KPMG report: Analysis of final FDII regulations – Tax reform

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The U.S. Treasury Department and the Internal Revenue Service ("IRS") (collectively "Treasury"), on July 9, 2020, released final regulations (T.D. 9901) (the "final regulations") that finalize the proposed regulations issued on March 4, 2019 (REG-104464-18) (the "proposed regulations") related to the deduction for foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI") under section 250.

Read the text of the **final regulations** [PDF 591 KB] (76 pages) as published in the Federal Register.

For a more detailed discussion of the 2019 proposed regulations, read ***TaxNewsFlash***

This report provides a detailed discussion of and observations about the final regulations. For an initial discussion of and observations about the final regulations, read ***TaxNewsFlash***

Contents

Applicability dates and reliance 2
Substantiation requirements 3
Change to the general approach 3
Modification of reliability standards 4
Change to the loss transaction rule 5
Changes to the special rules for small transactions and small businesses 5
Operating rules: FDDEI services 6
Categories of services 6
General services provided to consumers 7
In general 7
Electronically supplied services 7
General services provided to business recipients 7
In general 7
Identification of business recipient's benefited "operations" 8
Advertising services 8
Electronically supplied services 9
Related-party services 9
Substantiation rules for general services to business recipients 11
Other services 12
Transportation services 12
Property services 12
Proximate services 12
Operating rules: FDDEI sales 12
Foreign person requirement 13
Foreign use requirement for sales of general property 13
Sales of property to end users 14
Sales of property for resale 15
Sales of digital content 15
Sales of international transportation property 16
Sales for manufacturing, assembly, or other processing outside the United States 16
Related-party sales 18
Commodities 19
Hedging transactions 19
Foreign use requirement for sales of intangible property ("IP") 19
IP embedded in general property or used in connection with the sale of general property 20
IP used in providing a service 20

IP used in manufacturing 20
IP used in research and development 20
Form of payment rules for determining revenue 21
Substantiating foreign use of IP 22
Other rules related to FDDEI transactions 22
Predominant character rule 22
Foreign military sales and services 23
Computational rules 24
Definition of foreign branch income and sales of transparent entities 24
COGS and expense allocation 24
Certain deductions and limitations are not taken into account in determining FDDEI and DEI 25
Exclusive apportionment for R&E allocation and apportionment 25
Qualified business asset investment ("QBAI") 26
Taxable income limitation 27
Elimination of ordering rule for sections 163(j), 172, and 250 27
Pre-TCJA NOLs reduce taxable income 28
Section 962 28
Consolidated returns 29

Applicability dates and reliance

The proposed regulations were generally proposed to apply to tax years ending on or after March 4, 2019. However, for tax years beginning on or before March 4, 2019, the proposed regulations allowed taxpayers to use any reasonable documentation maintained in the ordinary course of business to establish that certain substantive requirements are met (the "transition rule"), in lieu of the strict documentation requirements in the proposed regulations. The transition rule also specifically allowed taxpayers to use the simplified documentation specified in the small business and small transaction exceptions (i.e., billing address and shipping address), regardless of whether the requirements for applying those exceptions were met. Notably, the proposed regulations permitted taxpayers to rely on the regulations for tax years ending before March 4, 2019, without any explicit requirement to consistently apply all of the proposed regulations.

The final regulations make important changes to these applicability dates. Generally, the final regulations apply prospectively for tax years beginning on or after January 1, 2021, rather than to tax years ending after March 4, 2019, as initially proposed. For tax years beginning before January 1, 2021 ("pre-2021 tax years"), the final regulations permit taxpayers to rely on the regulations, provided they apply the regulations in their entirety, other than the specific substantiation rules, described in detail below. Alternatively, the preamble to the final regulations provides that taxpayers may choose to apply the proposed regulations for pre-2021 tax years, provided they apply the proposed regulations in their entirety. Significantly, taxpayers that choose to apply the proposed regulations may apply the transition rule for all pre-2021 tax years, rather than only for tax years beginning on or before March 4, 2019.

KPMG observation

Taxpayers may choose to apply the statute, the proposed regulations, or the final regulations to pre-2021 tax years. There is a question, however, about the scope of the consistency requirement for reliance on the final regulations. Specifically, the requirement to apply them "in their entirety"

could be interpreted to require taxpayers that adopt the final regulations for any pre-2021 tax year to also apply the final regulations to all pre-2021 tax years, including tax years that precede such year. However, public comments by government officials indicate that the drafters only intended that, if a taxpayer chooses to adopt the final regulations for any pre-2021 tax year, the taxpayer must then apply the regulations consistently for that tax year and each subsequent tax year. The preamble to the proposed foreign tax credit regulations (REG-105495-19) issued on December 2, 2019, contained similarly ambiguous language, providing that taxpayers could rely on Prop. Reg. § 1.861-17 for tax years beginning after December 31, 2017, and before January 1, 2020, "if they apply it consistently." A subsequent technical correction (85 Fed. Reg. 29368) amended this language to eliminate the implication that taxpayers had to amend any return to accomplish consistency, adding "with respect to such taxable year and any subsequent taxable year." Perhaps a similar technical correction will clarify the scope of the consistency language in the preamble and final regulations.

Substantiation requirements

Change to the general approach

The final regulations make significant modifications to the rules related to the documentation requirements in the proposed regulations. The general themes are discussed immediately below, but some of the more detailed provisions are discussed in the context of the relevant substantive provisions.
The proposed regulations provided that, in general, the satisfaction of each required element of a FDDEI transaction—e.g., that the sale of property was to a foreign person for foreign use or that a general service was provided to a person located outside the United States—had to be properly documented for the sale or service to qualify as a FDDEI transaction (the "documentation rules"). The documentation rules of the proposed regulations generally prescribed not only the information to be documented, but also the form of such documentation (e.g., a written statement from the recipient representing that it is a foreign person or a bill of lading).

The final regulations replace the documentation requirements with "substantiation requirements." The final regulations provide specific substantiation requirements for (1) sales of general property for resale, (2) sales of general property for further manufacturing outside the United States, (3) sales of intangible property ("IP"), and (4) general services provided to business recipients. According to the preamble, the specific substantiation requirements are modeled after the substantiation requirements under section 170 (requiring substantiation for certain charitable deductions) and section 274(d) (requiring substantiation for certain travel, gift, and entertainment expenses).

The final regulations do not provide specific substantiation rules for establishing (1) foreign person status, (2) foreign use with respect to sales of certain general property directly to end users, (3) foreign use with respect to sales of digital content or international transportation property, (4) the location of a recipient of general services provided to consumers, (5) the location of a recipient of, or property associated with, a transportation service, proximate service, or property service, and (6) whether a foreign military sale or service qualifies as a FDDEI sale or a FDDEI service. However, the preamble explains that a taxpayer is generally required under section 6001 and Reg. § 1.6001-1(a) to substantiate that it is entitled to the section 250 deduction. Therefore, taxpayers must be able to substantiate each requirement for the FDII

deduction, regardless of whether specific substantiation requirements are prescribed in the final regulations.

KPMG observation

According to the preamble to the final regulations, the substantiation requirements shift the focus to the type of information needed rather than the form of that information in order to offer taxpayers more flexibility in collecting corroborating evidence. In some cases, the substantiation requirements will be less burdensome and more flexible than the proposed documentation requirements, particularly with respect to certain sales of general property, as discussed below. In other contexts, however, the specific substantiation requirements still limit the form of substantiation. In fact, as discussed below, the final regulations remove certain rules of convenience that were available for particular fact patterns under the proposed regulations.

That the specific substantiation requirements are modeled after sections 170 and 274(d) is significant because those requirements are exceptions to the "Cohan rule" set forth in *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). When applicable, the Cohan rule allows a court to estimate the amount of a deduction if the taxpayer can prove that it incurred a deductible expense, but not the amount of the expense. Public comments by government officials indicate that the specific substantiation requirements described in the final regulations are intended to give the IRS the authority to require strict compliance with the specific substantiation requirements. Accordingly, the IRS may exclude from FDDEI amounts that are not substantiated in the manner specified in the final regulations.

