, during the taxable year, FP sells to FP2 $60x of product Z. DC determines under the transfer pricing principles of IRC § 482 that the licensed know-how and the patented manufacturing method or process comprise 10% of the arm’s length price of the intangible property DC licenses to FP.

ANALYSIS: (A) End Users: FP is treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process, and is treated as located outside the USA because FP is a foreign unrelated party and DC does not know or have reason to know that the patented process and know-how will be used in the USA. DC2, FP, and FP2 are not the end users of the remaining IP because that IP is used in the sale of general property (the sale of product Z) and DC2, FP, and FP2 are not the end users of that general property. The unrelated party customers that purchase product Z from DC2 and FP2 are the end users of the remaining IP (other than the manufacturing process IP) because those customers are the unrelated party recipients of product Z.

“Foreign Use” for Intangible Property “Sales” Examples (continued)

Example 6 continued:

ANALYSIS:

(B) Foreign Use. Revenue from royalties paid for the IP other than the manufacturing method or process is earned from end users outside the USA to the extent the sale of the general property is for a foreign use. FP2 is a reseller of product Z to end users outside the USA, so all sales of product Z to FP2 are for a foreign use.

Because DC has determined that 10% of the value of the IP consists of a manufacturing method or process used to manufacture product Z, 10% of the royalty--i.e., $12x of the $120x royalty FP pays to DC during the taxable year--is for foreign use, based on the location of FP’s manufacturing that is utilizing the know-how and/or sequence of actions comprising the manufacturing method or process.

Based on the sales of product Z within and outside the USA, $32.4x of the royalties FP pays DC for rights to the licensed IP during the taxable year ((i.e., $60x of revenue from sales to FP2 for resale to customers located outside the USA divided by $200x total worldwide sales revenue FP receives from DC2 and FP2) × ($120x total royalties less $12 of those royalties attributable to the manufacturing method or process)) qualifies as income earned from the sale of IP for a “foreign use” and therefore such portion is an FDDEI sale. As a result, $44.40x of royalties (i.e., $12x + $32.40x) is included in DC’s gross FDDEI for the taxable year.

“Foreign Use” for Intangible Property “Sales”
Examples (continued)

Example 9: License of IP followed by a sale of general property in which the IP is embedded; unrelated parties. (See Ex. 9 at Reg. § 1.250(b)-4(d)(2)(iv)).

FACTS: DC owns the worldwide rights to a patent on a silicon chip used in computers, tablets, and smartphones. Assume that the patent does not qualify as a “manufacturing method or process” as defined in the Final Regulations at § 1.250(b)-4(d)(2)(ii)(C)(3). DC licenses the worldwide rights to the patent to FP in exchange for annual royalties of 30% of revenue from sales of the silicon chips. During the taxable year, FP manufactures silicon chips protected by the patent and sells all of those chips to FP2 for $1,000x. FP2 also purchases similar silicon chips from other suppliers. FP2 uses the silicon chips in computers, tablets, smartphones, and motherboards that FP2 manufactures in country X and sells to its customers located within the USA and foreign countries. Assume, for purposes of this example, that FP2’s manufacturing qualifies as subjecting the silicon chips to manufacture, assembly, or other processing outside the U.S.

ANALYSIS: FP is not the end user or treated as an end user because FP is not the unrelated party recipient of the general property in which the patent is embedded (and further, the patent does not qualify for the manufacturing method or process exception). Revenue from royalties paid for the patent is earned from end users outside the USA to the extent the sale of the general property is for a foreign use. Because FP2 is subjecting the silicon chips to manufacture, assembly, or other processing outside the USA, the revenue from royalties FP pays to DC qualifies for “foreign use” based on the location of FP2’s manufacturing, and therefore also qualifies as an FDDEI sale. **As a result, the entire $300x of annual royalties paid by FP to DC during the taxable year is included in DC’s gross FDDEI for the taxable year.**

(Note: This example is the result of practitioners “lobbying” the IRS to extend the manufacturing exception to sales of IP used for manufacturing.)

IV. Provision of Services

- The Relevant Statutory Provisions (and their ambiguity)
- Definition of “FDDEI Service”
- The five mutually exclusive Service Categories (as modified and delineated by the Final 2020 Regulations)
  - The two “new” sub-categories of “General Services”: “Advertising Services” and “Electronically Supplied Services”
  - The operative substantive rules (and proxies) for determining “location”
  - Elevated importance of importance of substantiation
- Illustrative examples

Key Statutory Provisions relevant to "FDDEI Services"

- Code Section 250(b)(4)(B) provides, in pertinent part, that foreign-derived deduction eligible income (FDDEI) includes a taxpayer's deduction eligible income (DEI) derived in connection with -- * * *

  (B) services provided by the taxpayer which the taxpayer establishes to the satisfaction of the Secretary are **provided to any person**, **<u>or</u> with respect to property**, **not located within the United States.**

- This provision is arguably ambiguous.

Key Statutory Provisions relevant to "FDDEI Services" (continued)

- In response to a practitioner-commenter who argued the IRC § 250(b)(4)(B) does not require that the serviced property be in the U.S., and that the 5 mutually exclusive categories in the Proposed Regs be removed, Treasury/IRS officials state in the Preamble to the 2020 Final Regs:

  Congress intended for there to be a category of services provided with respect to persons located outside the United States that would be FDDEI services <u>and</u> a separate category of services provided with respect to property located outside the United States that would be FDDEI services. The proposed regulations gave effect to this intent. The statute and legislative history are ambiguous, however, as to whether Congress intended for all services provided with respect to persons located outside the United States and all services provided with respect to property located outside the United States [are] to be included within the scope of the statute.

- Thus, according to Treasury Dept. and IRS "property services must be provided with respect to property located outside the United States in order to qualify as FDDEI Services. The purpose of the section 250 deduction is to help neutralize the role that tax considerations play when a taxpayer chooses the location of intangible income attributable to a foreign-market activity, that is, whether to earn such income through its U.S.- based operations or through its CFCs. * * * Providing an FDII deduction for all property services performed in the United States with respect to property with owners located outside the United States, regardless of the property's connection to foreign markets, would not further that purpose. * * * ."

Key Statutory Provisions relevant to "FDDEI Services" (continued)

Other subsections of IRC § 250 that are especially relevant to determining "FDDEI Services" of a taxpayer include the following two provisions, which function as anti-abuse rules.

- **IRC § 250(b)(5)(B)(ii)** ("Property or services provided to domestic intermediaries"), which provides:

  (B)(ii): "If a taxpayer provides services to another person (other than a related party) located within the United States, such services shall not be treated as described in paragraph (4)(B) even if such other person uses such services in providing services which are so described."

- **IRC 250(b)(5)(C)** ("Special Rules with respect to related party transactions), which provides in pertinent part at (C)(ii) ("Service provided to related parties")

  - If a service is provided to a related party who is not located in the United States, such service shall not be treated as described in subparagraph (A)(ii) unless the taxpayer established to the satisfaction of the Secretary that such service is not substantially similar to services provided by such related party to persons located within the United States.

- When analyzing whether, and the extent to which, a service may qualify as an "FDDEI Service," one must also always keep in mind the expansive definition of "Related Party" in IRC § 250(b)(5)(D) (discussed later), and fact that Congress gave the Secretary of the Treasury Department, in subsection (c) of Section 250, a broad and explicit grant of authority to write regulations pertaining Foreign Derived Intangible Income.

- As a consequence of the ambiguity in the Code provisions, and the broad grant of regulatory authority, almost all the operative substantive rules delineating what is a qualified "FDDEI Service" are in the Final § 250 Regulations. Accordingly, it would be difficult to argue that these regulations, including all their substantiation requirements, are somehow invalid, or antithetical to the statute and its underlying policy.

Five Main Categories of "FDDEI Services" adopted in the Final 2020 Regulations

- Like the 2019 Proposed FDII Regulations, the 2020 Final Regulations divide services into five mutually exclusive (and comprehensive) categories**, each of which have their own rules** for determining whether they are services that give rise to FDDEI (i.e., FDDEI services). These categories--listed from narrow to broad—are:
  1. **Transportation services:** a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle or any similar mode of transportation.
  2. **Property services:** a service (other than a proximate or transportation service) provided with respect to tangible property, if substantially all the service is provided at the location of the property and the service results in the physical manipulation of the property
  3. **Proximate services**: a service (other than a property or transportation service) provided to a recipient, if substantially all of the service is performed in the physical presence of the recipient.
  4. **General services provided to consumers**: a service that is provided to a consumer and does not fall into one of the other categories.
  5. **General services provided to business recipients**: a service that is provided to a business recipient and does not fall into one of the other categories.
- The Final Regulations also added two "new" subcategories (within the two General Services categories) for "**advertising services**" and "**electronically supplied services**."

