Government Releases Final Regulations on FDII and GILTI Deduction

Article By:

Michael J. Bruno

Brian H. Jenn

Gregory M. Weigand

Le Chen

OVERVIEW

On July 9, 2020, the US Department of the Treasury (Treasury) and Internal Revenue Service (IRS) released Final Regulations (Final Regulations) that provide guidance on the section 250 deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). Enacted as part of the Tax Cuts and Jobs Act (TCJA), section 250 currently provides a deduction for domestic corporations equal to the sum of 37.5% of their FDII and 50% of their GILTI and section 78 gross-up. Electing section 962 shareholders are entitled to claim the section 250 deduction with respect to GILTI. The Final Regulations finalize the proposed regulations (the Proposed Regulations) issued in March 2019 with significant modifications, but are generally taxpayer-friendly. Further, the preamble to the Final Regulations (the Preamble) provides temporary guidance on certain topics and notes the government's reservations in several areas where further guidance is expected. The discussion set forth below summarizes the key highlights from the Final Regulations and Preamble.

IN DEPTH

More Flexible Documentation Rules

As one of the most notable changes, the Final Regulations significantly modified the proposed documentation requirements, generally allowing taxpayers more flexibility to substantiate their transactions as for foreign use. For example, except for certain transactions that are subject to new specific substantiation requirements, the Final Regulations relax most documentation requirements, loosen prior reliability rules and generally allow taxpayers to presume foreign person status, such that taxpayers may claim a FDII benefit so long as they can substantiate that they are entitled to the section 250 deduction under section 6001 and its regulations. Further, the Final Regulations expanded the transition rule set forth under the Proposed Regulations, thereby allowing taxpayers to rely on the current taxpayer-friendly documentation standard until the Final Regulations are effective. Some of these points are discussed in the topics below, but for a more comprehensive and specific summary of the FDII documentation rules, please click here.

Notable Revisions to Deduction for FDII and GILTI

The Final Regulations reserve on coordinating sections 163(j), 172(a) and other Internal Revenue Code provisions with respect to section 250, and remove an example in the Proposed Regulations that applied this rule. The prior ordering rule in the Proposed Regulations provided that a taxpayer's taxable income for purposes of applying the taxable income limitation of section 250(a)(2) is determined *after* all of the corporation's other deductions are taken into account. As a result, taxpayers with sizable net operating losses (NOLs) and business interest expense could receive a significantly lower section 250 deduction, if any.

The Preamble allows taxpayers to use any "reasonable method" to determine how allowed deductions are taken into account in determining the section 250(a)(2) taxable income limitation, provided it is applied consistently for all taxable years beginning on or after January 1, 2021. Given that there is no carryback or carryforward of a taxpayer's FDII deduction in excess of their taxable income limitation, taxpayers should consider employing methods that afford priority to section 250 deductions over NOLs or business interest expense, each of which can be carried forward.

Notable Revisions to Computation of FDII (Treas. Reg. § 1.250(b)-1)

Cost of Goods Sold Allocation

In the Final Regulations, IRS retained the rule that for purposes of determining gross income included in gross deduction-eligible income (DEI) and gross foreign-derived deduction-eligible income (FDDEI), cost of goods sold is attributed to gross receipts with respect to gross DEI or gross FDDEI under any reasonable method. Although the rule was retained, the Final Regulations clarified that the cost of goods sold allocation method selected by a taxpayer must be consistently applied. Taxpayers cannot segregate cost of goods sold associated with activities undertaken in an earlier tax year (including a tax year before the effective date of the Final Regulations) into component costs and attribute them disproportionately to amounts excluded from gross FDDEI or to amounts excluded from gross DEI.

Expense Allocation

Section 250(b)(3) generally requires taxpayers to determine deductions that are "properly allocable" to gross DEI, but for that purpose, the statute does not specify an allocation method. The proposed section 250 regulations provided that reg. sections 1.861-8 through 1.861-14T and 1.861-17 were to be applied for purposes of allocating deductions to gross DEI and gross FDDEI by treating section 250(b) as an operative section described in reg. section 1.861-8(f). For purposes of allocating expenses under those specific section 861 regulations, the Proposed Regulations treated: (a) gross FDDEI and gross non-FDDEI as separate statutory groupings; and (b) excluded gross income as the residual grouping. Moreover, the Proposed Regulations did not take into account the exclusive apportionment rule contained in reg. section 1.861-17(b).