Modification of reliability standards

The final regulations also modify the proposed regulations' requirements for documentation to be considered reliable. In order to be considered reliable, the proposed regulations required a seller or renderer to obtain the documentation (1) by the FDII filing date with respect to the FDDEI transaction and (2) no earlier than one year before the date of the sale or service. Under the final regulations, when specific substantiation requirements apply, the substantiating documents must be in *existence* as of the FDII filing date. The specific substantiation rules also require the substantiation to be provided to the IRS within 30 days of a request (or another period agreed upon by the IRS and the taxpayer). The final regulations eliminate the proposed requirement that the documents must be obtained no earlier than one year before the transaction (the "stale documentation rule").

KPMG observation

The elimination of the stale documentation rule is welcome relief for taxpayers that operate under long-term sales contracts. Further, the requirement that substantiating documents be in existence, rather than obtained, by the FDII filing date may give taxpayers additional flexibility in obtaining substantiation after the filing date. However, the preamble notes that Treasury generally views substantiating documents created contemporaneously with the transaction as more credible than documents created significantly earlier or later in time.

Change to the loss transaction rule

The preamble to the proposed regulations noted that section 250(b) contemplates an aggregate approach to determining FDII, rather than a transaction-by-transaction approach. As a result, the proposed regulations included a special rule intended to prevent taxpayers from intentionally failing the proposed documentation rules for loss transactions in order to increase their FDII. Under the proposed loss transaction rule, if a seller or renderer of a service 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 seller or service renderer does not satisfy the documentation requirements, the sale or service is still deemed a FDDEI sale or FDDEI service if treating the sale or service as a FDDEI transaction would reduce FDDEI. In light of the narrowed scope of the specific substantiation requirements, the final regulations correspondingly narrow the scope of the loss transaction rule so that the rule only applies to transactions subject to the specific substantiation requirements. However, the preamble to the final regulations reiterates the view that FDII is determined on an aggregate basis, not a transaction-by-transaction basis. The final regulations do not provide an answer to whether taxpayers can choose to forgo a section 250 deduction, because, according to the preamble, whether taxpayers are permitted to forgo a deduction is governed by general tax principles and beyond the scope of the regulations.

KPMG observation

Although the loss transaction rule applies only to transactions subject to the specific substantiation requirements of the final regulations, the preamble indicates that Treasury does not believe taxpayers can choose to exclude other loss transactions that are not subject to the loss transaction rule, notwithstanding that section 250(b)(4) provides that a transaction gives rise to FDDEI only if a taxpayer "establishes" its qualification for such treatment.

Changes to the special rules for small transactions and small businesses

The proposed regulations provided relaxed documentation rules for small businesses (businesses with less than $10 million of gross receipts in the previous tax year) and small transactions (seller receives less than $5,000 in gross receipts during the tax year from the recipient). Taxpayers that qualified for these special rules could establish that a sale of general property was to a foreign person for a foreign use with a foreign shipping address for the recipient, or that a general service was provided to a consumer or business recipient located outside the United States with a foreign billing address for the consumer or business recipient.

The final regulations similarly include a small business exception, providing that the specific substantiation requirements do not apply to any FDDEI transaction if the taxpayer and all related parties, in the aggregate, receive less than $25 million in gross receipts during the preceding tax year. Thus, the final regulations increase the threshold for the small business exception but require that the determination of whether a taxpayer is under this threshold be based on the gross receipts of the taxpayer *and its related parties*. However, unlike the proposed regulations, the final regulations do not specify how small businesses can substantiate that a transaction is a FDDEI transaction. Instead, small businesses are required to follow the general substantiation rules under section 6001. As an example, the preamble suggests that a small business may substantiate that a sale of general property is for a foreign use by "having a foreign shipping address and memorializing conversations with the recipients explaining where the property will be resold, if sufficiently reliable, or having a copy of an export bill of

lading."

While the final regulations eliminate the proposed special rules for small transactions, the final regulations do contain modifications (discussed below) to the rules for transfers of digital content and electronically supplied services if the seller's gross receipts from the recipient are less than $50,000.

KPMG observation

The changes to the small business exception eliminate some of the certainty regarding the sufficiency of documentation for small businesses. As with the general replacement of the documentation requirements with substantiation, this change may provide more flexibility, but whether the change is favorable to a taxpayer will depend on the taxpayer's particular circumstances.

Operating rules: FDDEI services

Categories of services

Section 250(b)(4)(B) provides that FDDEI includes DEI derived in connection with services provided by a domestic corporation to any person, or with respect to property, not located in the United States. The proposed regulations divided services into five mutually exclusive categories, each of which have their own rules for determining whether they are services that give rise to FDDEI (i.e., FDDEI services): (i) transportation services, (ii) property services, (iii) proximate services, (iv) general services provided to consumers, and (v) general services provided to business recipients.

The final regulations retain this basic framework but add within the category of general services two new subcategories for advertising services and electronically supplied services. An "advertising service" is 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. An "electronically supplied service" is a general service, other than an advertising service, that is delivered primarily over the internet or an electronic network. 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 special rules for advertising services, which are provided solely to business recipients, and electronically supplied services, which can be provided to consumers or business recipients, are discussed below.

KPMG observation

Although the final regulations define electronically supplied services, the scope of that definition is ambiguous. Specifically, it is unclear whether the special rules for electronically supplied services are intended to apply only to services that by their nature can be provided only over the internet or an electronic network (such as maintaining a website), or whether the rules also apply to any service that is delivered over the internet or an electronic network (such as advice delivered via email). The example of a partial electronically supplied service in the regulatory text implies that the form of delivery of the service, rather than the nature of the service, is determinative.

General services provided to consumers

In general

"General services" are the residual category of services; a general service is any service other than a transportation service, property service, or proximate service. The final regulations retain the rule from the proposed regulations that a general service provided to a consumer is a FDDEI service if the consumer resides outside the United States. However, the final regulations make several changes to the rules for determining whether a general service is provided to a consumer that resides outside the United States.

First, the proposed regulations required documentation to establish the consumer's place of residence. In contrast, the final regulations do not impose any specific requirements for general services provided to consumers. In addition, in the case of general services other than electronically supplied services, the final regulations helpfully allow renderers that do not have, or cannot reasonably obtain, 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. In this regard, the final regulations provide new guidance on the "reason to know" standard, explaining that a renderer has "reason to know" that a consumer resides in the United States "if the information received as part of the provision of the service indicates that the consumer resides in the United States and the renderer fails to obtain evidence establishing that the consumer resides outside the United States."

Electronically supplied services

As noted above, the final regulations introduce electronically supplied services as a new subcategory of general services. In the case of a consumer of an electronically supplied service, the consumer is deemed to reside at the location of the device that is used to receive the service. If the renderer cannot after reasonable efforts obtain the consumer's device location, the device used to receive the service is treated as located outside the United States if the consumer has a foreign billing address, unless the renderer has "reason to know" that the consumer resides in the United States.

General services provided to business recipients

In general

Under the proposed regulations, a service was provided to a business recipient located outside the

United States to the extent the gross income derived by the renderer from the service was allocated to the business recipient's foreign operations. This allocation was based on the extent to which each of the business recipient's operations benefited from the service. The proposed regulations treated a business recipient as having operations in any location where it maintained an office or other fixed place of business, and treated a business recipient as including all related parties of the recipient.

The final regulations generally retain this basic approach, with several important revisions. Notably, except for a simplifying convention that applies to electronically supplied services in the circumstances described below, the final regulations do not include any relaxed small transaction rules for general services provided to business recipients. The final regulations do at least provide that, for purposes of determining the location of a business recipient, a renderer may make reliable assumptions based on the information available to it.

Identification of business recipient's benefited "operations"

The final regulations continue to provide that a general service is provided to a business recipient located outside the United States to the extent the service confers a benefit on the business recipient's foreign operations. The final regulations make several changes to the determination of the location of a business recipient's operations that benefit from a service. First, the final regulations provide a more precise definition of "office or other fixed place of business" as "a fixed facility, that is, a place, site, structure, or other similar facility, through which the business recipient engages in a trade or business." Although the definition of "office or other fixed place of business" in the final regulations is similar to a "fixed place of business" in Reg. § 1.864-7, the preamble explains that the final regulations do not incorporate the meaning in the section 864 regulations because section 864(c) applies on a taxpayer-by-taxpayer basis, whereas the final regulations define a business recipient to include all related parties of the recipient.

