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KPMG report: Correcting amendments to final regulations, FDII and GILTI

Correcting amendments from the U.S. Treasury Department and IRS published in the Federal Register on October 28, 2020, make changes to final regulations governing the deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). A second set of correcting amendments (released for publication in the Federal Register on November 2, 2020) reflects changes to the language in the preamble to the final regulations to be consistent with changes made in the October 2020 correcting amendments.

Read the **final regulations** as published in the Federal Register on July 15, 2020.

The final regulations introduced several novel concepts not included in the **proposed FDII regulations (March 2019)** [PDF 445 KB], which has created some ambiguity in applying the final rules.

These fairly substantive **correcting amendments** [PDF 263 KB], issued more than three months after the initial Treasury Decision, address a number of these ambiguities. Some notable points addressed by the corrections are described below.

The changes in the **second set of correcting amendments** [PDF 247 KB] (November 2, 2020) reflect revisions to the language of the preamble to the final regulations to be consistent with changes made to the final regulations by the October 2020 correcting amendments (the first set of correcting amendments).

Example 6 of Reg. § 1.250(b)-5 is modified to resolve an apparent inconsistency with the operative rule for electronically supplied services (ESS).

The final regulations provide new rules for determining whether income from an ESS qualifies as foreign-derived deduction eligible income (FDDEI) eligible for a FDII benefit. The operative rule of the final regulations provides that an ESS furnished to a business recipient is treated as provided to a person located outside the United States (and, therefore, potentially eligible for FDII benefits) if "the business recipient (including employees, contractors, and agents)" accesses the ESS outside the United States.

By contrast, Example 6 in the original text of the final regulations strongly implied that, at least in the context of a taxpayer that provided the service of maintaining a website for a customer, the relevant location was the location of access by the business recipient's *customers*, in addition to—or instead of—the location of access by the business recipient itself.

The correction modifies Example 6 to eliminate the implication that taxpayers are required to look to the location of access by their customers' customers. The ESS rule is further modified to provide that foreign use is determined based on where the business recipient "accesses *or otherwise uses*" the service. [Emphasis added]

KPMG observation

Prior to the correction, it was uncertain whether Example 6 should be read as a gloss on the operative rule, and thus viewed as expanding the items in the parenthetical list to include the customers of a business recipient, or as simply inconsistent with the operative rule. While the correction resolves this ambiguity, it introduces a new ambiguity as to when a business recipient might "otherwise use" an ESS, and in particular, how to apply the rule when a business recipient does not directly and meaningfully access the ESS. For example, one type of ESS that is described in the final FDII regulations is support of a business presence on a network, such as hosting a website. Non-interactive websites (e.g., a website that only provides information about the business such as services provided, location, hours, etc.) may only be materially accessed by the business recipient's employees that are responsible for maintaining the information on the website. In this case, it is unclear whether only the locations of those employees would be relevant, or if all of the business locations that benefit from the website could also be relevant.

The related-party rule is modified to expand the circumstances in which a related party sale qualifies for FDII.

The original text of the final regulations provided that a sale by a taxpayer to a foreign related party (e.g., a controlled foreign corporation (CFC)), followed by a sale to a U.S. person that is related to the taxpayer, may qualify for FDDEI as long as the related U.S. person ultimately sells the property to an unrelated foreign person for a foreign use. However, it was unclear whether this rule applied if the sale to a U.S. person was a sale to the taxpayer itself, rather than a person related to the taxpayer. The correction clarifies that a sale to a foreign related party followed by sale back to the taxpayer qualifies for the related-party rule.

KPMG observation

This correction addresses a supply-chain structure in which, for instance, a U.S. company (USCo) sells components to a manufacturing CFC, the manufacturing CFC sells the finished product back to USCo, which USCo then sells to foreign customers. The correction makes clear that USCo's income with respect to the sale of components to the manufacturing CFC, to the extent the finished product is ultimately sold in qualifying sales, may qualify for FDDEI, in addition to USCo's income from the sale of the finished product to foreign customers.