Advertising Services

- **Definition:** Advertising Services are defined as a general service that consists primarily of transmitting or displaying content (including via the internet) to consumers with a purpose to generate revenue based on the promotion of a product or service. This sub-category is only relevant to General Services provided to Business Recipients.
- **Location = where customers view/watch/hear the advertisement.** As discussed in the Preamble, the Treasury Department decided the "most reliable proxy for "locations" of the business recipient that benefit from advertising services is the place where the advertisements are viewed by individuals. Thus, the Final Regs provide that in determining whether advertising services qualify as "FDDEI Services," measure the benefit to the business recipient, using a reasonable method, but based on the location where the advertisements are viewed (or heard) by individuals, ***even if the business recipient does not maintain an office or other fixed place of business in that location.***
- If advertising services are displayed via the internet, the advertising services are viewed at the location of the device on which the advertisements are viewed. The Final Regs further suggest, but do not require, that an IP address may be used to determine where the advertisements (e.g., over the Internet) are being viewed.

Electronically Supplied Services

- **Background:** In comments to the Proposed FDII Regulations, some practitioners requested guidance from the Treasury Dept. as to how services like "Software as a Service" (SaaS), should be "located" for purposes of determining whether they are FDDEI Services, eligible for to be included in a corporate taxpayer's gross DEI. In response, the Treasury Department, in the Final Regulations added a second sub-category—**Electronically Supplied Services--** which is relevant to both General Services provided to Consumers, and General Services provided to Business Recipients.
- **Definition:** An "Electronically Supplied Service" is defined in the Final Regs as general service, other than an advertising service, that is delivered primarily over the internet or an electronic network.
- **Location (depends on recipient):** If the recipient is a consumer, then the electronically supplied services are treated as rendered at the location of the device used by the consumer to receive the service. If the recipient of the service is a "business recipient," then the service is treated as rendered at the location where the business' employees and agents access the service.
- **Mixed Electronic & Non-Electronic Services:** The final regulations contemplate that a service could be partially an electronically supplied service and partially a general service that is not an electronically supplied service, and provide as an example the case of "a service that is performed partially online and partially by mail or in person." The general rule is that the services are bifurcated, and separately classified for purposes of determining their location.

General Services provided to <u>Individual Consumers</u>

- **Definition:** A general service is any service other than a transportation service, property service, or proximate service (i.e., it is a "residual" concept). A "consumer" is an individual that is using the service for his/her personal benefit—not for business purposes.
- **Location:** The general rule is that the consumer's "residence" governs location of the person to whom the general services are being rendered for purposes of qualifying as an FDDEI. Thus, like the Proposed Regs, the Final Regs provide that a general service provided to a consumer/customer is an FDDEI service if the consumer resides outside the United States (and only if the renderer can obtain adequate substantiating documents—see below).
- **Foreign Billing Address may be used in certain cases :** Final Regs allow the taxpayer, who is providing the general consumer services, and who cannot (after reasonable efforts) obtain information concerning a consumer's residence to presume that the consumer resides outside the United States if the consumer has a foreign billing address. This presumption applies regardless of the gross receipts derived with respect to the transaction, but does not apply if the renderer has "reason to know" that the consumer resides in the United States. This rule may also not apply if the services fall under the more specific rule for "electronically supplied services."
- **Final Regs greatly simplify/change the "Documentation" required in the Proposed Regs.** But Final Regs also make clear that substantiation is no less important—just more flexible in terms of what the service renderer is able to obtain.
- **The new, more flexible "reliability standards" essentially function as substantive rules:** if the service renderer cannot obtain reliable evidence of the "location," then the service will not qualify as an FDDEI Service. (The new "reliability standards" are addressed below in the second half of this presentation.)

General Services provided to Business Recipients

- **General Rule and Location Proxy:** A general service is provided to a business recipient located outside the U.S. to the extent that the service ***confers a benefit on the business recipient's operations outside the U.S***. The location of residence, incorporation, or formation of a business recipient is not relevant to determining the location of the business recipient's operations that benefit from a general service. Reg. §1.250(b)-5(e)(1).
- **How to determine which operations of the business recipient located outside the U.S. "benefit" from the service??** This determination is to be made under the **principles of Reg. § 1.482–9** (i.e., the "controlled services transaction" rules) by treating the taxpayer as one "controlled taxpayer," portions of the business recipient's operations within the U.S. (if any) that may benefit from the general service as one or more controlled taxpayers, and the portions of the business recipient's operations outside the U.S. (if any) that may benefit from the general service, each as one or more controlled taxpayers. Then fictional arm's length transactions/negotiations are assumed treated as made between them to determine whether (or how much of) a "benefit" from the general service is economically conferred. (i.e., Ask: would an **unrelated** party agree to pay for the general service or not?)
  - Preamble states that the reference to Transfer Pricing Regs is "intended to clarify, using a concept that is based on existing tax principles, that a service confers a benefit on operations of a recipient ***only if*** an uncontrolled party with similar operations would pay for the service under comparable circumstances. For example, if a service benefits particular operations of a business recipient so indirectly or remotely that an unrelated party with similar operations would not pay for the service, [then] the service does not confer a benefit on those operations." (Emphasis added). Final FDDEI Services Regs provide that the extent to which a business recipient's operations within or outside of the U.S. are treated as one or more separate controlled taxpayers may be **determined under any reasonable method** (e.g., separate controlled taxpayers may be determined on a per entity or per country basis, or by aggregating all of the business recipient's operations outside the U.S. as one controlled taxpayer).
- **Advertising Services & Electronically-Supplied Services provided to Business Recipients:** The relevant location is where the advertisements are viewed (or heard) by individuals, *even if the business recipient does not maintain an office or other fixed place of business in that location* . Electronically-supplied services are treated as conferring a benefit where the business recipient's agents or employees access the service.

Other Services

- **Transportation Services:** Rejecting practitioner suggestions to change them, the Final Regulations retain the rules in the 2019 Proposed Regs, and provide that the provision of a transportation service is an FDDEI service if both the origin and the destination of the service are outside the U.S. (See Prop.§ 1.250(b)–5(h)). Where either the origin or destination (but not both) are outside the U.S., then 50% of the transportation service is considered an FDDEI service. A transportation service is defined as a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any similar mode of transportation.

- **Property services:** Under the 2019 Proposed Regs, the location of a property service was determined based on the location of the tangible property during the time the service is being provided. The 2020 Final Regs make two changes to these rules: (1) property services may still qualify as an FDDEI Service if the property is in the U.S. temporarily so long as: (a) the property is temporarily in the U.S. for the purpose of receiving the property service; (b) the property will be primarily stored or used outside the U.S.; (c) the property is not used to generate revenue in the U.S. during the duration of the service; and (d) a foreign person that resides or primarily operates outside the U.S. owns the property. In addition, the Final Regs clarify that manufacturing services are property services.

- **Proximate Services:** Under the 2109 Proposed Regs, a service performed for a business recipient could qualify as a "proximate service" only if "substantially all" of the service was performed in the physical presence of the business recipient's employees. The Final Regs expand this definition to also include persons working for the business recipient, such as its contractors or agents. "Substantially all" of a service is performed in the physical presence of a consumer or persons working for a business recipient <u>only if</u> the renderer spends more than 80 % of the time providing the service in the physical presence of such persons.

Example 1: Determination of business operations that benefit from the service

FACTS: For the taxable year, Domestic Corporation DC provides a consulting service to Recipient R, a company that operates restaurants within and outside of the USA, in exchange for $150x. Fifty percent of the sales earned by R and its related parties are from customers located outside the USA. However, the consulting service DC provides relates specifically to a single chain of fast food-greasy-spoon type restaurants that R operates. Sales information R provides to DC indicates that 70% of the sales of the fast food restaurant chain are from locations within the USA (surprise!!), while just 30 % are in France—the other country. DC determines that the use of sales is a reasonable method under the principles of § 1.482–9(k) to allocate the benefit of the consulting service among R's fast food operations.

ANALYSIS and RESULT: DC's service is provided to a person located outside the USA to the extent that DC's service confers a benefit to R's operations outside the USA. DC, R's fast food operations within the USA, and R's fast food operations in France, are treated as if they were controlled taxpayers because only these operations may benefit from DC's service. The principles of § 1.482–9(k) apply to determine the amount of DC's service that benefits R's operations outside the USA. DC's gross income is allocated based on the sales of the fast food chain of restaurants that benefits from DC's service because using sales is a reasonable method. Therefore, 30% of the provision of the consulting service is treated as the provision of a service to a person located outside the USA and thus an FDDEI service. Accordingly, $45x ($150x × 0.30) of DC's gross income from the provision of the consulting service is included in DC's gross FDDEI for the taxable year

Example 2: Determination of business operations that benefit from the service with “alternative facts”

FACTS: Assume the same facts as in Ex. 1, except that DC provides an information technology service to R that benefits R’s entire business. DC determines that the use of sales is a reasonable method under the principles of §1.482–9(k) to allocate the benefit of the information technology service among R’s entire business.