Finally, the preamble discusses a comment requesting guidance on how to determine the location of a business recipient that does not have an office or fixed place of business, such as a partnership that that does not itself have any offices or employees but is managed by one or more of its partners. In response to the comment, the final regulations provide that, "if the business recipient does not have an identifiable office or fixed place of business (including the office of a principal manager or managing owner)," the business recipient is deemed to be located at its primary billing address.

KPMG observation

The parenthetical in the final rule regarding business recipients with no office or fixed place of business strongly suggests that an entity that otherwise has no office or fixed place of business will be imputed the office of a principal manager or managing owner. That paradigm is likely to be particularly relevant in the investment fund context, given that the fund itself may not have its own office or fixed place of business, with the result that the fixed place of business of its manager would control.

Advertising services

As noted above, the final regulations introduce advertising services as a new subcategory of general services. The operations of a business recipient that benefit from an advertising service are deemed to be located where the advertisements are viewed 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. For this purpose, the IP address may be used to establish the location of a

device on which an advertisement is viewed, though the regulations do not mandate this approach to determine device location. The preamble to the final regulations provides that Treasury determined that where an advertisement is viewed serves as a "reliable proxy" for the locations of the business recipient that benefit from the service.

Electronically supplied services

The operations of a business recipient that benefit from an electronically supplied service are deemed to be located where the business recipient (including employees, contractors, or agents) accesses the service, even if the business recipient does not maintain an office or other fixed place of business in that location. If those locations cannot be determined, and the gross receipts from all services with respect to that recipient total less than $50,000 for the renderer's tax year, the billing address is deemed to be the location that benefits; otherwise, the benefitted locations are deemed to be in the United States.

KPMG observation

The operative rule in the final regulations says that a business recipient is deemed located where the electronically supplied service is accessed by a business recipient. This rule does not explicitly refer to a business recipient's customers when describing how to determine the benefitted locations of the business recipient. However, the final regulations provide an example in which the locations where the business recipient's customers access the service appears determinative of the recipient's benefitted locations. In the example, a domestic corporation maintains a website for a business recipient that only has U.S. offices but that sells goods through the website to customers within and outside the United States. Based on IP addresses of the devices that accessed the website, 30% of the devices were located outside the United States. While not entirely clear, the title of the example ("Electronically supplied services that are accessed by the business recipient's customers") indicates that the devices that access the website are the customers of the business recipient, rather than its employees or agents. The example concludes that 30% of the website maintenance service is treated as a FDDEI service.

The example therefore appears to apply the electronic services rule by treating the location of the business recipient's customers (rather than the business recipient) as the location where the business recipient accesses the service, even though the final regulations do not contain specific language providing such a rule. The substantive rules of the final regulations do make clear, however, that a business recipient may be treated as accessing a service even from locations where the business recipient does not have an office or fixed place of business. The example therefore suggests that if a taxpayer has information regarding where a business recipient's customer accesses the service (e.g., because of the nature of the service provided by the taxpayer), the location where the business recipient's customer accesses the service may be the best indicator of the location benefiting from the service.

Related-party services

Section 250 provides that a service provided to a related party (a "related-party service") is not a FDDEI service if the related party performs substantially similar services for persons located in the United States. The proposed regulations restricted the application of this rule so that it applies only to general services provided to a related business recipient and narrowly interpreted the scope of "substantially similar" services.

As a threshold matter, the proposed regulations applied the related-party rule only to services that are

"used" by the related party in the provision of services to persons located in the United States. Thus, the proposed regulations replaced the subjective determination of whether any service is "substantially similar" to a service provided by the related party to a person located in the United States with an inquiry into whether the particular service is "used" by the related party in providing services to a person located in the United States.

Further, the proposed rule treated a service provided to a related party (the "first service" or "related party service") as substantially similar to a service proved by the related party (the "second service") only if the related party used the first service to provide the second service and either (i) at least 60% of the benefit of the second service is provided to persons located in the United States ("benefit test"); or (ii) at least 60% of the price paid for the second service is attributable to the first service ("price test"). If the service is substantially similar by reason of the benefit test, the full amount of the related-party service income was disqualified from FDDEI. If the service is substantially similar solely by reason of the price test, only the portion of the related-party service income that corresponded to the portion of the second service that benefitted persons located in the United States (under the benefit test) was disqualified from FDDEI services. Both tests are further described below.

The final regulations retain the proposed related-party service rules with the following modifications. First, to conform the timing of the related-party service rules and the related-party sales rules (discussed below), the final regulations clarify that a related-party service is a FDDEI service only if the related-party service is not substantially similar to a second service that "has been or will be" provided by the related party to a person located in the United States. Second, the final regulations provide that, in applying the benefit test, only the benefits from a related-party service that the related party "directly uses" to confer benefits on persons in the United States are considered. According to the preamble, this change clarifies that a first service that only indirectly benefits the customers of a second service will not be taken into account (i.e., when the benefits to such customers are "indirect and remote" within the meaning of Reg. § 1.482-9(l)(3)), such that the customers would not be willing to pay for the first service.

The benefit test

The final regulations provide additional guidance on how to apply the benefit test. Under the benefit test, the first step is to determine whether the related party directly uses the first service to provide a second service. If so, the second step is to determine the portion of the benefits from the first service that are conferred through the second service on recipients located in the United States. The final regulations clarify that, for this purpose, the benefits provided in the first service are allocated to the recipients of the second service based on the proportion of benefits provided to recipients of the second service located in the United States. For example, if the first service confers a benefit on the related party that the related party directly uses to provide the second service, and 60% or more of the recipients of the second service are located in the United States, the first service will not be a FDDEI service due to the cliff effect that applies when the benefit test is failed. The final regulations clarify that the location of the recipients of the second service is determined under the general rules applicable to FDDEI services.

The price test

The final regulations also provide additional guidance on how to apply the price test. If the second service confers benefits on persons located in and outside the United States, a new rule explains how to determine the portion of the total amount that persons in the United States paid for the second service that is attributable to the first service. To make this determination, the first service is deemed to relate to services provided to persons located in the United States in the same proportion that the second service provides benefits to persons located in the United States. For example, if half of the total amounts paid ("aggregate price") for the second service is paid by persons located in the United States, the transaction is not substantially similar under the benefit test because only half (less than 60%) of the benefit of the

second service is conferred on persons located in the United States. The price test will then compare half of the price of the first service to half of the aggregate price of the second service. If half of the price of the first service is 60% or more of half of the aggregate price of the second service, then the second service is substantially similar to the first service by reason of the price test. However, under the price test there is no cliff effect, so that only half of the price paid for the first service (the amount corresponding to the portion of the second service that benefits persons located in the United States) would be excluded from gross FDDEI.

KPMG observation

As under the statute and proposed regulations, the final related-party service rules only apply when a related recipient uses the services to itself provide services. Thus, the related-party service rules do not apply if the related-party service directly benefits a related recipient's business of selling goods into the United States.

It is also noteworthy that the related-party service rules apply separately to each related-party service transaction. Properly delineating separate related-party service transactions may be particularly important for certain fact patterns because the final regulations apply the benefit and price tests by deeming the portion of the benefits of the first service that are conferred through the second service on persons located in the United States, and the price paid with respect to that portion, on a pro rata basis by reference to the price and benefit allocations for the second service. Proper delineation of separate related-party transactions may be challenging for some taxpayers whose transfer pricing process results in a single net payment for a wide-ranging bundle of services.

Substantiation rules for general services to business recipients

The final regulations eliminate the rule in the proposed regulations that allowed taxpayers that did not have reliable information regarding the specific locations of a business recipient that benefitted from a general service to ratably allocate the "benefit" of the service to all of the recipient's locations. According to the preamble, this change was made because Treasury determined that "it would be inappropriate to allow a deduction that is not based on reliable information."

Furthermore, the rules for substantiating FDDEI from general services provided to business recipients no longer explicitly allow the use of publicly available information such as financial statements. In addition, in the context of sales of a fungible mass of general property, the preamble indicates that Treasury views market research or information obtained from public data as generally unreliable for purposes of substantiation, whereas the proposed regulations specifically contemplated the use of such information in documenting foreign use for a fungible mass.

KPMG observation

The elimination of the ratable allocation rule and the explicit ability to use publicly available information, in connection with the retention of the rule that treats a business recipient as including all related parties, may make it difficult for certain taxpayers that provide general services to multinational corporations to substantiate the services as FDDEI services, in the absence of representations provided by the customer. However, the generally less prescriptive approach of the final regulations with respect to substantiation, as well as the rules related to advertising services and electronically supplied services, may make substantiation easier for some other

taxpayers.

