KPMG report: Initial impressions of final regulations related to the deduction for FDII and GILTI under section 250

July 10, 2020

The U.S. Treasury Department and IRS yesterday, July 9, 2020, released for publication in the Federal Register final regulations (T.D. 9901) related to the deduction for "foreign-derived intangible income" (FDII) and "global intangible low-taxed income" (GILTI) under section 250—regulations that finalize proposed regulations from March 2019.

Read the **final regulations** [PDF 806 KB] (295 pages).

The final regulations provide guidance related to determining a taxpayer's section 250 deduction, which was enacted on December 22, 2017 (Pub. L. No. 115-97, commonly referred to as the "Tax Cuts and Jobs Act" or "TCJA"). The final regulations finalize the proposed regulations with significant modifications, including changes to the requirements for substantiating the deduction under section 250. The final regulations also provide additional guidance related to specific rules for determining the amount of a taxpayer's section 250 deduction, computing FDII, computing qualified business asset investment ("QBAI"), identifying foreign-derived deduction eligible income ("FDDEI") transactions, FDDEI sales[1] and FDDEI services, and the related-party rules.

Definition of terms

FDII = foreign-derived intangible income

GILTI = global intangible low-taxed income

QBAI = qualified business asset investment

FDDEI = foreign-derived deduction eligible income

DEI = deduction eligible income

IP = intangible property

R&E = research and experimentation

NOL = net operating loss

FTC = foreign tax credit

[1] In determining FDDEI sales, the terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition. Section 250(b)(5)(E). Accordingly, this report generally adopts the same approach in this document.

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Applicability dates: Electivity to apply either the proposed or final regulations

The final regulations apply for tax years beginning on or after January 1, 2021, such that the statute itself is generally the only *binding* guidance for tax years beginning before 2021. For tax years beginning before 2021, taxpayers may choose to rely on either the final regulations or the proposed regulations, as long as they apply either set of regulations in their entirety (except where noted in the preamble). Notably, taxpayers that choose to apply the proposed regulations may apply the transition documentation rule, which contained relaxed documentation requirements, for all tax years beginning before 2021 (rather than only for tax years beginning on or before March 4, 2019, as set forth in the proposed regulations).

Guidance related to substantiating the FDII deduction

The final regulations make significant modifications to the rules related to the documentation requirements in the proposed regulations. We describe the general themes below, and discuss some of the more detailed provisions in the context of the relevant substantive provision.

From documentation to substantiation

The proposed regulations were very prescriptive in specifying the forms of documentation necessary for establishing that a recipient of property was a foreign person, the sale of property was for a foreign use, and a general service was provided to a person located outside the United States. The final regulations replace these requirements with more generalized "substantiation requirements," which focus more on the type of information needed rather than the form of that information.

Specific and general substantiation rules

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, and (4) general services provided to business recipients. The final regulations do not provide specific substantiation rules to establish (1) foreign person status, (2) foreign use with respect to sales of certain general property that are made directly to end users, and (3) the location of general services provided to consumers. However, the preamble explains that a taxpayer is generally required under section 6001 and Treas. 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. According to the preamble, the more relaxed substantiation requirements are meant to offer taxpayers flexibility in collecting corroborating evidence. However, as discussed below, in some contexts, taxpayers may find that the final regulations provide fewer options for substantiation than the proposed regulations.

Changes to the small business rules

The final regulations provide an exception to the specific substantiation requirements for small businesses, which are defined as businesses with less than $25 million in gross receipts (an increase from the $10 million threshold in the proposed regulations). However, unlike the proposed regulations, the final regulations do not specify the amount of substantiation required by small businesses. In particular, small businesses must still comply with the general requirement to substantiate a deduction 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 general exceptions for small transactions included in the proposed regulations, as discussed below, the final regulations do contain certain modifications to the rules for transfers of digital content and electronically supplied services if the transactions are less than $50,000.

Modification of reliability standards

The final regulations also modify the proposed regulations' requirements for documentation to be considered reliable. Under the final regulations, as in the proposed regulations, substantiation must be in existence as of the FDII filing date. The final regulations further provide that the substantiation must generally be provided to the IRS within 30 days of a request. However, the final regulations eliminate the proposed requirement that the documents must be obtained no earlier than one year before the sale, thus permitting taxpayers to generally rely on long-term contracts for substantiation.