ANALYSIS and RESULT: DC, R’s operations within the USA, and R’s operations in France, are treated as if they were controlled taxpayers because the service that DC provides relates to R’s entire business. DC’s gross income is allocated based on sales of the entire business and because using sales is a reasonable method to determine the amount of DC’s service that benefits R’s operations outside the USA under the principles of § 1.482–9(k). Therefore, 50% (see facts above) of the provision of the info technology service is treated as a service to a person located outside the USA and thus an FDDEI service. Accordingly, \$75x (\$150x × 0.50) of DC’s gross income from the provision of the information technology service is included in DC’s gross FDDEI for the taxable year.

Example 3: Advertising Services

FACTS: Assume the same facts as in Example 1 above, except that DC provides an advertising service to R. DC displays advertisements for R's restaurant chain on its social media website and smartphone application. Based on the IP addresses of the devices on which the advertisements are viewed, 20% of the views of the advertisements were from devices located outside the USA.

ANALYSIS and RESULT: Because the service that DC provides is an advertising service, R's operations that benefit from DC's advertising service are deemed to be where the advertisements are viewed. Therefore, 20% of the provision of the advertising service is treated as a service to a person located outside the USA and an "FDDEI Service." Accordingly, \$30x (\$150x × 0.20) of DC's gross income from the provision of the advertising service is included in DC's gross FDDEI for the taxable year.

V. Related Party Rules

Definition of a "Related Party" for FDDEI purposes

- IRC § 250 (b)(5)(D) defines "related party" as follows:

(D) Related party For purposes of this paragraph, the term "related party" means any member of an affiliated group as defined in section 1504(a), determined—

(i) by substituting "more than 50 percent" for "at least 80 percent" each place it appears, and

(ii) without regard to paragraphs (2) and (3) of section 1504(b). [i.e., without regard to § 1504(b)'s exclusions for insurance companies and foreign corporations]

Any person (other than a corporation) shall be treated as a member of such group if such person is controlled by members of such group (including any entity treated as a member of such group by reason of this sentence) or controls any such member. For purposes of the preceding sentence, ***control shall be determined under the rules of section 954(d)(3).***

[Note: Section 954(d)(3) defines "related person" for Subpart F purposes, and includes a special definition of "control" in its flush language that expressly incorporates the stock ownership attribution rules of section 958.]

§1504(a) "affiliation"

IRC § 1504(a)(1) provides:

(1) **IN GENERAL:** The term "affiliated group" means—

(A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if—

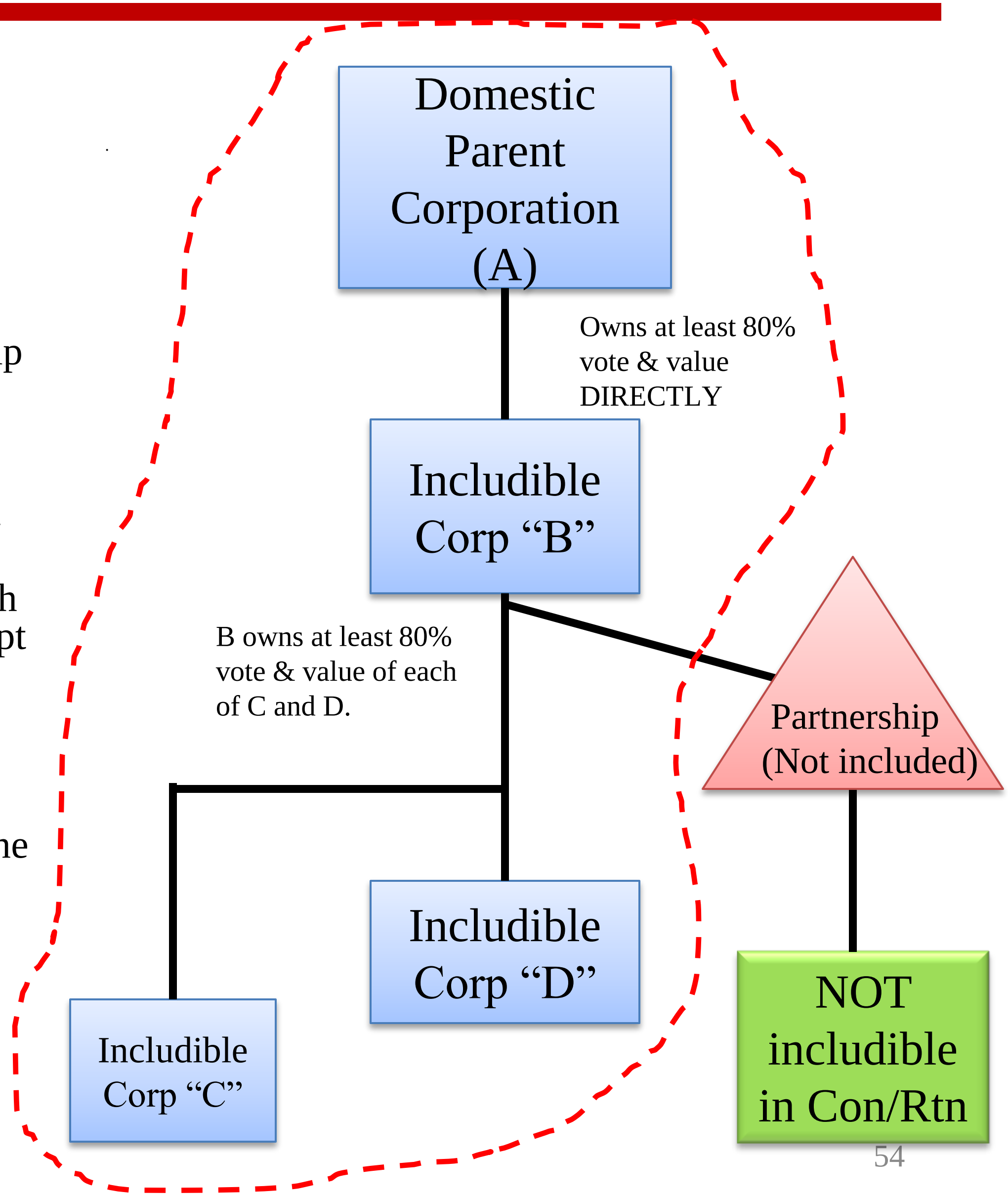
(B)(i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and

(ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.

(2) **80-PERCENT VOTING AND VALUE TEST** The ownership of stock of any corporation meets the requirements of this paragraph if it—

(A) possesses at least 80 % of the total voting power of the stock of such corporation, **and**

(B) has a value equal to at least 80% of the total value of the stock of such corporation.



§ 954(d)(3) "Control" is broad & labyrinthine

Section 954(d) (3) -- RELATED PERSON DEFINED For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if—

(A) such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the controlled foreign corporation, or

(B) such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the controlled foreign corporation.

For purposes of the preceding sentence, **control means**, with respect to a corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of stock of such corporation. **In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interests in such partnership, trust, or estate. <u>For purposes of this paragraph, rules similar to the rules of section 958 shall apply.</u>**

- Section 958(b) incorporates (and modifies) the ownership attribution rules of Section 318 for several Subpart F purposes, including the determination of CFC status, "related person" status, and "U.S. shareholder" status.

- It appears that the definition of "related party" in section 250(b)(5)(D) incorporates these ownership attribution rules of Sections 958 and 318 as well. And, if so, the definition of "related party" in section 250(b)(5)(D) is quite broad, and might end up including persons that are seemingly remote.

Did Congress intend "Related Party" definition in FDII provisions to be so broad ?

- The ownership attribution rules of section 958(b) (which rules are part of the definition of "control" in section 954(d)(3)) incorporates, by reference, the well-known, far-reaching ownership attribution rules of section 318, but with some modifications.

- It thus appears that the definition of "related party" in section 250(b)(5)(D) incorporates, for purposes of determining and limiting the FDII deduction, the broad definition of "control" in section 954(d)(3), which in turn includes modified stock attribution rules.

- This broad statutory definition of "related party" in section 250(b)(5)(D) could end up including persons that are seemingly remote.

- Congress may have intended a broad definition of "related party" in the FDII provisions to work as a strong anti-abuse measure.

