Proposed regulations set out how to determine FDII

In March, the IRS issued proposed regulations that cover determining the amount of the deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). The regs also coordinate the FDII and GILTI deduction with other tax provisions.

In this article, we'll review what led to the proposed regs, as well as how to determine FDII under the guidance. For an expansive look at this important tax development, see "An overview of the proposed regs on the FDII and GILTI deduction," also in this issue.

Determining FDII

Under the proposed regs, a domestic corporation's FDII would be the corporation's deemed intangible income (DII) multiplied by the corporation's foreign-derived ratio. A domestic corporation's DII would be the excess (if any) of the corporation's deduction eligible income (DEI) over its deemed tangible income return (DTIR). A domestic corporation's DTIR would be 10% of the corporation's qualified business asset investment (QBAI). The foreign-derived ratio would be the domestic corporation's ratio of foreign-derived deduction eligible income (FDDEI) to DEI.

A domestic corporation's DEI would be the excess of its gross income without regard to certain excluded items (gross DEI) over the deductions properly allocable to gross DEI. Gross DEI excludes six categories of gross income:

1. Any amount included in gross income under Section 951(a),
2. GILTI,
3. Financial services income,
4. Dividends from CFCs,
5. Domestic oil and gas extraction income, and
6. Foreign branch income.

The proposed regs clarify that, for this purpose, a dividend includes any amount treated as a dividend under any other provision of subtitle A of the Internal Revenue Code, including the Sec. 78 gross-up attributable to inclusions under Sec. 951(a) and Sec. 951A(a). The proposed regs would define foreign branch income by reference to Prop. Reg. Sec. 1.904-4(f), except that it also includes the sale, directly or indirectly, of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest. The result is that income from the sale of any such asset would not be included in gross DEI.

For purposes of calculating the foreign-derived ratio, FDDEI would be the excess of gross FDDEI over deductions properly allocable to gross FDDEI. The proposed regs would define gross FDDEI as the portion of a corporation's gross DEI that's derived from all its "FDDEI sales" and "FDDEI services" (collectively, "FDDEI transactions"). The determination of whether a sale of property or a provision of a service would be a FDDEI sale or a FDDEI service, respectively, is made under the provisions of Prop. Reg. Sec. 1.250(b)-3 through Prop. Reg. Sec. 1.250(b)-6.

The portion of a corporation's gross DEI that's not gross FDDEI would be referred to as gross non-FDDEI. Accordingly, all income included in gross DEI would be included in either gross FDDEI or gross non-FDDEI. In addition, all income included in either gross FDDEI or gross non-FDDEI would be included in gross DEI.

In the case of property produced or acquired for resale, gross income would be generally determined by subtracting cost of goods sold from gross sales receipts. In determining the amount of gross income included in gross DEI or gross FDDEI, cost of goods sold would be attributed to gross receipts with respect to gross DEI and gross FDDEI using any reasonable method. The proposed regs would clarify that cost of goods sold that is associated with activities undertaken in an earlier tax year cannot be segregated into component costs and attributed disproportionately to amounts excluded from gross FDDEI or to amounts excluded from gross DEI.

A taxpayer's deductions that are "properly allocable" to gross DEI and gross FDDEI would have to be determined for purposes of calculating its DEI and FDDEI. The proposed regs would provide that the rules set out in Reg. Sec. 1.861-8 through Reg. Sec. 1.861-14T and Reg. Sec. 1.861-17 would apply for purposes of determining DEI and FDDEI. To avoid circularity in applying those rules for purposes of determining DEI and FDDEI, the Sec. 250 deduction would not be treated as giving rise to exempt income or assets.

In certain circumstances, because of expense apportionment or attribution of cost of goods sold, a domestic corporation's FDDEI could exceed its DEI. Accordingly, the proposed regs would clarify that the foreign derived ratio cannot exceed 1.

Partnerships

The proposed regs would provide that a domestic corporate partner of a partnership considers its distributive share of a partnership's gross DEI, gross FDDEI and deductions to calculate the partner's FDII. For purposes of determining a domestic corporate partner's DTIR, a domestic corporation's QBAI would be increased by its share of the partnership's adjusted basis in partnership specified tangible property.