Guidance related to "foreign person" status

The final regulations retain the general requirement that a sale of general or intangible property must be to a foreign person to qualify as a FDDEI sale, 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 provide broadly-applicable presumptions for determining foreign person status that, depending on the type of sale, are based on the place of sale, shipping address, or billing address, unless the seller knows or has reason to know that the recipient is not a foreign person. For this purpose, the seller has reason to know that a recipient is not foreign if the information received as part of the sale process indicates that the recipient is not a foreign person and the seller fails to obtain evidence establishing that the recipient is in fact a foreign person.

Guidance related to "foreign use" standard for general property

The final regulations revise the standard for determining whether a sale of general property is for a foreign use.

Modifications to rules relating to subsequent domestic use of general property

For sales of general property, the final regulations generally provide that "foreign use" means the sale (or eventual sale) of property to end users outside the United States or the sale of general property to a person that subjects the property to manufacture, assembly, or other processing outside the United States. This is a departure from the proposed rules, which generally required the absence of domestic use within three years of delivery of the property unless the manufacturing exception applied. This definition 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.

New rule for electronic transfers of digital content outside the United States

Although the proposed regulations could be read to suggest that sales of copies of software might be treated as a sale of intangible property, the final regulations clarify that such copyrighted articles are characterized as general property for purposes of applying the regulations. Further, the final regulations provide that whether a sale of general property that primarily contains digital content that is transferred electronically is for foreign use is determined based on the location where an end user downloads, installs, receives, or accesses the digital content. If such information 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). The final regulations do not provide guidance regarding the character of a transfer of a copyrighted article, but defer to general U.S. tax principles, taking into account the regulations issued under section 861.

New criteria for sales of international transportation property

The final regulations provide new rules for sales of international transportation property that generally focus on where the end user registers the property. For property not used for compensation or for hire, the final regulations impose the additional requirement that the property is hangared or stored primarily outside the United States.

Modifications to the manufacturing exception for general property

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 (the "manufacturing exception"). Under the final regulations, as in the proposed regulations, property 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").

Physical and material change test

The final regulations clarify that property is subject to a material change if it is substantially transformed and is distinguishable from, and cannot be readily returned to, its original state.

Component test

The final regulations 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).

Guidance related to "foreign use" standard for intangible property

The final regulations maintain the general approach of the proposed regulations that a sale of intangible property is for a foreign use only to the extent it is "exploited" outside the United States, but provide significant modifications to the rules for when this standard is satisfied.

Additional guidance on the general exploitation standard for sales of IP

The final regulations clarify that the general rule for determining whether a sale of IP is for a foreign use is based on the location of the "end users." The final regulations provide specific guidance regarding who and where the end users are that depend on whether the IP is embedded in or used in connection with the sale of general property, is used in providing a service, consists of a manufacturing method or process, or is used in research and development.

IP embedded or associated with product sales.

- **General rule based on end user of product.** With respect to IP that is embedded in general property or used in connection with the *sale* of general property, the final regulations clarify that the end user is the end user of the general property. Accordingly, the sale or license of intangible property will be for a foreign use to the same extent that the sale of the general property would be for a foreign use under the rules applicable to sales of general property.

- **Limited exception for process IP.** The final regulations provide that, 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 for purposes of the foreign use determination, even if the manufactured product is ultimately sold to persons within the United States ("process IP exception”). The process IP exception is subject to several important limitations. First, for purpose of the exception, “a manufacturing method or process” is defined narrowly as a sequence of actions or steps that comprise 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 foreign party, or to a sale or license of IP to a foreign unrelated party 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 providing a service

The final regulations provide that the end user of a sale or license of IP that is used to provide a service is the recipient of the service, and that the sale is for a foreign use only to the extent that the provision of the service would qualify as a FDDEI service. Notably, the process IP exception is not available for IP that is used to provide a service.

IP used in research and development

The final regulations provide that, if IP is sold for use in the development of other intangible property, the end user is the end user of the other intangible property, as determined under the rules described above.

Unclear relevance to traditional sourcing rules

Despite the parallel language defining the statutory “foreign use” requirement for FDDEI sales and a foreign source royalty under section 862 for royalties, the preamble to the final regulations notably does not attempt to address whether the new FDDEI rules should be viewed as relevant for determining where IP is exploited under the sourcing rules.