- However, in the same 2017 Act (the TCJA) in which FDII was enacted, Congress made an admitted mistake in not anticipating the full collateral effects of repealing Section 958(b)(4) (which was the longstanding pre-2018 limit on the downward attribution rules of section 318(a)(3)). The Treasury and IRS have indicated they do not have the power to "fix" the inadvertent collateral effects of this change by regulation because they cannot override the plain words of the statute enacted by Congress.

- **Query:** Did Congress fully anticipate the full reach of the incorporated ownership attribution rules in defining "Related Party" for FDII purposes? The answer to this question remains unclear.

Maximizing the FDII Deduction for U.S. Exported Property and Services

Substantiation Requirements and Computations

Melody C. Horton, CPA

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Related Party Sales

- **Look through rule**: Sale of property – qualifies only if an unrelated party transaction subsequently occurs
- **New regs**: qualifies if you can establish that it ***will occur*** based on contractual terms, such as:
  1. the related party is contractually bound to only sell the product to foreign unrelated parties,
  2. based on past practices such as selling to only foreign market,
  3. a showing that the product sold is designed specifically for a foreign market, or
  4. books and records otherwise evidencing that sales will be made to foreign unrelated parties

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Related Party Sales

- **Look through rule**: Sale of property used to produce another product or used in the provision of a service – qualifies only if an unrelated party transaction subsequently occurs
- **New regs**: qualifies based on the percentage of revenue that the related party ***reasonably expects (as of the FDII filing date)*** to earn from all qualifying unrelated party transactions compared to the total revenue that the related party ***reasonably expects (as of the FDII filing date)*** to earn from all transactions with respect to the property purchased in the related party sale.

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Related Party Services

- **Round Tripping Rule**: Qualified only if the related party service is not substantially similar to a service that has been provided or will be provided by the related party to a person located within the United States
- Substantially similar – 60% of the benefits are used by the RP to confer benefits on US located recipients or 60% of the price paid by US located recipients is attributable to the RP service

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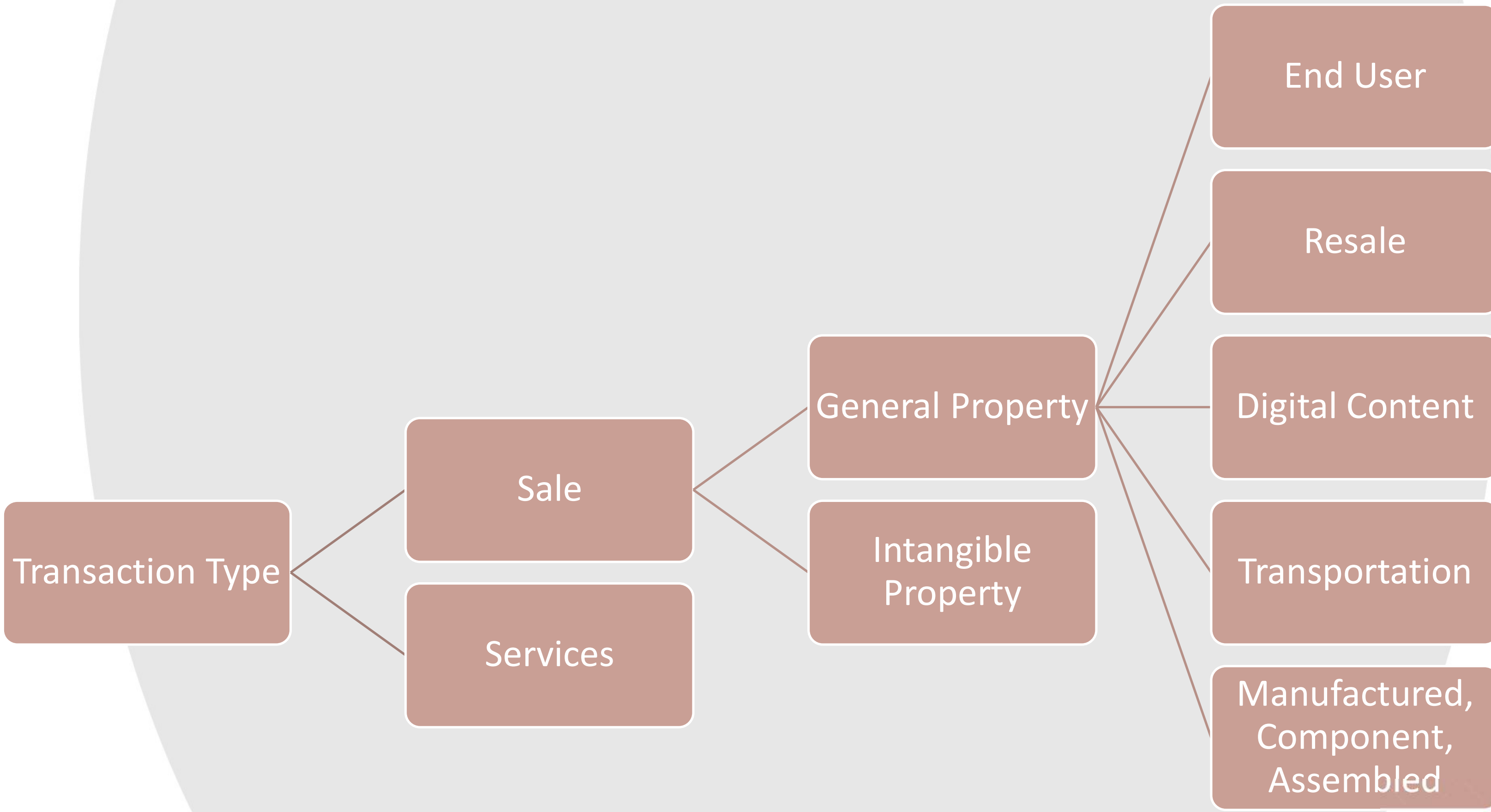
FDDEI Sales Flow Chart



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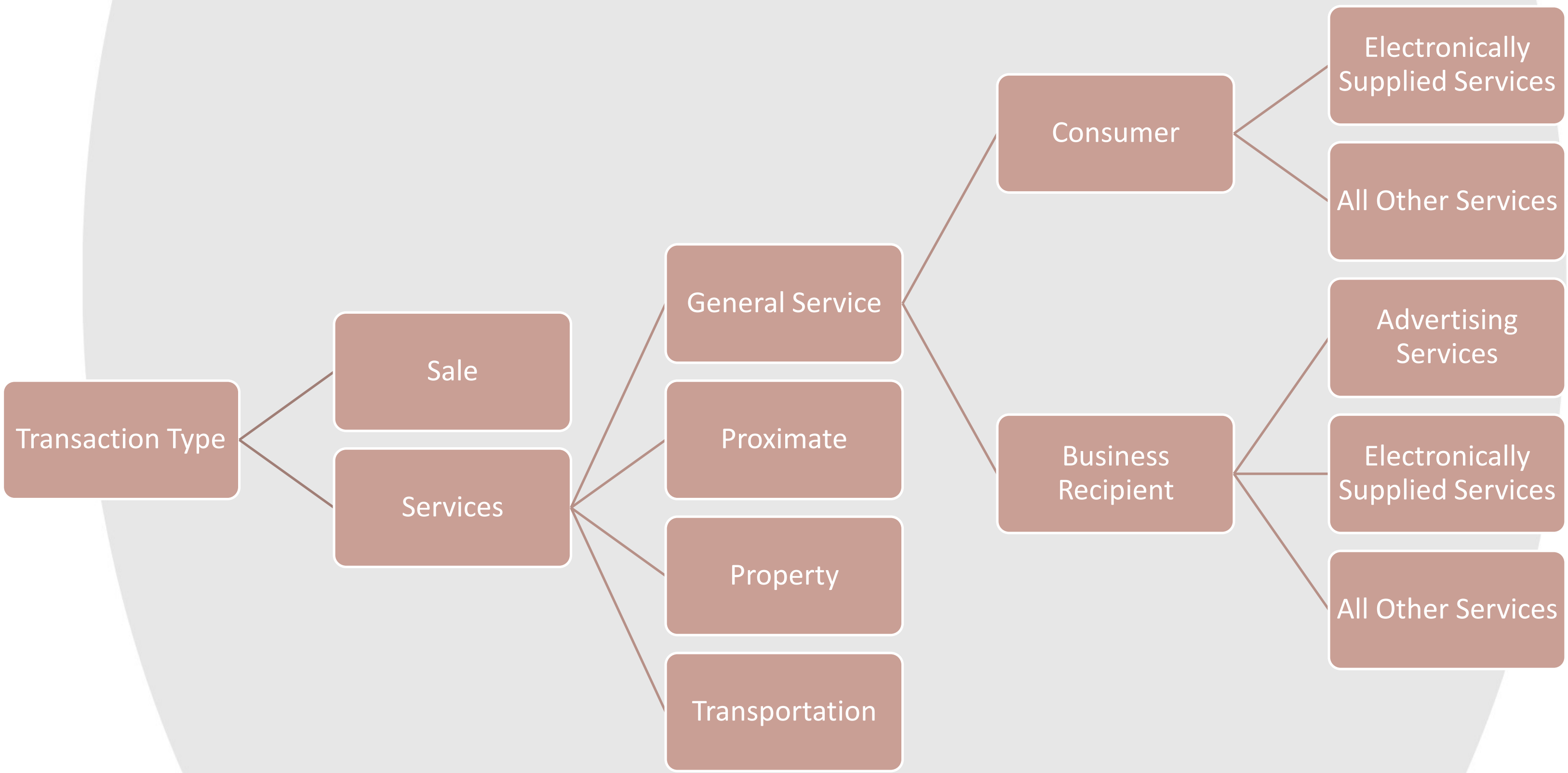
FDDEI Services Flow Chart