The effective date of the final regulations is modified to provide that taxpayers that early adopt the final regulations must continue to apply them.

The final regulations apply to any tax year beginning on or after January 1, 2021. The original text also allowed taxpayers to rely on them for any pre-2021 tax year, "provided they apply the regulations in their entirety." The correction clarifies that taxpayers that early adopt the final regulations for any pre-2021 tax year are only required to continue to apply the final regulations for all subsequent years.

KPMG observation

Before the correction, it was unclear whether "in their entirety" meant that taxpayers that applied the final regulations for any pre-2021 tax year had to apply them for all pre-2021 tax years, including an earlier year for which a return had already been filed. Consistent with public statements by Treasury subsequent to the issuance of the final regulations, the correction clarifies that a taxpayer does not have to be consistent with respect to each pre-2021 tax year so long as the taxpayer applies the final regulations to any succeeding year.

The correction clarifies that the allocation and apportionment rules of Reg. §§ 1.861-8 through 1.861-17 do not apply for FDII for pre-2021 tax years.

The final regulations provide that section 250 is an operative section for purposes of the allocation and apportionment rules of Reg. §§ 1.861-8 through 1.861-17. See Reg. § 1.861-8(f)(1)(vi)(N). Although the final regulations generally apply prospectively to tax years beginning on or after January 1, 2021, the rule designating section 250 as an operative section appeared to be subject to the general effective date of Reg. § 1.861-8—making it applicable to all post-TCJA tax years—rather than the prospective effective date of the final regulations. The correction provides that the rule designating section 250 as an operative section for purposes of Reg. § 1.861-8 is effective for tax years beginning on or after January 1, 2021.

KPMG observation

The correction clarifies that taxpayers that choose to apply the statute for purposes of determining their FDII benefit for pre-2021 years are not bound by the rules in Reg. §§ 1.861-8 through 1.861-17. This clarification also appears in the recently released foreign tax credit **final regulations** [PDF 1.07 MB] (287 pages). The redundancy may have resulted from uncertainty at Treasury regarding which regulatory package would appear first in the Federal Register.

Corresponding corrections to the preamble language clarify that taxpayers that apply the statute for pre-2021 tax years may nonetheless apply the allocation and apportionment rules of Reg. §§ 1.861-8 through 1.861-17, but that no inference is intended as to whether other approaches for allocating and apportioning deductions for purposes of section 250(b) may be considered to result in properly allocable deductions.

The correction clarifies that general property that satisfies the manufacturing exception is considered "foreign use" for purposes of the embedded intangible property (IP) rule.

Under the final regulations, a transfer of IP rights to a transferee that embeds the IP in general property (or uses it in connection with the sale of general property) is for foreign use to the extent the subsequent sale of the general property is for foreign use under Reg. § 1.250(b)-4(d)(1)(ii) (the "embedded IP rule"). A sale of property that does not satisfy the foreign use standards in Reg. § 1.250(b)-4(d)(1)(ii) (e.g., because it is not sold to a foreign end-user) may nonetheless be for a foreign use if the property is subject to "manufacturing, assembly, or processing outside the United States" within the meaning of Reg. §1.250(b)-4(d)(1)(iii) (the "manufacturing exception"). The original text of the embedded IP rule only cross-referenced Reg. § 1.250(b)-4(d)(1)(ii), but an example in the final regulations indicates that the manufacturing exception is intended to apply for purposes of the embedded IP rule. The correction conforms the operative rule with the example by modifying the cross-reference in the embedded IP rule for foreign use to Reg. § 1.250(b)-4(d)(1)(ii) and (iii).

For more information, contact a tax professional with KPMG's Washington National Tax:

Danielle Rolfes | +1 202 533 3378 | drolfes@kpmg.com
Gary Scanlon | +1 202 533 4651 | gscanlon@kpmg.com
Marissa Rensen | +1 202 533 4497 | mrensen@kpmg.com

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