The Final Regulations eliminated the provision that excluded the exclusive apportionment rule contained in reg. section 1.861-17(b). The IRS explained the removal of such provision was in view of the proposed section 1.861-17 regulations it issued in December 2019.

Treasury and IRS also adopted and expanded the taxpayer recommendation that pre-2018 NOLs (*i.e.*, NOLs incurred before the effective date of the Proposed Regulations or, in certain cases, NOLs incurred before the effective date of the TCJA) be disregarded when allocating expenses to gross DEI and gross FDDEI. Namely, the Final Regulations provide that sections 163(j), 170(b)(2), 172, 246(b) and 250 are inapplicable when allocating and apportioning deductions to gross DEI or gross FDDEI of a taxpayer for a given tax year.

Foreign-Derived Ratio

Treasury and IRS adopted a rule in the Final Regulations indicating that the foreign-derived ratio (FDDEI to DEI) cannot exceed 1. By mechanically applying the definitions and rules in the statute and Proposed Regulations, the preamble to the Proposed Regulations noted that it could be possible that the foreign-derived ratio could exceed 1 in certain factual situations, and several comments to the Proposed Regulations argued for that to be permitted. However, Treasury and IRS took the position that permitted the foreign-derived ratio to exceed 1 would be inconsistent with section 250.

Foreign Branch Income for FDII Purposes

The Final Regulations include a definition of "foreign branch income" for FDII purposes that is fully consistent with the definition in the final foreign tax credit regulations issued in 2019. The Proposed Regulations had defined foreign branch income for FDII purposes by cross-reference to the foreign tax regulations but had also treated as foreign branch income any income or gain from the disposition of an asset that gives rise to foreign branch income. The Proposed Regulations' expanded definition created the possibility of foreign branch income when disposing of a disregarded entity holding a foreign branch or when disposing of an asset that had been transferred from a foreign branch to its owner. This is significant because foreign branch income cannot be gross FDDEI. By making the foreign branch income definition for FDII purposes consistent with the foreign tax credit regulations, the Final Regulations allow for a FDII deduction with respect to income from disposition of a disregarded entity or an asset formerly on the books of a foreign branch.

Revisions to the Determination of Qualified Business Asset Investment

The Final Regulations revise the Proposed Regulations' rules for determining qualified business asset investment (QBAI) with respect to dual-use property. Consistent with earlier revisions made with respect to analogous GILTI provisions, the Final Regulations remove the concept of "directly identifiable income" and generally provide that the basis of dual-use property is included in QBAI for FDII purposes in proportion to the extent that depreciation deductions with respect to such property would be allocable to gross DEI. Also, the Final Regulations include a relief provision providing that the sale/leaseback anti-avoidance rule of Treas. Reg. § 1.250(b)-2(h) does not apply to transfers of property occurring before March 4, 2019.

FDDEI Transactions

Reliability of Documentation

The Final Regulations replace the documentation requirements contained in the Proposed Regulations with more flexible substantiation rules, where different types of corroborating evidence may be used in that regard. The "reason to know" standard was retained: A taxpayer has a "reason to know" that a transaction fails to satisfy a substantive requirement if the information received by a taxpayer contains information indicating the substantive requirement is not met and, after making reasonable efforts, the taxpayer cannot establish the substantive requirement is met.

Sales or Services to a Partnership

In the partnership context, questions requiring clarification were: (i) whether a domestic corporation may deduct its share of a partnership's FDII; and (ii) whether FDII be computed based on the entity approach (at the partnership level and the approach suggested in the Proposed Regulations) or based on the aggregate approach (computed at the partner level). The Final Regulations retained the rule in the Proposed Regulations that domestic corporate partners in a partnership are permitted to include their share of such partnership's items of gross DEI, gross FDDEI and related deductions for purposes of calculating their FDII amount—thus, an aggregate approach is applied.

Conversely, for purposes of determining whether a sale or service is a FDDEI transaction, Treasury and IRS require the application of the entity approach. Because sales to a domestic partnership do not qualify as a FDDEI sale because such partnership is not a "foreign person," taxpayers recommended alternatives to the entity approach; namely, to treat a sale to a partnership as a FDDEI sale: (i) to the extent the partnership predominantly engages in a foreign business; or (ii) to the extent of its ownership by direct and indirect foreign partners. Those approaches were not adopted, which gives rise to a curious result that a sale to a foreign partnership owned by US persons can qualify as a FDDEI sale.