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Substantiation & Documentation

- Proposed regulations called for burdensome documentation requirements
- New final regulations allow for broader substantiation requirements (§1.250(b)-3 - 1.250(b)-5)
  - Final regs apply to any tax year beginning on or after January 1, 2021 but can early adopt
  - Can choose to adopt only the relaxed substantiation rules early
  - In some cases, can rely on information the taxpayer already keeps on record during normal course of business rather than specific documentation requirements

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Foreign Person Status - Substantiation

Sale Type	Description	Status Based On
General Property	Foreign retail sale	Physical retail location
General Property	Property delivered (not foreign retail sale)	Shipping address
General Property	Not foreign retail sale or delivered property	Billing address
Intangible Property		Billing address

***Knowledge or Reason to Know Exception**: If the seller knows or has reason to know that the sale is not to a foreign person. Information that indicates that a recipient is not a foreign person include, but are not limited to:

•US phone number, billing address, shipping address, or place of residence, or

•Evidence the entity is incorporated, formed or managed in the U.S.

If info gathered indicates the recipient is not a foreign person -- must follow up and obtain evidence establishing the recipient is a foreign person.

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Foreign Use - Substantiation

Sale Type	Recipient	Description	Status Based On
General Property	Distributor or Retailer	Resale	Physical retail location
General Property	End User	Property delivered (by a carrier or freight forwarder)	Shipping address
General Property	End User	Property not delivered	Location of property at time of sale
General Property	End User	Digital content	Device location (IP address) *$50k sales exception - billing address
***Knowledge or Reason to Know Exception**			

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Foreign Use - Substantiation

Sale Type	Description	Status Based On
Transportation Property	Used for compensation or hire	Property registration location
Transportation Property	Not used for compensation or hire	Property registration location and property storage location
General Property	Sales for manufacturing, assembly, or other processing	Property location of manufacturing, assembly, or other processing
Intangible		Location where property is exploited
***Knowledge or Reason to Know Exception**		

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Foreign Use Documentation for Resale

- A binding contract that specifically limits subsequent sales to sales outside the US;
- Proof that property is specifically designed, labeled, or adapted for a foreign market;
- Proof that the cost of shipping the property back to the US relative to the value of the property makes it impractical that the property will be resold in the US;
- Credible evidence obtained or created in the ordinary course of business from the recipient evidencing that property will be sold to an end user outside the US (or, in the case of sales of fungible mass property, stating what portion of the property will be sold to end users outside the US); or
- A written statement prepared by the seller containing the information described in paragraphs needed corroborated by evidence that is credible and sufficient to support the information provided.
  - The name and address of the recipient;
  - Date(s) the property was shipped or delivered to the recipient;
  - The amount of gross income from the sale;
  - A full description of the property subject to resale;
  - A description of the method of sales to the end users, such as direct sales by the recipient or sales by the recipient to retail stores;
  - If known, a description of the end users; and
  - Description of how the seller determined that property will be ultimately sold to an end user outside the US (or, in the case of sales of fungible mass property, of how the taxpayer determined what portion of the property that will ultimately be sold to end users outside the US).

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Foreign Use Documentation for Manufacturing, Assembly, or Other Processing

- Credible evidence that the property has been sold to a foreign unrelated party that is a manufacturer and such property generally cannot be sold to end users without being subject to a physical and material change;
- Credible evidence obtained or created in the ordinary course of business from the recipient to support that the product purchased will be subject to manufacture, assembly, or other processing outside the US; or
- A written statement prepared by the seller containing the information needed corroborated by evidence that is credible and sufficient to support the information provided.
  - The name and address of the manufacturer of the property;
  - The date or dates the property was shipped or delivered to the recipient;
  - The amount of gross income from the sale;
  - A full description of the general prop. sold and the type(s) of finished goods that will incorporate the general property the taxpayer sold;
  - A description of the manufacturing, assembly, or other processing operations, including the location or locations of manufacture, assembly, or other processing; how the general property will be used in the finished good; and the nature of the finished good's manufacturing, assembly, or other processing operations as compared to the process used to make the general property used to make the finished good;
  - Description of how the seller determined the general prop. was substantially transformed or the activities were substantial in nature; &,
  - If the seller is relying on the 20% rule, an explanation of how the seller satisfies the requirements.

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Foreign Use Documentation for Intangible

- A binding contract that specifically provides that the intangible property can be exploited solely outside the US;
- Credible evidence obtained or created in the ordinary course of business from the recipient establishing the portion of its revenue for a taxable year that was derived from exploiting the intangible property outside the US; or
- A written statement prepared by the seller containing the information needed corroborated by evidence that is credible and sufficient to support the information provided.
  - The name and address of the recipient;
  - The date of the sale;
  - The amount of gross income from the sale;
  - A description of the intangible property;
  - An explanation of how the intangible property will be used by the recipient;
  - An explanation of how the seller determined what portion of the sale is a FDDEI sale;
  - If the intangible property consists of a manufacturing method or process, an explanation of it follows those rules;
  - If the sale is for periodic payments, an explanation of how the seller determined the extent of foreign use based on the actual revenue earned by the recipient from the use of the intangible property for the taxable year in which a periodic payment is received, or, if actual revenue cannot be obtained after reasonable efforts, an explanation of why actual revenue is unavailable and how the seller determined the extent of foreign use based on estimated revenue; and
  - If the sale is for a lump sum, an explanation of how the seller determined the total NPV of revenue it expected to earn from the exploitation of the intangible property outside the US and the total NPV of revenue it expected to earn from the exploitation of the intangible property.

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FDDEI Services - Substantiation

Service Type	Recipient	Description	Status Based On
General Service	Consumer	Electronically supplied services	IP address/billing address
General Service	Consumer	Non-electronically supplied services	Consumer’s residence/billing address
General Service	Business	Electronically supplied services	Location where the business recipient (employees, contractors, or agents) access the service/IP address *$50k sales exception - billing address
General Service	Business	Advertising services	Location where the advertisements are viewed by individuals/IP address
General Service	Business	General	Location where business recipient’s operations benefit

*No substantiation requirements for consumers but must **follow Knowledge or Reason to Know Exception.**

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FDDEI Services – Business Recipient Substantiation for General Service

Option 1

- Credible evidence obtained or created in the ordinary course of business from the business recipient establishing the extent to which operations of the business recipient outside the US benefit from the service, or

Option 2

- A written statement from the renderer with the following info:
  - The name of the business recipient,
  - The date or dates of the service,
  - The amount of gross income from the service,
  - A full description of the service,
  - A description of how the service will benefit the business recipient, and
  - An explanation of how the renderer determined what portion of the service will benefit the business recipient's operations located outside the US
- Must be corroborated by evidence that is credible and sufficient to support the information provided

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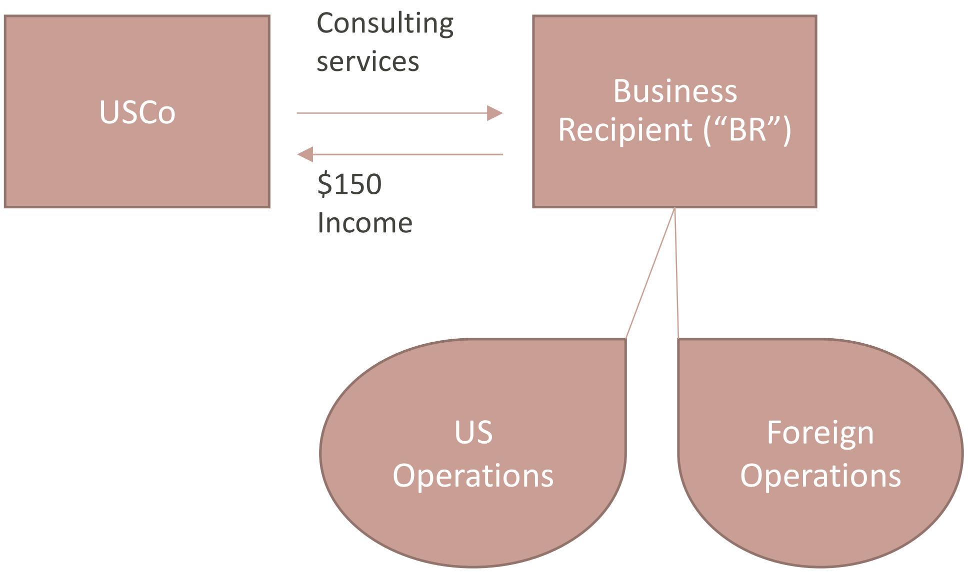
Case Study #1: FDDEI Services – Provided to a Person Outside the US



USCo provides consulting services that benefits only a specific fast-food chain that BR owns

BR has operations both inside and outside of the US

Approximately 50% of the total revenue of BR and its related parties is from customers outside the US

70% of the revenue for the fast food chain comes from locations within the US and 30% is from locations outside the US

Which method is the best to allocate the benefit?