Other services

Transportation services

The final regulations retain the approach in the proposed regulations that the qualification of a transportation service is based on the origin and destination of the transportation service, with a 50/50 split between domestic and foreign when either the origin or the destination (but not both) are outside the United States. In addition, the final regulations clarify that freight forwarding and similar services are included within the definition of "transportation service." The final regulations do not define "freight forwarding" for this purpose.

Property services

Under the proposed regulations, the location of a property service was determined based on the location of the tangible property while the service is provided. The final regulations make two changes to the rules for property services. First, the final regulations allow property services with respect to property temporarily in the United States to qualify as FDDEI services if: (i) the property is temporarily in the United States for the purpose of receiving the property service; (ii) the property will be primarily hangared, stored, or used outside the United States; (iii) the property is not used to generate revenue in the United States during the duration of the service; and (iv) a foreign person that resides or primarily operates outside the United States owns the property. In addition, the final regulations clarify that manufacturing services are property services. The combination of these two changes clarifies when manufacturing services performed in the United States are eligible to be FDDEI services.

Proximate services

Under the proposed regulations, a service performed for a business recipient was a proximate service only if substantially all of the service was performed in the physical presence of the business recipient's employees. The final regulations expand this definition to also include persons working for the business recipient, such as its contractors or agents.

Operating rules: FDDEI sales

Section 250(b)(4)(A) provides that FDDEI includes DEI derived in connection with property sold to any foreign person (the "foreign person requirement"), and which the taxpayer establishes to the satisfaction of the Secretary is for a foreign use (the "foreign use requirement"). Section 250(b)(5)(E) provides that, for purposes of FDII, the term "sale" includes any lease, license, exchange, or other disposition. Section 250(b)(5)(A) defines "foreign use" as "any use, consumption, or disposition which is not within the United States."

Both the proposed and final regulations subdivide sales of property into sales of general property (including international transportation property) and IP. In addition, the final regulations clarify that

transfers of copyrighted articles that are delivered electronically rather than on a physical medium ("digital content") are characterized as general property rather than IP, and provide special rules, discussed below, for such sales.

Foreign person requirement

The proposed regulations provided a single standard for determining and documenting whether sales of general property or IP are to a foreign person. Under the proposed regulations, a recipient was treated as a foreign person only if the seller obtained documentation evidencing the recipient's status as a foreign person and did not know or have reason to know that the recipient was not a foreign person. The final regulations retain the general requirement that a sale of general property or IP must be to a foreign person, and that for this purpose a domestic partnership, including a domestic partnership owned solely by foreign persons, is not a foreign person. However, the final regulations eliminate the specific documentation requirements with respect to the foreign person requirement. In addition, the final regulations generally allow taxpayers to presume that a sale is to a foreign person if the sale is described in one of four categories: (1) sales made in foreign retail stores, (2) sales of general property that are delivered to a foreign shipping address, (3) in the case of sales of general property not described in the preceding two categories (for example, sales of digital content), sales with a foreign billing address, and (4) in the case of sales of IP, sales with a foreign billing address. Like the proposed rule, this presumption is subject to a "reason to know" standard. The final regulations clarify that a seller has "reason to know" that a person is not foreign only if information collected *as part of the sales process* contains indicia that the person is not a foreign person and the seller does not obtain evidence that the recipient is in fact a foreign person.

KPMG observation

Although the specific substantiation rules, including the requirement that substantiating documents must exist by the FDII filing date, do not apply with respect to the foreign person requirement, apart from foreign retail sales the foreign person presumption applies only if taxpayers have a shipping address (in the case of general property physically delivered) or a billing address (in the case of other general property, such as digital content). Therefore, in practice, satisfying the foreign person requirement generally will require substantiating the shipping or billing address of the recipient.

Foreign use requirement for sales of general property

The final regulations depart substantially from the proposed rules for determining whether a sale of general property satisfies the foreign use requirement.

Under the proposed regulations, a sale of general property (other than international transportation property) was for a foreign use if the property was not subject to a domestic use within three years of the date of delivery or if the property was subject to manufacture, assembly, or other processing outside the United States before the property was subject to a domestic use. General property was subject to domestic use if the property was subject to any use, consumption, or disposition within the United States, or the property was subject to manufacture, assembly, or other processing within the United States.

In contrast, the final regulations provide different rules for determining whether a sale of general property

is for foreign use depending on which of the following six categories describe the sale: (1) sales delivered to an end user by a carrier or freight forwarder, (2) sales to an end user without the use of a carrier or freight forwarder, (3) sales for resale, (4) sales of digital content, (5) sales of international transportation property used for compensation or hire, and (6) sales of international transportation property not used for compensation or hire. While the precise method of satisfying "foreign use" is different for each category of general property sales, except with respect to certain sales of international transportation property, the foreign use requirement with respect to a sale of general property generally is satisfied if there is a sale (by direct delivery, through resale, at a foreign retail store, or digitally) to an end user located outside the United States. An "end user" is defined generally as either the person that ultimately uses or consumes property or a person that acquires property in a foreign retail sale. A person that acquires property for resale or otherwise acquires property as an intermediary is not an end user.

In a further departure from the proposed regulations, the final regulations do not require that the seller not know, or have reason to know, that there will be a domestic use within three years of delivery of the property. This change in the final regulations allows for the possibility of some domestic use after a sale to an end user and eliminates the implication that the use of the property must be tracked for a particular period of time after the sale.

Under the final regulations, a sale of general property for manufacture, assembly, or other processing outside the United States is excepted from the requirement that there ultimately be a sale to an end user outside the United States (the "manufacturing exception"). This exception, which also was included in the proposed regulations is retained and expanded in the final regulations.

The final regulations do not provide any specific substantiation requirements with respect to sales of general property, except with respect to sales for resale and sales for manufacturing, assembly, or other processing outside the United States, as discussed in more detail below.

Sales of property to end users

The final regulations provide that a sale of property that is delivered through a carrier or freight forwarder to an end user outside the United States is for a foreign use. This rule does not apply if the sale is made with a "principal purpose" of having the property transported from outside the United States to the United States for ultimate use or consumption. The final rules also provide that a sale of property that is not delivered to an end user (such as property sold in a foreign retail sale) is for a foreign use if the property is located outside the United States at the time of the sale. A "foreign retail store" is defined as a sale of general property to a recipient that acquires the general property at a physical retail location (such as a store or warehouse) outside the United States. The final regulations do not prescribe any particular form of documentation to substantiate that a sale to an end user is for a foreign use.

KPMG observation

Under the final regulations, a sale of general property to an end user outside the United States is not merely evidence of foreign use, it is foreign use. Therefore, even if the seller knows, or has reason to know, that the property delivered to an end user outside the United States will be used or consumed in the United States, the sale is for foreign use unless the sale is made with a bad "principal purpose." The preamble to the final regulations explains that such a principal purpose exists when a seller and buyer "arrange" to have the property delivered outside the United States "only to be redelivered for use or consumption into the United States with a principal purpose of causing what would otherwise not be a FDDEI sale to be treated as a FDDEI sale." However, even this limited principal purpose exception does not apply to a sale of property that is sold to an end

user without being delivered by a carrier.

Sales of property for resale

If general property is sold to a reseller rather than to an end user, the final regulations provide that the sale will be for a foreign use if the general property ultimately will be sold to an end user outside the United States. In the case of sales of a fungible mass of general property, the final regulations provide that a seller may presume that the proportion of its sales that are ultimately sold to end users outside the United States is the same as the proportion of the recipient's resales of that fungible mass to end users outside the United States. The final regulations eliminate the proposed rules providing that, if 90% or more of the sale of a fungible mass would be for a foreign use, then all of the sale would be treated as for a foreign use, and if less than 10% of the sale would be for a foreign use, then no part of the sale would be for a foreign use.

The final regulations provide specific substantiation requirements for sales of general property for resale. In the case of sales of general property to resellers, a taxpayer must maintain and provide credible evidence upon request that the general property ultimately will be sold to end users located outside the United States. This substantiation requirement is satisfied if the taxpayer maintains one or more of the following:

- A binding contract specifically limiting subsequent sales to outside the United States;
- Proof that the property is specifically designed, labeled, or adapted for a foreign market;
- Proof that the cost of shipping the property back to the United States relative to the value of the property makes it impractical to resell the property in the United States;
- Credible evidence obtained or created in the ordinary course of business from the recipient that the property (or, in the case of fungible mass property, a specified portion of the property) will be sold to an end user outside the United States; or
- A written statement prepared by the seller, corroborated by credible evidence, that contains specifically enumerated information.