Treatment of Certain Loss Transactions

The Final Regulations generally retained the rule set forth in the Proposed Regulations that if a taxpayer knows or has reason to know that property is sold to a foreign person for a foreign use or a general service is provided to a person located outside the United States, but the taxpayer does not satisfy the documentation requirements applicable to such sale or service, the sale of property or provision of a service is nonetheless deemed a FDDEI transaction if treating the sale or service as a FDDEI transaction would reduce a taxpayer's FDDEI. The rule contained in the Proposed Regulations was also modified by causing the loss transaction rules to only apply to transactions for which there is a specific documentation requirement.

Predominant Character of a Transaction

The Final Regulations retained the rule set forth in the Proposed Regulations that the predominant character of a transaction will prevail in determining whether such transaction is governed under the FDDEI sales rules or the FDDEI services rules. Taxpayers suggested including an election based on generally accepted accounting principles (GAAP) that would permit taxpayers to elect whether a transaction was a sale or a service transaction. However, Treasury and IRS declined to adopt such a rule, citing, among other things, complexity and administrability issues.

FDDEI Sales

Presumptions Regarding Foreign Person Status and Foreign Use

The Proposed Regulations had required specific documentation to establish that a sale was made to a foreign person and was for a foreign use. In contrast, the Final Regulations generally provide presumptions that eliminate the need for taxpayers to collect specific documents from third-party purchasers. In particular, under the Final Regulations, foreign person status generally can be presumed if property is sold in a foreign retail sale, or based on a shipping address or a billing address. Additionally, foreign use generally can be presumed for sales to end users, while sales to other recipients are subject to substantiation requirements (which may be satisfied by statements prepared by the seller).

Sales for Further Manufacturing or Assembly

The Proposed Regulations provided that general property may be considered used outside the United States if: (1) there is a physical and material change to the property; or (2) the property is incorporated as a component into a second product. To satisfy the component test, the value of the property received by the recipient could not be more than 20% of the value of the property into which it was incorporated. In contrast, under the Final Regulations, general property may be considered used outside the United States if: (1) it is substantially transformed and is distinguishable from, and cannot be returned to, its original state; or (2) it is incorporated as a component into another product by way or activities that are substantial in nature and generally considered manufacturing, assembly or processing (not just packaging, or minor assembly). Additionally, the 20% requirement in the Proposed Regulations is merely a safe harbor in the Final Regulations.

Manufacturing Method or Process Intangibles

Under the Proposed Regulations, in contrast to the rule for general property, intangible property that is used in manufacturing is considered used where the manufactured product is used. In response to comments requesting that such intangible property be considered used where manufacturing occurs, the Final Regulations include a narrow rule that an unrelated purchaser of a manufacturing method or process intangible is treated as an end user of the intangible. The Final Regulations otherwise follow the approach of the Proposed Regulations.

Establishing Foreign Use of Intangible Property

The Final Regulations clarify the rules for determining the extent to which intangible property is treated as used outside the United States. With regard to intangible property transferred in exchange for periodic payments, foreign use is determined annually based on actual revenue in that year. Significantly, if there is a periodic payment in a year when the intangible property does not actually produce revenue, no portion of the intangible property is treated as having a foreign use in that year. In contrast, where intangible property is transferred in exchange for a lump sum, foreign use is determined based on projections of the net present value of income the seller would have earned from exploiting the intangible property outside the United States.

FDDEI Services

The Proposed Regulations divided FDDEI services into five mutually exclusive categories, each of which have their own rules for determining FDDEI eligibility. The Final Regulations retain the five categories, but make a number of changes, which include the following:

- Add two net subcategories of general services for “electronically supplied services” and “advertising services.” Electronically supplied services are general services that are delivered primarily over the internet or an electronic network, but exclude advertising services. Advertising services are general services that consist primarily of transmitting or displaying content (including via the internet) to consumers to generate revenue based on promotion of a product or a service. Each subcategory provides special rules for determining where a service is accessed, with varying rules for recipients that are consumers (individuals) or businesses. For example, for electronically supplied services to consumers, the Final Regulations provide that a customer is deemed to reside at the <u>location</u> of the <u>device</u> used to receive the service, which may be based on the location of an IP address, if available. And if the location of the device cannot be determined after reasonable efforts, the general rule based on billing address applies, subject to not knowing or having reason to know standard. For electronically supplied services to businesses, the Final Regulations provide that a business is deemed to reside where the service is accessed by the business recipient, which includes its employees, contractors or agents.