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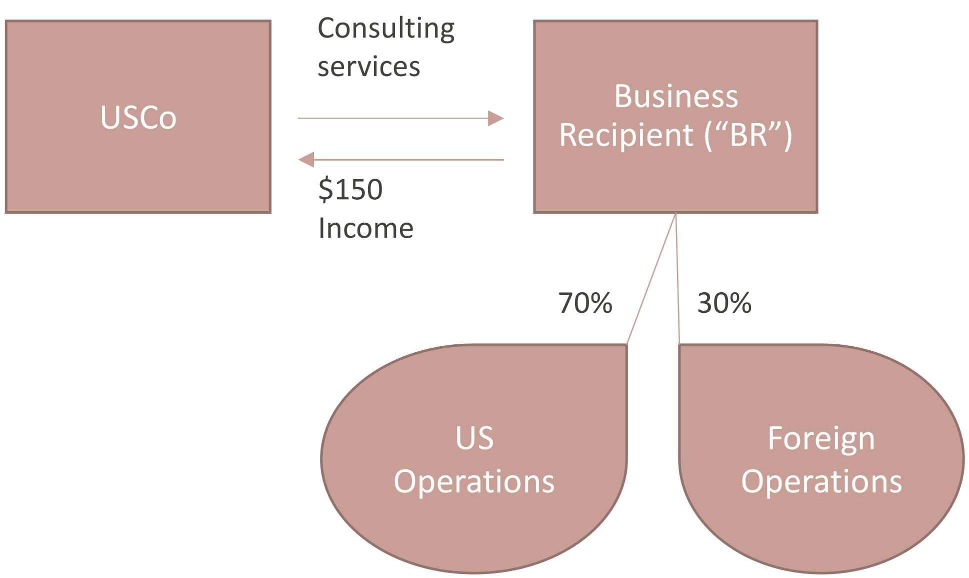
Case Study #1: FDDEI Services – Provided to a Person Outside the US



Which is the best method to allocate the benefit?

Sales method is the most reasonable method under §1.482-9(k) because this directly relates to the services provided in this case

$150 consulting income X 30% foreign apportionment = $45 included in gross FDDEI

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FDDEI Services - Substantiation

Service Type	Status Based On
Proximate Service	Location where service is performed If performed partly within and outside the US, then apportion based on time
Property Service	Location where the service is performed on the property Exception for temporary services performed in the US
Transportation Service	100% - both the origin and destination are located outside the US 50% - if only the origin or destination is located outside of the US

*No specific substantiation requirements for proximate, property, or transportation services.

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Calculating the FDII Deduction: Simplified Terms

$$\text{FDII Deduction} = \frac{\text{Foreign Income}}{\text{Total Income}} \times \text{Total Income less 10\% Fixed Assets} \times 37.5\%$$

$$\text{Total Income less 10\% Fixed Assets} = \text{Total Income} - \left(\text{Fixed Assets} \times 10\%\right)$$

Calculating the FDII Deduction: Precise Formula

$$\text{FDII Deduction} = \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}} \times \text{Deemed Intangible Income} \times 37.5\%$$

$$\text{Deemed Intangible Income} = \text{Deduction Eligible Income} - \left(\text{Qualified Business Assets Investment} \times 10\%\right)$$

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Computation

- Taxable Income Limitation: the deduction for FDII and GILTI is limited if the total of FDII and GILTI exceeds taxable income
- Ordering Rules:
  - IRC §172 and §163 provide their own income limitations
  - Proposed §1.250(a)-1 would have provided a five-step coordination rule to apply these limitations.
  - Treasury and the IRS is spending more time to evaluate this issue. Until guidance is issued, taxpayers may use any reasonable method if they apply it consistently for all taxable years beginning on or after January 1, 2021. Reasonable methods could include the proposed regulations' ordering rule or simultaneous equations.

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Qualified Business Assets Investment

- QBAI is the quarterly average of corporation’s aggregate adjusted tax bases in specified tangible property (§1.250(b)-2)
- Specified tangible property:
  - Tangible property used in the production of gross DEI, &
  - Must be eligible for deduction under IRC §167
- Piggybacks off GILTI
- Calculate QBAI based on ADS method

<u>Practice Note</u>*: Tangible property includes both personal and real property (not land). A common mistake is not including buildings or leasehold improvements or mistakenly including computer software amortized under IRC 168(k).*

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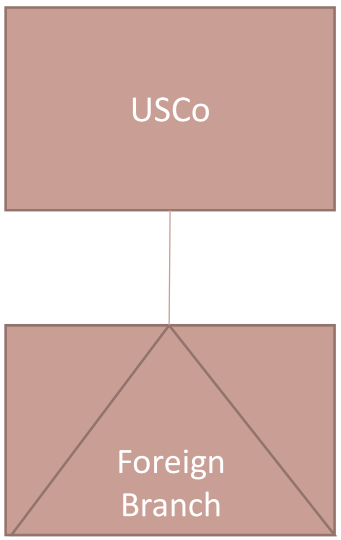
Case Study #2: QBAI



$200 Cost Basis in Real Property
$150 Cost Basis in Equipment
$175 Accumulated Depr under MACRS
$100 Accumulated Depr under ADS

$100 Cost Basis in Equipment
$25 Accumulated Depr under ADS

How much is QBAI?

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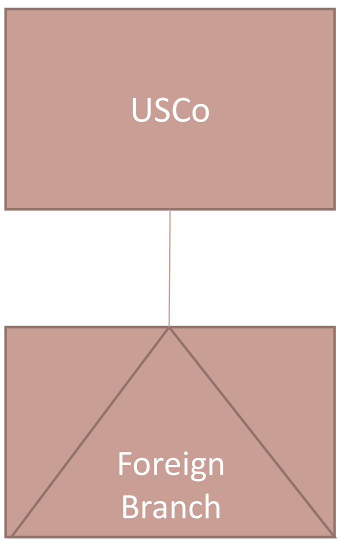
Case Study #2: QBAI



$200 Cost Basis in Real Property
$150 Cost Basis in Equipment
$175 Accumulated Depr under MACRS
$100 Accumulated Depr under ADS

$100 Cost Basis in Equipment
$25 Accumulated Depr under ADS

How much is QBAI?

The real property and equipment ($250 + $150) in USCo are included but the equipment in the foreign branch is not included because it does not produce deduction eligible income. Foreign branch income is excluded from DEI.

The accumulated depreciation ($100) should be calculated under ADS, not MACRS.

The total QBAI is $300 ($250 RE + $150 Equip - $100 AD).

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Deduction Eligible Income

- Deduction Eligible Income (DEI) is the excess of a domestic corporation's gross DEI over properly allocable deductions including taxes (§250(b)(3))
- Items excluded from gross DEI:
  - Subpart F income
  - GILTI
  - Financial services income
  - CFC Dividends
  - Domestic oil and gas extraction income
  - Foreign branch income

Practice Note: *Gross income = gross receipts less COGS*

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Computation

- COGS is attributed between DEI and FDDEI based on ***any reasonable method*** that is applied ***consistently***
- Cannot segregate COGS with respect to a particular product into component costs and attribute those component costs disproportionately to gross receipts for amounts excluded from gross DEI or gross FDDEI
- Final regs regarding the allocation and apportionment rules of §1.861-8 through 1.861-17 apply to any tax year beginning on or after January 1, 2021

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Allocation and Apportionment

- Deductions are allocated and apportioned to gross DEI and gross FDDEI under the rules of §1.861-8 through 1.861-14T and 1.861-17 by treating IRC §250(b) as an operative section described in §1.861-8(f).
- ***Only for purposes of determining allocation and apportionment to gross DEI and gross FDDEI***, the deductions are determined without regard to sections §163(j), 170(b)(2), 172, 246(b), and 250.
- Some deductions will be definitely related to some class of a taxpayer's total gross income while others will be related to all gross income. Deductions definitely related are allocated to that specific income. Deductions not definitely related will be apportioned to all gross income.