Sales of digital content

As noted above, the final regulations clarify that copyrighted articles are characterized as general property for purposes of applying the rules. Further, the final regulations provide that a sale of general property that primarily contains digital content that is transferred electronically rather than in a physical medium is for foreign use if the end user downloads, installs, receives, or accesses the digital content outside the United States. If information regarding the location of access (for instance, IP address) is unavailable, and the gross receipts from all sales with respect to the end user (which may be a business) are in the aggregate less than $50,000, a sale of such property is for a foreign use if it is to an end user that has a billing address located outside the United States. For these purposes, digital content is defined as a computer program or any other content in digital format (e.g., books, movies, and music in digital format).

KPMG observation

Two examples in the proposed regulations treated the sale of a limited use license of software, which would be a copyrighted article under Prop. Reg. § 1.861-18, as a sale of IP for purposes of the FDII regulations. The final regulations modify these examples to make clear that such a sale will be treated as a sale of general property.

The final regulations do not otherwise provide guidance regarding the character of a transfer of digital content. The preamble states that general U.S. tax principles apply for this purpose, taking into account the regulations issued under section 861. The characterization of a transaction is important because the FDII rules differ in many respects depending on whether a transaction is a sale or license of IP, a sale or lease of general property, or a service. As a result, a taxpayer's FDII analysis may require a deeper dive into the character of a transaction involving digital content - *i.e.*, whether such transaction is a transfer of a copyrighted article (subject to the rules for sales of general property), a transfer of a copyright right (subject to the rules for sales of IP), or a service. In this regard, note that Prop. Reg. § 1.861-19(c)(3) provides that an arrangement comprising multiple transactions generally requires separate classification for each transaction. It is unclear when a particular contract or payment might relate to a single "transaction" that is characterized by its predominant character under the final regulations for purposes of FDII, as opposed to when it might relate to multiple transactions that must first be disaggregated under Prop. Reg. § 1.861-19.

Sales of international transportation property

The proposed regulations provided that sales of international transportation property are for a foreign use only if, during the three-year period from the date of delivery of the property, the property is located outside the United States more than 50% of the time and more than 50% of the miles traversed using the property are traversed outside the United States. The final regulations take a different approach, and distinguish between sales of international transportation property used for compensation or hire and other sales. Specifically, sales of international transportation property used for compensation or hire are for a foreign use if the end user registers the property with a foreign jurisdiction. Sales of international transportation property not for compensation or hire are for a foreign use if the end user registers the property in a foreign jurisdiction and hangars or stores the property primarily outside the United States.

Sales for manufacturing, assembly, or other processing outside the United States

The final regulations liberalize and clarify the proposed rule that property is sold for a foreign use if the property is "subject to manufacturing, assembly, or other processing outside the United States," regardless of whether the resulting property is subsequently sold within the United States. Under the final regulations, as in the proposed regulations, property sold to a foreign unrelated party satisfies the manufacturing exception if the property is either (1) subject to a physical and material change (the "physical and material change test") or (2) incorporated as a component into a second product (the "component test").

With respect to the physical and material change test, the final regulations clarify that property is subject to a physical and material change if it is substantially transformed and is distinguishable from, and cannot be readily returned to, its original state. The final regulations also provide a new substantive rule for the component test. Under this new rule, general property is a component incorporated into a second product if the incorporation of the general property into the second product involves activities that are substantial in nature and generally considered to constitute the manufacture, assembly, or other processing of property based on all the relevant facts and circumstances. Significantly, the final

regulations convert into a safe harbor the proposed rule that required the fair market value of the component when it is delivered to the recipient to constitute no more than 20% of the fair market value of the second product into which the component is incorporated.

The final regulations further liberalize this 20% safe harbor by providing that the comparison is between the fair market value of the component sold to the manufacturer and the fair market value of the finished goods sold to consumers (or a representative sample if the property is incorporated into multiple finished goods), rather than the second product (which could itself be an unfinished good), and by limiting the scope of the aggregation rule. Under the proposed aggregation rule, for purposes of the 20% determination, if a seller sold multiple components, the seller would have had to treat all components incorporated into a second product as a single component, even if the seller had no reason to know that such components would be incorporated into the second product. In contrast, the final regulations require aggregation only if the seller knows or has reason to know that the components will be incorporated into a single item of property (e.g., where multiple components are sold as a kit). A seller knows or has reason to know that the components will be incorporated into a single item of property if the information received as part of the sales process indicates that the components will be included in the same second product or the nature of the components compels inclusion into the second product and the seller fails to obtain evidence to the contrary.

As previously noted, the final regulations require taxpayers to substantiate foreign use for sales of general property subject to manufacturing, assembly, or other processing outside the United States. This substantiation requirement is satisfied if the taxpayer maintains one or more of the following:

- Credible evidence that the property was sold to a foreign unrelated party that is a manufacturer and that the property typically cannot be sold to end users without being subject to manufacture, assembly, or other processing (for example, the sale of raw materials that cannot be used except in a manufacturing process);

- Credible information obtained from the recipient in the ordinary course of business that the property will be subject to manufacture, assembly, or other processing outside the United States; or

- A written statement prepared by the seller, corroborated by credible evidence, that contains specifically enumerated information.

As discussed above, the final regulations no longer define "foreign use" by reference to the lack of "domestic use." Therefore, to ensure that a sale of property for manufacturing within the United States does not qualify as a FDDEI sale, the final regulations include a new rule that provides that a sale of general property for manufacturing, assembly, or other processing in the United States is not for a foreign use even if the foreign use requirement would otherwise be satisfied. For this purpose, the term "manufacture, assembly, or other processing" has the same meaning as in the manufacturing exception.

KPMG observation

The change of the component test to a "facts and circumstances" determination (with a safe harbor) will be welcomed by taxpayers that sell valuable components to unrelated manufacturers. In particular, the standard for the component test – whether "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" – encompasses, for instance, the insertion of batteries into tablets (see Examples 1 and 2 of Reg. § 1.250(b)-4(d)(1)(v)(B)) and the incorporation of silicon chips into computers, tablets, smartphones, and

motherboards (see Example 9 of Reg. § 1.250(b)-4(d)(1)(v)(B)).

Significantly, the manufacturing exception, like the rule for a sale or license of manufacturing process IP discussed below, only applies to sales to unrelated foreign parties. However, unlike the rule for manufacturing process IP, there is no limitation in the manufacturing exception with respect to manufacturing outside the United States by unrelated foreign parties on behalf of the seller (for example, a contract manufacturing arrangement).

Related-party sales

Section 250(b)(5)(C) provides that a sale of property to a foreign related party is not treated as a sale for foreign use unless such property ultimately is sold by a related party, or used by a related party in connection with property that is sold, or the provision of services, to an unrelated foreign person (in either case, an "unrelated-party transaction"). The proposed regulations narrowed this rule by providing that sales or licenses of IP are not subject to the related-party sales rules, on the grounds that the exploitation standard applicable to IP transactions was sufficient to address the "round-tripping" concerns underlying the related-party rules. The final regulations retain the general approach of the proposed regulations with respect to related-party sales, including the non-application to IP, with the following changes.

Elimination of amended return requirement

Under the proposed regulations, if a taxpayer sold property to a foreign related party, and the related party resold the property to an unrelated party after the FDII filing date, the FDII deduction could be claimed for the year of the sale to the related party only in an amended return (provided the statute of limitations is open) (the "amended return requirement"). The final regulations eliminate the amended return requirement, permitting a FDII benefit to be claimed in the year of a related-party sale if an unrelated-party transaction "will occur" after the FDII filing date. The final regulations clarify that a taxpayer may establish that an unrelated-party transaction will occur with respect to the property, or the portion of property that will be sold in an unrelated-party transaction in the case of sale of a fungible mass of general property, based on contractual terms, past practices, a showing that the product sold is designed specifically for a foreign market, or books and records otherwise evidencing that sales will be made to foreign unrelated parties.