Guidance related to the location of the recipient of general services

The final regulations retain the proposed rules that a general service provided to a consumer is a FDDEI service if the consumer resides outside the United States, and a general service provided to a business recipient is a FDDEI service to the extent that the service confers a “benefit” (as defined in Treas. Reg. § 1.482-9(l)(3)) on the operations of the recipient, which continues to be defined as including all related parties. However, the final regulations make several significant modifications to these rules.

New subcategories

The final regulations add two new subcategories of general services, for which the location of the consumer or business recipient is determined based on new standards that differ from those otherwise applicable to general services:

Advertising services

For advertising services, the recipient is deemed to be located where the advertisements are viewed by individuals. 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. 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.

Electronically supplied services

A recipient of an electronically supplied service is deemed to be located, in the case of a consumer, where the device of the recipient is located or, in the case of a business recipient, where the service is accessed by its employees, contractors, or agents. In the case of an electronically supplied service provided to a consumer, if the renderer cannot with reasonable effort obtain the consumer's device location, then the location of the device is determined based on the billing address for the consumer, subject to the reason to know standard. In the case of an electronically supplied service that is provided to a business recipient, if the location where the service is accessed cannot be determined, and the gross receipts from all services with respect to the business recipient are in the aggregate less than $50,000 for the renderer's tax year, the operations of the business recipient that benefit from the service provided by the renderer are deemed to be located at the recipient's billing address; otherwise, the operations of the business recipient that benefit are deemed to be located in the United States. An "electronically supplied service" is a general service that is delivered primarily over the internet or an electronic network, other than an advertising service.

Elimination of the ratable allocation rule for general services provided to business recipients

The final regulations eliminate the proposed rule 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 and the IRS determined that "it would be inappropriate to allow a deduction that is not based on reliable information." Furthermore, the rules for substantiating the amount of 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 and the IRS view market research or information obtained from public data as generally unreliable for purposes of substantiation, although the proposed regulations specifically contemplated the use of such information in documenting foreign use for a fungible mass. These changes in the final regulations, 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.

Business recipient with no operations

The final regulations clarify that, in the case of a business recipient that does not have an office or fixed place of business (e.g., a partnership that that does not itself have any offices or employees but is managed by one or more of its partners), including an office of a principal manager or managing owner, the business recipient is deemed to be located at its primary billing address.

Guidance related to other services.

Property temporarily in the United States.

The final regulations expand the circumstances under which property services may be FDDEI services to include certain services performed with respect to property temporarily in the United States.

Freight forwarding services

The final regulations clarify that freight forwarding and similar services are characterized as transportation services. Accordingly, the qualification of freight forwarding services as FDDEI will depend on the origin and destination of the service. However, the final regulations do not define "freight forwarding" for this purpose.

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.

Guidance related to the related-party rules

The final regulations generally retain the proposed rules with respect to related-party transactions, with the following modifications:

Relaxation of timing requirements in the related-party rules

The final regulations now allow a sale to be treated as a FDDEI sale as long as, as of the FDII filing date, an unrelated party transaction has occurred, or will occur, in the ordinary course of business with respect to the property that is sold.

Sale 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 certain related U.S. persons as part of the single foreign related party, so that intermediate sales to a U.S. related-party will not disqualify the sale from being a FDDEI sale. However, this change only applies to the foreign use requirement; it does not modify the general requirement that the initial sale must be to a foreign person (related or otherwise).

Clarifications to substantially similar services rules

When applying the benefit test for substantially similar services, the final regulations specify that the benefits considered are those "directly used" by the related party.

Guidance related to the interaction between sections 163(j), 172, and 250

Sections 163(j), 172, and 250 each contain a limitation based on a taxpayer's tax income, and the proposed regulations would have provided an ordering rule to avoid circularity in the application of those sections. The final regulations substantially modify the proposed rules, as follows:

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

According to the preamble, the IRS and Treasury require further study regarding the interaction of sections 163(j), 172, and 250, and thus eliminate the ordering rule for sections 163(j), 172, and 250 contained in the proposed regulations. The preamble provides that, until guidance is provided, taxpayers may choose any reasonable method in determining the tax 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. However, in determining reasonableness, taxpayers should consider section 172(a)(2)(ii)(I), as amended by the CARES Act, and section 172(d)(9), which generally provide that section 172 is applied 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).