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Allocation and Apportionment

- Gross FDDEI and gross RDEI are treated as separate statutory groupings. The deductions allocated and apportioned to gross DEI equal the sum of the deductions allocated and apportioned to gross FDDEI and gross RDEI.
- All items of gross income excluded from DEI are in the residual grouping.

Total Income		
DEI		Non DEI (Subpart F, GILTI, FB inc., etc.)
FDDEI Statutory Grouping	RDEI Statutory Grouping	Residual Grouping

Allocation and Apportionment

- Deductions definitely related to a class of income – specifically allocate to that income
- Deductions related to all gross income - ratably apportioned to all gross income.
- Deductions not definitely related to any gross income – ratable apportioned between the statutory groupings and the residual grouping
- Methods of apportionment include but are not limited to:
  - Comparison of units sold,
  - Comparison of the amount of gross sales or receipts,
  - Comparison of the Cost of Goods Sold,
  - Comparison of the profit contribution,
  - Comparison of the following items which are attributable to the activities or properties giving rise to the class of gross income: expenses incurred, assets used, salaries paid, space utilized, time spent, etc.
  - Comparison of the amount of the gross income.

Practice Note: *A method of apportionment is generally not a method of accounting within the meaning of IRC 446.*

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Allocation and Apportionment

- Support expenses –may be allocated and apportioned along with the deductions to which they relate or on some reasonable basis directly to activities or property which generate gross income
- Interest expense – apportioned based on assets
- Research and experimental expense – apportion based on SIC code category of global intangible income or sales method/optional gross income method depending upon regs. adopted
- Stewardship expense - are ordinarily definitely related and allocable to specific classes of gross income, remaining expenses are allocated between statutory and residual groupings based on the values of the entity or entities in each grouping that are owned by the investor taxpayer
- Legal and accounting fees and expenses – are ordinarily definitely related and allocable to specific classes of gross income or to all the taxpayer's gross income
- Income taxes - allocated and apportioned among the applicable statutory and residual groupings

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Research & Experimental Expenses – Old Regs.

1. Determine allowable R&E expense
2. Allocate to gross income from broad product categories to which income is definitely related.
3. Reduce by any legally mandated R&E, which is allocated to a specific geographic source, if applicable.
4. Reduce by any exclusive apportionment of R&E expense apportioned to a specific geographic source – (based on fixed percentages).
5. Apportion the balance using the sales method or the optional gross income method

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Research & Experimental Expenses – New Final Regs.

1. Determine allowable R&E expense
2. Allocate to gross ***intangible*** income from broad product categories to which income is definitely related.
3. ~~Reduce by any legally mandated R&E, which is allocated to a specific geographic source, if applicable.~~
4. ~~Reduce by any exclusive apportionment of R&E expense apportioned to a specific geographic source – (based on fixed percentages).~~
5. Apportion the balance using the ~~sales~~ ***gross receipts of sales and services method*** ~~or the optional gross income method~~

__Practice Note__: Once a taxpayer selects a SIC code category or Major Group for the first taxable year, it must continue to use that category in following years unless it receives permission from the Commissioner.

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Interest expense

- For tax years after December 31, 2017, must use the tax book value method for allocating interest expense
- Based on the average tax basis as the beginning and end of the year, unless that provides a distortion

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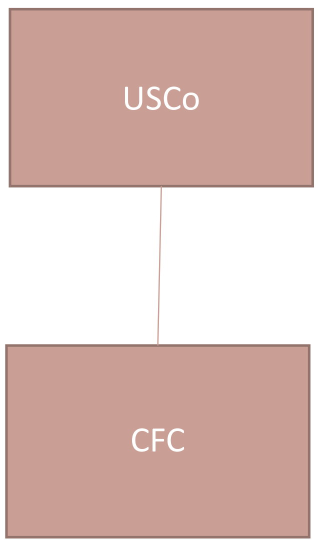
Case Study #3: Comprehensive Example

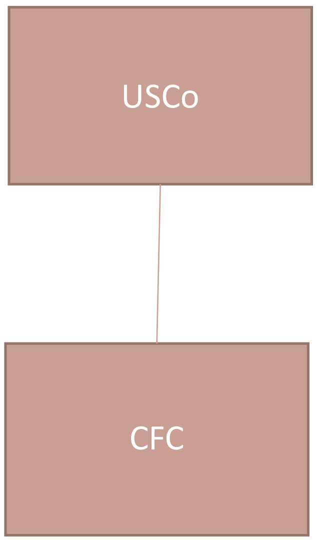


USCo is a vineyard which grows and sells pinot noir grapes and chardonnay grapes to both US and Canadian wineries. These grapes will then be turned into wine, bottled, and sold both inside and outside the US.

USCo owns a CFC, which produces GILTI.

For purposes of this example, assume the two types of grapes fit into different SIC categories.

Case Study #3: Comprehensive Example



- $1,000 revenue from sales of pinot noir grapes - $900 in the US and $100 in Canada
- $1,000 revenue from sales of chardonnay grapes - $500 in the US and $500 in Canada
- The cost of the pinot noir grapes sold is approximately $700 and the cost of the chardonnay grapes sold is $600.
- The vineyard incurs $100 in R&E related to the chardonnay grapes, $100 legal costs definitively related to a legal matter for the pinot noir grapes sold to the US, and $400 in SG&A not definitely related to any gross income.
- The vineyard has $1,000 in fixed assets used to produce DEI. The accumulated depreciation under ADS is $200.
- $300 GILTI.

Case Study #3: Comprehensive Example

	DEI				Non DEI	Total
	RDEI		FDDEI		Residual	
	Pinot Noir	Chardonnay	Pinot Noir	Chardonnay	GILTI	
Sales Revenue	$900	$500	$100	$500		$2,000
COGS	$630	$300	$70	$300		$1,300
Other Income	$0	$0	$0	$0	$300	$300
Gross Income	$270	$200	$30	$200	$300	$1,000
R&E	$0	$50	$0	$50	$0	$100
Legal	$100	$0	$0	$0	$0	$100
Other SG&A	$108	$80	$12	$80	$120	$400
Net	$62	$70	$18	$70	$180	$400

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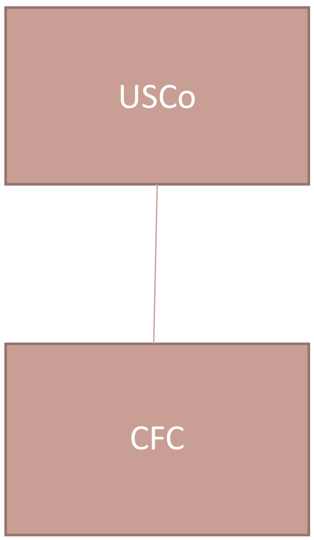
Case Study #3: Comprehensive Example



$18 FDDEI from pinot noir + $70 FDDEI from chardonnay = $88 FDDEI

$300 GILTI

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Case Study #3: Comprehensive Example

$$\text{FDII Deduction} = \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}} \times \text{Deemed Intangible Income} \times 37.5\%$$

$$\text{Deemed Intangible Income} = \text{Deduction Eligible Income} - \left(\text{Qualified Business Assets Investment} \times 10\%\right)$$

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Case Study #3: Comprehensive Example

$$\text{FDII Deduction} = \frac{\text{\$88 FDDEI}}{\text{Deduction Eligible Income}} \times \text{Deemed Intangible Income} \times 37.5\%$$

$$\text{Deemed Intangible Income} = \text{Deduction Eligible Income} - \left(\text{Qualified Business Assets Investment} \times 10\%\right)$$

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Case Study #3: Comprehensive Example

$$\text{FDII Deduction} = \frac{\text{\$88 FDDEI}}{\text{\$220 DEI}} \times \text{Deemed Intangible Income} \times 37.5\%$$

$$\text{Deemed Intangible Income} = \text{\$220 DEI} - \left(\text{Qualified Business Assets Investment} \times 10\%\right)$$

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Case Study #3: Comprehensive Example

FDII Deduction = 40.0% FDR × Deemed Intangible Income × 37.5%

Deemed Intangible Income = $220 DEI − ($800 QBAI × 10%)

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Case Study #3: Comprehensive Example

$$\text{FDII Deduction} = 40.0\%\ \text{FDR} \times \$140\ \text{DII} \times 37.5\%$$

$$\$140\ \text{DII} = \$220\ \text{DEI} - (\$800\ \text{QBAI} \times 10\%)$$

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Case Study #3: Comprehensive Example