Sales of property for use in an unrelated-party transaction

The proposed regulations provided that for a sale of property to be used by the related party rather than resold, no part of the sale qualified as a FDDEI sale unless the seller reasonably expected more than 80% of the revenue earned by the foreign related party from using the property would be earned from unrelated-party transactions that are FDDEI transactions. If that threshold was met, all of the initial sale would be treated as a FDDEI sale. The final regulations replace this rule with a rule that generally conforms to the rules for related-party sales of property for resale and requires proportionate treatment of the related-party sale corresponding to the portion of revenue reasonably expected to be earned by the foreign related party from unrelated-party FDDEI transactions.

Sales to related domestic intermediaries

The proposed regulations provide that, for purposes of determining whether a related-party sale is for a foreign use, all foreign related parties of the seller are treated as if they were a single foreign related party. The final regulations revise this rule to also include related U.S. persons (for this purpose, determined based on an 80% threshold, rather than 50%) as part of the single foreign related party.

KPMG observation

As a result of this modification to include related U.S. persons as part of the single foreign related party, intermediate sales to U.S. related parties will not disqualify the first sale from being a FDDEI sale. However, this treatment is only relevant for the foreign use requirement; it does not modify the general requirement that the initial sale must be to a foreign person (related or otherwise).

Commodities

The final regulations clarify that a sale of a physical commodity in satisfaction of a forward contract is not excluded from the definition of "general property" (and therefore eligible to be treated as a FDDEI sale) unless the sale is pursuant to a section 1256 contract. However, to prevent cherry picking, the final rules provide that this rule applies to the sale of a commodity pursuant to a forward or option contract only to the extent that the seller physically settles the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances.

Hedging transactions

The proposed regulations did not directly address hedging transactions. In response to comments, the final regulations provide that the amount of gross FDDEI derived from FDDEI sales of general property is increased by any gain, or decreased by any loss, taken into account with respect to certain hedging transactions related to sales of the underlying general property. This rule applies only if (i) the hedging transaction meets the requirements of Reg. § 1.1221-2; (ii) the transaction hedges price risk or currency fluctuation with respect to ordinary property (as defined in Reg. § 1.1221-2(b)(1)); and (iii) the property being hedged is general property sold in a FDDEI sale. Notably, these rules do not extend to hedges of the cost of providing a service.

Foreign use requirement for sales of intangible property ("IP")

The proposed regulations provided that a sale (including a license) of IP is for a foreign use to the extent revenue is earned from exploiting the IP outside the United States. The proposed regulations further provided that, for 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 the end user. For purposes of these rules, a sale of IP included a deemed sale in exchange for deemed royalty payments under section 367(d).

The final regulations maintain the general approach of the proposed regulations that a sale of IP is for a foreign use only to the extent it is "exploited" outside the United States, but significantly modify the rules for when this standard is satisfied. The general rule for determining whether a sale of IP is for a foreign use is based on the portion of the revenue earned using the IP from end users located outside the United States. The determination of the location of the end users depends on 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. In addition, the final regulations require specific substantiation of foreign use for a sale of IP.

IP embedded in general property or used in connection with the sale of general property

With respect to IP that is embedded in general property or used in connection with a sale of general property, the final regulations provide that the end user is the end user of the general property. The final regulations further provide that revenue is earned from an end user of general property outside the United States to the extent the sale of the general property is for a foreign use under the rules applicable to sales of general property. Accordingly, a sale or license of IP will be for a foreign use to the same extent the sale of the general property in which the IP is embedded is for a foreign use.

IP used in providing a service

The proposed regulations did not directly address the use of IP in providing a service. The final regulations provide that a sale of IP that is used to provide a service is for a foreign use to the extent the provision of the service would qualify as a FDDEI service.

IP used in manufacturing

In response to comments requesting that the foreign manufacturing exception for FDDEI sales be extended to include sales of IP used in manufacturing, the final regulations provide that a sale of a "manufacturing method or process" for use in manufacturing outside the United States is for a foreign use. Specifically, if a manufacturing method or process is sold or licensed to a foreign unrelated party for use outside the United States, the foreign unrelated party is treated as an end user located outside the United States for purposes of the foreign use determination, even if the manufactured product ultimately is sold to persons in the United States ("process IP exception").

The process IP exception is subject to several important limitations. First, "a manufacturing method or process" is defined narrowly as a sequence of actions or steps that constitute 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. Therefore, the process IP exception would not apply to the sale or license of typical make-sell rights to a foreign unrelated party. Also, the exception does not apply to a sale or license of IP to a related person, or 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. Finally, 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.

IP used in research and development

The final regulations provide that, if IP ("primary IP") is sold for use in the development or modification of other IP ("secondary IP"), the end user is the end user of the secondary IP. The preamble to the final regulations further clarifies that if secondary IP qualifies as manufacturing method or process IP, the rules applicable to sales of manufacturing or process IP apply for purposes of determining whether the sale of the secondary IP is for a foreign use.

KPMG observation

Despite the similar statutory language defining "foreign use" for FDDEI sales ("'foreign use' means any use . . . which is not within the United States") and a foreign source royalty under section 862 ("royalties for the use of or for the privilege of using without the United States"), the preamble to the final regulations does not address the divergence in the final regulations between the FDDEI "foreign use" standard and the sourcing rules, in particular whether the new FDII rules

are a sign of things to come in the sourcing area. Public comments from Treasury officials indicate that the IP rules in the final regulations are only intended to apply for purposes of section 250, and that taxpayers should not read those rules as applying more broadly.

Form of payment rules for determining revenue

The proposed regulations provided special rules for establishing foreign use for IP sales that varied based on whether the sale was in exchange for periodic payments (e.g., a royalty) or a lump sum. The final regulations generally retain this approach, with certain modifications, for IP that does not qualify for the process IP exception.

Lump sum payments

For IP sold in exchange for a lump sum payment, the proposed regulations provided that the foreign use determination was based on the ratio of the total net present value the seller reasonably would have expected to earn from exploiting the IP outside the United States to the total net present value the seller reasonably expected to earn from exploiting the IP worldwide (the "lump sum payment rule"). The final regulations clarify that when a recipient is a foreign unrelated party, net present values of revenue that the recipient (rather than the seller) expected to earn from exploiting the IP within or outside the United States may also be used if the seller obtained the revenue data from the recipient near the time of the sale and that data was used to negotiate the lump sum price.

Periodic payments

For IP sold in exchange for periodic payments, the proposed regulations based the foreign use determination on the actual revenue earned by the recipient, determined annually (the "periodic payment rule"). For purposes of satisfying the proposed documentation requirements for periodic payments that are not contingent on the revenue or profit of a foreign unrelated party, the proposed rules provided an exception that allowed a seller that could not obtain the unrelated party's actual revenue breakdown without undue burden to establish foreign use using the principles of the lump sum payment rule so long as the determination was made annually.

The final regulations modify this exception in two respects. First, the principles of the lump sum payment rule are used to estimate the portion of an IP *purchaser's* revenue from foreign exploitation, whereas the proposed rules required this estimate to be based on the revenue the seller would have expected to earn from foreign exploitation had it retained the IP. Second, taxpayers no longer must revisit the estimated allocation annually.

KPMG observation

The requirement in the proposed rules for a taxpayer that sold IP for noncontingent proceeds to project the revenue it would have expected to earn from foreign exploitation had it retained the IP did not make sense for taxpayers that are in the business of developing IP, such as custom software, for sale to customers. The final rules appear to fix this issue for sales for noncontingent periodic payments by allowing the estimation to be performed from the perspective of a recipient of the IP, but could be interpreted to continue to focus on the perspective of the seller for sales in exchange for a lump sum. Although the final rules allow taxpayers to use the recipient's revenue data if that data was used to negotiate the lump sum price, that condition would not typically be

met, for example, in the case of a sale of custom software.

Manufacturing method or process IP

The foregoing rules do not apply to manufacturing method or process IP that is sold to an unrelated foreign party, for which the recipient of the IP is treated as the end user. If manufacturing method or process IP is bundled with other IP, a taxpayer must determine the portion of the revenue earned with respect to the manufacturing method or process IP using section 482 principles.