- Adopt a more flexible approach to documentation requirements for general services provided to consumers by not including a finite list of specific documentation. Further, if a provider does not have consumer's location of residence, the consumer is treated as residing outside the United States if the consumer has a foreign billing address, subject to a "knows or reason to know" standard.

- For determining location of a business recipient (other than those that receive advertising or electronically supplied services), taxpayers are allowed to make "reliable assumptions" based upon available information. Further, the Final Regulations remove the provision stating that if the renderer cannot obtain "reliable information" regarding which specific locations of a business are conferred a benefit, then the gross income is allocated ratably to all business locations. In line with more flexible documentation regime, the Final Regulations remove the Proposed Regulations' bright-line rule wherein "market research" would establish foreign use.

- Expand definition of a "property service" to include circumstances where services are provided with respect to tangible property that is "temporarily" located in the United States, but requires several conditions to be satisfied.

Related-Party Transactions

The Final Regulations make several changes to the Proposed Regulations' rules for determining the circumstances in which the sale of property by a domestic corporation to a foreign related party (related-party sales) could constitute FDDEI sales.

Most prominently, in situations where a foreign related party purchases property in a related-party sale and then sells the property to an unrelated party in a FDDEI transaction (unrelated sale), the Proposed Regulations provided that the domestic corporation could not treat the related-party sale as a FDDEI sale until the unrelated sale occurred. In particular, if the unrelated sale did not occur until after the FDII filing date with respect to the related-party sale, then the domestic corporation would have to file an amended return to claim any additional FDII benefit resulting from treating the related-party sale as a FDDEI sale.

Recognizing the administrative burdens (and possible statute of limitations issues) associated with filing amended returns, the Final Regulations remove the "amended return requirement" and provide that the domestic corporation can treat a related-party sale as a FDDEI sale if it can substantiate that an unrelated sale "will occur" with respect to the property sold in the related-party sale. The Final Regulations provide examples of information that can provide substantiation, such as contractual terms that restrict the foreign related party to sell the property to foreign unrelated parties.

In situations where a foreign related party purchases property in a related-party sale and then uses the property to produce other property sold to unrelated parties or to provide services to unrelated parties in FDDEI transactions (unrelated transactions), the Proposed Regulations provided that the related-party sale could be treated as a FDDEI sale only if more than 80% of the foreign related party's revenue with respect to the property purchased will be earned from unrelated transactions.

Recognizing the potential for a cliff effect, the Final Regulations remove the 80% threshold and provide that such a related-party sale can be treated as a FDDEI sale to the extent that the domestic corporation "reasonably expects" the revenue with respect to the property purchased to be earned from unrelated transactions.

The Final Regulations also expand Treas. Reg. § 1.250(b)-6(c)(3) to provide that a related-party sale can generally be treated as a FDDEI sale despite the presence of a US intermediary in the later supply chain. Under the Proposed Regulations, such sales could be treated as FDDEI sales only if the later supply chain consisted exclusively of foreign entities.

Electing Section 962 Shareholders

The Final Regulations retain the rule in the Proposed Regulations that allows section 962-electing taxpayers to take into account the section 250 deduction for GILTI. The Preamble notes uncertainty regarding situations in which individuals may make a section 962 election on an amended return, and states that the Treasury and IRS are considering issuing further guidance under section 962. Further, the Preamble provides that until further guidance is published on this issue, individuals are permitted to make a section 962 election on an amended return for the 2018 tax year and subsequent years, provided the interests of the government are not prejudiced by the delay and the Preamble provides further explanation in this regard.

Non-corporate US taxpayers with controlled foreign corporation (CFC) structures should examine their US federal income tax reporting to determine if a section 962 election might benefit them in prior years 2018 or 2019, or thereafter. For example, to the extent a non-corporate US taxpayer has recently discovered that the repeal of section 958(b)(4) has caused CFC implications to a closely held structure, a section 962 election might be a favorable solution to minimizing the adverse tax consequences of CFC status. For more information on the repeal of section 958(b)(4), click here.

National Law Review, Volume X, Number 206