$21 FDII Deduction = 40.0% FDR × $140 DII × 37.5%

$140 DII = $220 DEI − ($800 QBAI × 10%)

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New Revised Form 8993

Form **8993** (Rev. December 2020) Department of the Treasury Internal Revenue Service	**Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)** ▶ Go to *www.irs.gov/Form8993* for instructions and the latest information.	OMB No. 1545-0123 Attachment Sequence No. **993**

Name of person filing this return	**Identifying number**

Part I **Determining Deduction Eligible Income (DEI) and Deemed Intangible Income (DII)** (see instructions)

1	Gross income			1	
2	Exclusions				
a	Income included under section 951(a)(1) (see instructions)	2a			
b	Income included under section 951A (see instructions)	2b			
c	Financial services income	2c			
d	CFC dividends (see instructions)	2d			
e	Domestic oil and gas extraction income	2e			
f	Foreign branch income	2f			
3	Total exclusions (add lines 2a through 2f)			3	
4	Gross DEI (subtract line 3 from line 1)			4	
5	Deductions properly allocable to the amount on line 4			5	
6	DEI (subtract line 5 from line 4)			6	
7	Deemed tangible income return (10% of QBAI)			7	
8	DII (subtract line 7 from line 6)			8	

Part II **Determining Foreign-Derived Deduction Eligible Income (FDDEI)** (see instructions)

		(A) Foreign-derived income from all sales of general property	(B) Foreign-derived income from all sales of intangible property	(C) Foreign-derived income from all services		(D) Total (Add columns (A) through (C))
9a	Gross receipts				9a	
b	Gross receipts from partnerships				9b	

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New Revised Form 8993

Part II Determining Foreign-Derived Deduction Eligible Income (FDDEI) (see instructions)

		(A) Foreign-derived income from all sales of general property	(B) Foreign-derived income from all sales of intangible property	(C) Foreign-derived income from all services		(D) Total (Add columns (A) through (C))
9a	Gross receipts				9a	
b	Gross receipts from partnerships				9b	
c	Total gross receipts (add lines 9a and 9b)				9c	
10a	Cost of goods sold (COGS) (see instructions)				10a	
b	COGS from partnerships (see instructions)				10b	
c	Total COGS (add lines 10a and 10b)				10c	
11	Gross FDDEI (subtract line 10c from line 9c)				11	
12	Allocable deductions				12	
13	Allocable deductions from partnerships				13	
14	Interest deductions				14	
15	Research and experimental deductions				15	
16	Other apportioned deductions				16	
17	Other apportioned deductions from partnerships				17	
18	Total deductions (add lines 12 through 17)				18	
19	FDDEI (subtract line 18 from line 11)				19	

Part III Determining FDII and/or GILTI Deduction (see instructions)

20	Foreign-derived ratio (FDDEI/DEI) (divide line 19 by line 6)	20	
21	FDII (multiply line 8 by line 20)	21	
22	GILTI inclusion (see instructions)	22	
23	Total FDII and GILTI (add lines 21 and 22)	23	
24	Taxable income (see instructions) (If zero or less, skip lines 25 through 27 and enter -0- on lines 28 and 29.)	24	
25	Excess FDII and GILTI over taxable income (subtract line 24 from line 23). If zero or less, enter -0- here and on lines 26 and 27	25	
26	FDII reduction (divide line 21 by line 23; multiply by line 25)	26	
27	GILTI reduction (subtract line 26 from line 25)	27	
28	FDII deduction (see instructions). Enter here and on Form 1120, Schedule C	28	
29	GILTI deduction (see instructions). Enter here and on Form 1120, Schedule C	29	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37817J Form **8993** (Rev. 12-2020)

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Case Study #3: Comprehensive Example

Form **8993** (Rev. December 2020) Department of the Treasury Internal Revenue Service

Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)

► **Go to *www.irs.gov/Form8993* for instructions and the latest information.**

OMB No. 1545-0123

Attachment Sequence No. **993**

Name of person filing this return	Identifying number
Taxpayer Name	01-2345678

Part I **Determining Deduction Eligible Income (DEI) and Deemed Intangible Income (DII)** (see instructions)

1	Gross income			1	1,000
2	Exclusions				
a	Income included under section 951(a)(1) (see instructions)	2a	300		
b	Income included under section 951A (see instructions)	2b			
c	Financial services income	2c			
d	CFC dividends (see instructions)	2d			
e	Domestic oil and gas extraction income	2e			
f	Foreign branch income	2f			
3	Total exclusions (add lines 2a through 2f)			3	300
4	Gross DEI (subtract line 3 from line 1)			4	700
5	Deductions properly allocable to the amount on line 4			5	480
6	DEI (subtract line 5 from line 4)			6	220
7	Deemed tangible income return (10% of QBAI)			7	80
8	DII (subtract line 7 from line 6)			8	140

Part II **Determining Foreign-Derived Deduction Eligible Income (FDDEI)** (see instructions)

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Case Study #3: Comprehensive Example

8 DII (subtract line 7 from line 6) 8 140

Part II **Determining Foreign-Derived Deduction Eligible Income (FDDEI)** (see instructions)

		(A) Foreign-derived income from all sales of general property	(B) Foreign-derived income from all sales of intangible property	(C) Foreign-derived income from all services		(D) Total (Add columns (A) through (C))
9a	Gross receipts	600			9a	600
b	Gross receipts from partnerships	0			9b	0
c	Total gross receipts (add lines 9a and 9b)	600			9c	600
10a	Cost of goods sold (COGS) (see instructions)	370			10a	370
b	COGS from partnerships (see instructions)	0			10b	0
c	Total COGS (add lines 10a and 10b)	370			10c	370
11	Gross FDDEI (subtract line 10c from line 9c)	230			11	230
12	Allocable deductions	142			12	142
13	Allocable deductions from partnerships	0			13	0
14	Interest deductions				14	0
15	Research and experimental deductions				15	0
16	Other apportioned deductions				16	0
17	Other apportioned deductions from partnerships				17	0
18	Total deductions (add lines 12 through 17)				18	142
19	FDDEI (subtract line 18 from line 11)				19	88

Part III **Determining FDII and/or GILTI Deduction** (see instructions)

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Case Study #3: Comprehensive Example

Part III **Determining FDII and/or GILTI Deduction** (see instructions)

20	Foreign-derived ratio (FDDEI/DEI) (divide line 19 by line 6)	**20**	.40
21	FDII (multiply line 8 by line 20)	**21**	56
22	GILTI inclusion (see instructions)	**22**	300
23	Total FDII and GILTI (add lines 21 and 22)	**23**	356
24	Taxable income (see instructions) (If zero or less, skip lines 25 through 27 and enter -0- on lines 28 and 29.)	**24**	400
25	Excess FDII and GILTI over taxable income (subtract line 24 from line 23). If zero or less, enter -0- here and on lines 26 and 27	**25**	0
26	FDII reduction (divide line 21 by line 23; multiply by line 25)	**26**	0
27	GILTI reduction (subtract line 26 from line 25)	**27**	0
28	FDII deduction (see instructions). Enter here and on Form 1120, Schedule C	**28**	21
29	GILTI deduction (see instructions). Enter here and on Form 1120, Schedule C	**29**	150

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FDII Impact on Effective Tax Rate

ETR Based on FDDEI	
FDDEI	$88
FDII Deduction	($21)
Net Foreign Income	$67
Tax @ 21%	$14
ETR (Tax/FDDEI)	15.9%

ETR Based on FDII	
FDII	$56
FDII Deduction	($21)
Net Foreign Income	$35
Tax @ 21%	$7.35
ETR (Tax/FDII)	13.125%

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Notes & Planning Points

- 962 election applies for purposes of GILTI inclusion but you cannot make a 962 election for FDII
- Partnership passes through attributes to corporate partners; make sure to disclose in K-1 footnotes
- Consolidated groups determined a consolidated FDII deduction amount which is then allocated to each individual entity based on the rules of sections 1.1502-11 through 13
- Make sure to look for taxable income limitations for FDII and GILTI based on the total amount, not the deduction amount
- Forms 5472, 5471 and 8865 all require reporting on intercompany transactions if the taxpayer is claiming the FDII deduction

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Notes & Planning Points

- Planning:
  - Consider segregating activities or business restructuring
  - Evaluate the impact of any transfer pricing or supply chain changes
  - Evaluate allocation and apportionment methodology
  - Review contracts/invoices to determine if restructuring with the foreign party would be more beneficial
  - Model whether purchasing versus leasing new fixed assets is more beneficial
  - Consider preparing a FDII study to document eligibility for the deduction as well as report methodology for the calculation

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Questions?

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