Substantiating foreign use of IP

The final regulations provide specific substantiation requirements to corroborate foreign use for sales of IP. Specifically, a taxpayer must maintain and be able to provide to the IRS credible evidence of the amount of revenue the IP generates from end users outside the United States. Generally, the final regulations provide three items that may be used to meet the substantiation requirements:

- A binding contract that specifically provides that the IP can be exploited solely outside the United States;
- Credible evidence obtained in the ordinary course of business from the recipient establishing the portion of its revenue that was derived from exploiting the IP outside the United States; or
- A written statement prepared by the seller, corroborated by credible evidence, that contains specifically enumerated information, including how the seller determined the portion of the sale that is a FDDEI sale.

KPMG observation

The final regulations allow reliance on a binding contract that specifically provides that the IP can be exploited solely outside the United States. It is not clear whether such a contract is required to incorporate the specific rules in the final regulations that are used to determine where IP is "exploited."

Other rules related to FDDEI transactions

Predominant character rule

The proposed regulations provided that a transaction that includes both a sale component and a service component is classified according to the predominant character of the transaction for purposes of determining whether the transaction is subject to the rules for a FDDEI sale or a FDDEI service (the "predominant character rule"). The final rules expand the predominant character rule to apply to any transaction that has multiple elements. As an example, the final regulations provide that whether a transaction that consists of a sale of general property and IP is subject to the rules applicable to general property or IP is determined based on its predominant character.

KPMG observation

The proposed and final regulations provide a hierarchy to address overlap in the definitions of the various service categories (transportation service, property service, etc.). The definitions for property and proximate services also include, in effect, specific predominant character rules based on the time spent in proximity to the property or recipient, respectively. The final rule for electronically supplied services also contains its own predominant character rule. If a service provided to a business recipient is partially an electronically supplied service and partially a general service that is not an electronically supplied service, the applicable rule depends on whether the primary purpose of the service is to provide electronically supplied services.

The expanded predominant character rule in the final regulations can now also apply for purposes of categorizing a bundled service when the hierarchy for the definitions of the service categories does not itself resolve an overlap (e.g., a single service that includes elements of both a transportation service and a general service). This could be significant when very different rules would apply to determine FDDEI qualification based on the predominate character.

The predominant character rule only applies when a bundled arrangement is a single transaction. Neither the proposed nor final regulations address when a taxpayer should treat a bundled service or other bundled arrangement with multiple elements as a single transaction or multiple transactions with a separate analysis under the appropriate rules.

Foreign military sales and services

The proposed regulations treated foreign military sales and services provided to the United States pursuant to the Arm's Export Control Act of 1976 (22 U.S.C. 2751, et. seq.) ("AECA") as sales or services provided to a foreign person for purposes of applying the FDDEI rules. However, for this purpose, the resale or on-service from the United States to a foreign government was required to be "on commercial terms" and the contract with the United States was required to refer to the resale or on-service. Further, the proposed regulations were silent as to how a taxpayer would establish foreign use with respect to a sale of property or the location of the recipient in the case of a service.

The final regulations relax these rules in two respects. First, the final regulations eliminate the requirement that the on-sale or on-service by the U.S. government must be on "commercial terms," and the requirement that the contract must refer to the resale or on-service. Second, the final regulations provide that a sale of property or a provision of service that is pursuant to the AECA is treated as a FDDEI sale or FDDEI service "without regard to Reg. § 1.250(b)-4 or § 1.250(b)-5." Accordingly, under the final regulations, sales of property or services to the U.S. government pursuant to the AECA is a FDDEI sale or FDDEI service, without regard to the type of property sold or the category of service.

KPMG observation

In response to the proposed regulations, comments questioned how foreign use and location of the recipient could be established in the case of foreign military sales pursuant to the AECA. The government responded to these questions by providing that a sale or service pursuant to the AECA is, per se, a FDDEI sale or a FDDEI service. Accordingly, there is no specific substantiation required

for these foreign military sales. Presumably, a taxpayer would only have to substantiate that the transaction occurred pursuant to the AECA under the general substantiation rules of section 6001.

Computational rules

Definition of foreign branch income and sales of transparent entities

Section 250(b)(3) excludes foreign branch income (as defined in section 904(d)(2)(J)) from DEI. The proposed regulations generally followed the definition of foreign branch income provided in Reg. § 1.904-4(f)(2), but also included income from the sale of a foreign branch in foreign branch income. The final regulations eliminate this deviation from the foreign tax credit regulations, and instead define "foreign branch income" by cross reference to Reg. § 1.904-4(f)(2) without modification. In addition, the final regulations confirm that, under Federal income tax principles, the sale of an interest in a disregarded entity is considered the sale of the assets of that entity, and therefore the rules for FDDEI sales apply to determine whether the sale of each asset qualifies as a FDDEI sale. However, the final regulations clarify that a partnership interest is not general property, and therefore a sale of a partnership interest, like a sale of corporate stock, cannot give rise to FDDEI.

KPMG observation

The proposed regulations would have excluded income recognized from sales of foreign branches (including through sales of disregarded entities) from DEI and FDDEI. The final regulations, by conforming the definition of foreign branch income for FDII to the definition in Reg. § 1.904-4(f)(2), will generally ensure that such income, if not recorded on the books and records of a branch, will be included in DEI and, if the foreign person and foreign use requirements with respect to the branch assets are satisfied, in FDDEI. This could be a significant benefit to a domestic corporation in the case of a taxable disposition of a foreign branch, a benefit not available under the proposed regulations.

COGS and expense allocation

The final regulations do not revise the proposed regulations relating to the allocation of COGS to gross DEI and gross FDDEI, except to add a consistency requirement to the rule that COGS can be attributed under any reasonable method. Thus, as under the proposed regulations, the final regulations explicitly require COGS to be attributed to gross receipts with respect to gross DEI or gross FDDEI without regard to whether certain costs included in COGS can be associated with activities undertaken in a pre-TCJA year. In addition, the final regulations generally adopt the approach of the proposed regulations with respect to the allocation of expense to gross DEI and gross FDDEI, providing that the general expense allocation rules under section 861 apply for purposes of allocating deductions to gross DEI and gross FDDEI under the rules of Reg. §§ 1.861-8 through 1.861-14T and 1.861-17 (collectively, "the section 861 regulations") by treating section 250(b) as an operative section for section 861 purposes.

KPMG observation

The 2019 proposed foreign tax credit ("FTC") regulations, which are proposed generally to apply to tax years that end on or after December 16, 2019, would provide that litigation awards and settlement payments that accrue in a post-TCJA tax year but relate to a pre-TCJA tax year must be allocated and apportioned to the grouping(s) to which the related income would be assigned if the income were recognized in the post-TCJA year. Thus, this proposed rule is similar to the FDII rule that requires attribution of COGS to gross DEI and gross FDDEI without regard to whether any component costs relate to a pre-TCJA year.

In contrast to these specific rules, neither the final FDII regulations nor the section 861 regulations explicitly address the ability to use a facts-and-circumstances based allocation of other below-the-line expenses away from DEI and FDDEI under the principles of section 861. Of course, a facts-and-circumstances approach is not available for expenses subject to formulary rules, such as interest and R&E expenditures, but taxpayers should evaluate other below-the-line expenses to determine whether any of those expenses are attributable to revenue that accrued prior to the effective date of section 250. For example, pension expense is a common example of an expense that can be partially attributed to activities that occurred in the years before the expense is incurred.

Certain deductions and limitations are not taken into account in determining FDDEI and DEI

The proposed regulations provided a complex ordering rule for purposes of taking section 163(j) (limitation on business interest expense) and section 172 (net operating losses) into account in determining DEI and FDDEI. The final regulations eliminate this ordering rule and instead provide that sections 163(j) and 172, as well as section 170(b)(2) (limitation on deduction for charitable contributions and gifts) and section 246(b) (limitation on dividend-received deduction) are not taken into account in calculating DEI and FDDEI. The preamble explains that this change, to disregard provisions which limit certain deductions and provide for the carryover of the amounts not currently allowed, is intended to simplify the calculation of FDII at the loss of some "theoretical precision" and "is consistent with the premise that the section 250 deduction is calculated based on annual income and expenses."

KPMG observation

Whether this change is beneficial to a taxpayer will depend on the taxpayer's specific circumstances. For a taxpayer that carries forward NOLs related to FDDEI losses, under the final regulations, these losses will be disregarded in computing DEI and FDDEI, and thus potentially increase the section 250 deduction, subject to the application of the taxable income limitation. On the other hand, for a taxpayer whose deductible interest is limited by section 163(j), the disallowed interest will be taken into account in computing DEI and FDDEI, thus potentially decreasing the section 250 deduction.