Guidance regarding the allocation and apportionment of expenses in determining determine DEI and FDDEI

The final regulations generally retain the proposed rule that a corporation's deductions are allocated and apportioned to gross DEI and gross FDDEI under the rules of Treas. Reg. §§1.861-8 through 1.861- 14T and 1.861-17 by treating section 250(b) as an operative section described in §1.861-8(f), with the following modifications:

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

The final regulations provide that sections 163(j), 170(b)(2), 172, 246(b), and 250 are not taken into account for purposes of calculating DEI and FDDEI. Therefore, for example, NOLs that arise from losses allocable to FDDEI will not reduce DEI or FDDEI in the year that such loss is absorbed. Likewise, interest expense allocable to FDDEI may reduce benefits under section 250 for the tax year incurred even if that interest is non-deductible by reason of section 163(j).

Exclusive apportionment for R&E allocation and apportionment

Because the 2019 FTC proposed regulations clarify that exclusive apportionment applies solely for purposes of section 904, the final regulations remove the language in proposed rule §1.250(b)-1(d)(2) that the exclusive apportionment rule in Treas. Reg. § 1.861-17(b) does not apply for purposes of apportioning R&E expenses to gross DEI and gross FDDEI. However, the IRS and Treasury will consider the application of exclusive apportionment for purposes of FDII as part of finalizing the 2019 FTC proposed regulations (REG-105495-19).

Pre-TCJA expenses accruing post-TCJA

The final regulations do not address how expenses that accrue post-TCJA, but relate to pre-TCJA periods (e.g., certain executive compensation), are taken into account in calculating FDII. Cf. Prop. Reg. § 1.861-8(e)(5) (providing that litigation awards and settlement payments that accrue post-TCJA but relate to pre-TCJA periods must be allocated to groupings that the related income would be assigned if recognized in the post-TCJA year).

Expansion of predominant character rule

The proposed predominant character rule provided that a transaction that includes both a sale component and a service component is classified according to the overall 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 final regulations expand the predominant character rule to apply to transactions that include multiple elements of FDDEI sales. For example, a transaction that includes both a sale of general property and a sale of intangible property will be characterized as either a FDDEI sale of general property or a FDDEI sale of intangible property based on the predominant character of the transaction, when taking into consideration all relevant facts and circumstances. However, the predominant character rules does not apply to determine the particular category into which the provision of a service falls for purposes of determining whether such service is a FDDEI service. Rather, the final regulations provide specific rules relevant to particular services with multiple elements that determine the applicable standard (e.g., for a service that is partially an electronically supplied service and partially a general service that is not an electronically supplied service, the location of the business recipient is determined using the rule for electronically supplied services).

New rules for hedging transactions

The final regulations provide that the amount of gross FDDEI from FDDEI sales of general property are 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. Notably, these rules do not extend to hedges of the costs of providing a service.

Sales of branches and partnerships

The final regulations eliminate the proposed rule that would treat the sale of a branch as foreign branch income, and instead define "foreign branch income" by cross reference to Treas. Reg. §1.904-4(f)(2) without modification. 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.

Foreign military sales

The final regulations do not impose any specific substantiation requirements for foreign military sales or services, and eliminate the proposed rule that the United States government resell or on-service a foreign military sale or service "on commercial terms."

No guidance on whether taxpayers can waive the FDII deduction

The final regulations do not provide guidance on whether a taxpayer may choose not to claim a FDII deduction. Rather, the preamble notes that "[w]hether an allowable deduction must be claimed is governed by general tax principles and rules on whether such deduction can be elective is beyond the scope of these regulations."

Transition period for the QBAI anti-abuse rule

The final regulations modify the applicability date of the QBAI anti-abuse rule with respect to certain transfers of property so that it only applies to tax years ending on or after March 4, 2019 (the applicability date of the proposed regulations).

No guidance on whether the CARES Act changes to section 168(g) apply for QBAI purposes

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"), and without regard to any law enacted after December 22, 2017, unless the law specifically amends the QBAI definition. The CARES Act amends section 168(g) to treat qualified improvement property ("QIP") as 20-year property for ADS under section 168(g) (and 15-year property eligible for bonus depreciation under the general depreciation system ("GDS") of section 168), and provides that this amendment "shall take effect as if included in [the TCJA]." The effect of the CARES Act change for QIP was to shorten the recovery period from 40 years to 20 year for ADS, and from 39 to 15 years for GDS. The application of this rule would generally be to increase a taxpayer's FDII by decreasing 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.

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