Exclusive apportionment for R&E allocation and apportionment

The proposed regulations provided that expenses were allocated to gross DEI and gross FDDEI under the rules of Reg. §§ 1.861-8 through 1.861-14T and 1.861-17, except without regard to the exclusive apportionment rule for research and experimental ("R&E") expenditures under Reg. § 1.861-17. The final

regulations remove the explicit rule providing that exclusive apportionment does not apply for FDII, noting in the preamble that the proposed R&E regulations provide that exclusive apportionment applies solely for section 904 purposes. According to the preamble, Treasury intends to consider the application of exclusive apportionment for FDII purposes in connection with finalizing the R&E proposed rule (as part of the 2019 FTC proposed regulation package (REG-105495-19)).

KPMG observation

In contrast to most of the other proposed applicability dates in the 2019 proposed FTC regulations, the proposed R&E regulations are proposed to apply to tax years *beginning* after December 31, 2019. As discussed above, a taxpayer may choose to apply the final FDII regulations for pre-2021 tax years, which include tax years to which the proposed R&E regulations are not proposed to apply. Therefore, there is a question whether the elimination of the explicit prohibition on exclusive apportionment in the final FDII regulations may permit an early adopter of the final regulations to apply exclusive apportionment for FDII purposes for tax years beginning before January 1, 2020. There is some logic to applying exclusive apportionment to disproportionately apportion R&E performed in the United States to RDEI because the existing R&E regulations justify exclusive apportionment on the basis of the benefits R&E confers to the nearest "market," and FDDEI transactions are primarily focused on foreign market activity. However, Reg. § 1.861-17(b)(1) provides that exclusive apportionment applies only "where an apportionment based upon geographic source of income of a deduction for research and experimentation is necessary." For FDII purposes, the geographic "source" of income, within the commonly understood meaning of that term, is irrelevant. Moreover, the Tax Court in *St. Jude Medical, Inc. v. Commissioner*, 97 T.C. 457 (1991), *aff'd in part, rev'd in part*, 34 F.3d 1394 (8th Cir. 1994), held that exclusive apportionment was not applicable in the analogous context of section 994 and the DISC regime.

Qualified business asset investment ("QBAI")

The proposed FDII regulations regarding QBAI generally adopted the relevant provisions of the QBAI rules in the proposed GILTI regulations. Likewise, the final FDII regulations generally adopt the changes that the final GILTI regulations made to QBAI.

In response to comments, the final regulations provide that the QBAI anti-avoidance rule in Prop. Reg. § 1.250(b)-2(h)(3) does not apply to a transfer of property that occurs before March 4, 2019, the date the proposed regulations were published. However, the final regulations do not adopt a comment requesting that taxpayers be able to rebut the presumption that a transfer or leaseback transaction was undertaken for a principal purpose of reducing the transferor's deemed intangible income return if the transfer and leaseback occurred within a six-month span.

For purposes of GILTI and FDII, the adjusted basis of property for QBAI is required to be determined under section 168(g) (the "alternative depreciation system" or "ADS"). A comment recommended that the final regulations permit taxpayers to follow U.S. GAAP for purposes of determining QBAI when the difference between U.S. GAAP and ADS is immaterial. Like the final GILTI regulations, the final regulations do not include a general election to use a depreciation method other than ADS. Unlike the

final GILTI regulations, the final FDII regulations do not permit a taxpayer, under any circumstances, to use their non-ADS depreciation method for purposes of calculating QBAI.

KPMG observation

For purposes of GILTI and FDII, section 951A(d)(3) provides that the adjusted basis of property for QBAI must be determined under ADS "notwithstanding any provision of this title (or any other provision of law) which is enacted after the date of the enactment of this section." The final regulations further provide that ADS is to be applied "without regard to any provision of law enacted after December 22, 2017, unless such later enacted law specifically and directly amends the definition of QBAI under section 250 or section 951A."

The CARES Act amends section 168(g) by, among other things, shortening the recovery period for qualified improvement property ("QIP") from 40 years to 20 years for purposes of ADS, and provides that this amendment "shall take effect as if included in [the TCJA]." The application of this rule would generally be to increase a taxpayer's FDII by decreasing QBAI (and therefore the "normal return" with respect to its business assets). The final regulations do not address whether this amendment should be treated as retroactive to the date of the TCJA, and thus taken into account for purposes of determining QBAI, or should be viewed as a later enacted law, and thus disregarded for purposes of QBAI.

Taxable income limitation

Elimination of ordering rule for sections 163(j), 172, and 250

Sections 163(j), 172, and 250 each contain a limitation based on a taxpayer's taxable income. Section 163(j) provides that "adjusted taxable income" is determined without regard to section 172 (section 163(j)(8)(A)(iii)), and the application of section 172 is generally determined without regard to section 250 (section 172(a)(2)(ii)(I)) and section 172(d)(9)). However, the Code does not provide any rule with respect to ordering section 163(j) and section 250.

The proposed regulations had provided an ordering rule in order to eliminate the circularity in the application of these sections. The final regulations remove the proposed ordering rule, and state in the preamble that Treasury will continue to study the interaction of sections 163(j), 172, and 250. Until guidance is provided, the preamble instructs taxpayers to choose any reasonable method in determining the taxable income limitation for purposes of section 250, including the ordering rule described in the proposed regulations or simultaneous equations, if the method is applied consistently for all tax years beginning on or after January 1, 2021.

A companion rule in the 2018 proposed regulations under section 163(j) provided that, for purposes of calculating a domestic corporation's section 163(j) limitation, the corporation reduced its adjusted taxable income by the amount of its tentative section 250 deduction (i.e., without regard to the taxable income limitation under section 250(a)(2)). The recently released final regulations under section 163(j) eliminate this provision.

KPMG observation

While the preamble to the final regulations authorizes any "reasonable method" to ordering the various provisions, a reasonable method would have to consider the relevant statutory language. For instance, in applying sections 172 and 250(a)(2) with respect to a tax year, taxpayers must take into account section 172(d)(9), which, by cross-reference in sections 172(c) and 172(b)(2)(A), provides that NOLs (including carryforwards) are determined without regard to section 250. In addition, section 172(a)(2)(ii)(I), as amended by the CARES Act, provides that, for tax years beginning after December 31, 2020, the amount of the an NOL arising in a tax year beginning after December 31, 2017 that is allowed as a deduction in the tax year is determined without regard to section 250.

Pre-TCJA NOLs reduce taxable income

The final regulations confirm that pre-TCJA NOLs are taken into account in determining taxable income for purposes of applying the taxable income limitation of section 250(a)(2).

Section 962

Although the section 250 deduction is generally available only to corporations, the proposed regulations allowed U.S. individuals, trusts, and estates that make a section 962 election with respect to a controlled foreign corporation to take into account the section 250 deduction applicable to GILTI inclusions (and the related section 78 gross up). This rule is finalized without change, along with the proposed rule adding GILTI inclusions to the amounts subject to a section 962 election. The previously proposed section 962 rules are finalized to apply to tax years of foreign corporations that end on or after March 4, 2019.

The final regulations also update the section 962 rules to replace obsolete cross-references and to update an example in the section 962 regulations. The new final rules under section 962 apply to tax years that end on or after July 15, 2020. However, taxpayers can choose to apply any of the rules (whether previously proposed or introduced only in the final regulations) for tax years beginning on or after January 1, 2018.

In response to long-standing questions, the preamble notes that pending further guidance, a section 962 election may be made on an amended return for the 2018 tax year and subsequent years, provided the interests of the government are not prejudiced by the delay, applying the standards in Reg. § 301.9100-3(c).

Consolidated returns

The proposed regulations included guidance for determining the amount of the section 250 deduction for taxpayers that file consolidated returns. In particular, the proposed consolidated return regulations provided for the computation of the section 250 deduction on an aggregate, group-wide basis, with rules allocating the deduction among group members based on the relative contribution to group FDDEI and added a new example to the intercompany transaction rules that demonstrated how the intercompany transaction rules applied for section 250 purposes. The proposed regulations also included a special rule providing that basis adjustments attributable to intercompany transactions are disregarded in determining QBAI.

The final regulations generally maintain the proposed approach to applying section 250 to consolidated groups. However, the final regulations modify the rule that excludes intercompany transactions in calculating QBAI to provide that the rule applies only while the intercompany gain or loss is deferred.

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