Under the proposed regs, the Sec. 250 deduction would be calculated and allowed solely at the level of a domestic corporate partner. Regardless of whether the deduction gives rise to exempt income in other contexts, and because it is calculated and allowed solely at the level of a domestic corporate partner, the Sec. 250 deduction wouldn't exempt the deducted income from tax for purposes of applying Sec. 705(a)(1)(B). As a result, a basis adjustment to a domestic corporate partner's interest in a domestic partnership would not be appropriate to account for a Sec. 250 deduction.

Tax-exempt corporations

The proposed regs clarify that such corporation's FDII for this purpose is determined only with respect to the corporation's items of income, gain, deduction or loss, and adjusted bases in property. These are considered in calculating its unrelated business taxable income.

The proposed regs also clarify how a tax-exempt corporation subject to the unrelated business income tax under Sec. 511 would calculate the dual use ratio without respect to property used in the production of gross DEI and income that isn't gross DEI for purposes of determining its QBAI.

Determination of QBAI

A domestic corporation's QBAI for FDII would be equal to its aggregate average adjusted bases in specified tangible property, which is defined as tangible property used in the production of gross DEI. The proposed regs also provide rules for dual use property, calculating QBAI in a short tax year and calculating a domestic corporate partner's share of partnership QBAI.

For purposes of calculating a domestic corporation's QBAI, the proposed regs would disregard a transfer of specified tangible property by the domestic corporation to a related party whose QBAI wouldn't be considered in calculating the corporation's DTIR if:

- Within a two-year period beginning one year before the transfer, the domestic corporation or a related party whose QBAI would be considered in calculating the corporation's DTIR leases the same or substantially similar property from a related party, and
- Such transfer and lease occurs pursuant to a principal purpose of reducing the domestic corporation's DTIR.

Such a transfer and lease would be treated per se as occurring pursuant to a principal purpose of reducing a domestic corporation's DTIR if both the transfer and the lease occur within the same six-month period. If this antiavoidance rule applies, the domestic corporation that transferred the property would be treated as owning such property from the later of the beginning of the lease term or date of the transfer until the earlier of the end of the lease term or the end of the recovery period of the transferred property.

The antiavoidance rule wouldn't apply to a transfer to and lease from an unrelated party, unless it was pursuant to a structured arrangement. A structured arrangement would exist only if either a reduction in the domestic corporation's DTIR is a material factor in the pricing of the arrangement with the transferee or, based on all the facts and circumstances, the reduction in the domestic corporation's DTIR is a principal purpose of the arrangement. The proposed regs provide a noninclusive list of facts and circumstances indicating that a principal purpose of an arrangement is the reduction of DTIR.

FDDEI transactions

The proposed regs provide general rules for determining gross income included in gross FDDEI, which is a component of the computation of FDII. They would define a FDDEI sale as a sale of property to a foreign person for a foreign use. For purposes of determining whether a sale of property is a FDDEI sale, the proposed regs define "sale" to include a lease, license, exchange or other disposition of property, including a transfer of property resulting in gain or an income inclusion under Sec. 367.

Under the proposed regs, a foreign person is defined as a person that isn't a U.S. person. This includes a foreign government or international organization for purposes of the proposed regs. To prevent the disparate treatment of sales to entities in a U.S. territory (potentially qualifying as a FDDEI sale) and sales to individuals in a U.S. territory (not qualifying as a FDDEI sale), the proposed regs exclude bona fide residents of a U.S. territory from the definition of U.S. person.

A partnership is generally a "person" for purposes of the Internal Revenue Code. And so, in determining whether a sale of property to or by a partnership qualifies as a FDDEI sale, or the provision of a service to or by a partnership qualifies as a FDDEI service, the proposed regs treat a partnership as a person.

Knowledge and reason to know

A sale of property qualifies under the proposed regs as a FDDEI sale only if the seller or renderer doesn't know or have reason to know that the recipient isn't a foreign person or that the property won't be for a foreign use. The proposed regs provide that the provision of a general service qualifies as a FDDEI service only if the renderer of the service doesn't know or have reason to know that the recipient is in the United States.

Reliability of documentation

For a transaction to constitute a FDDEI transaction, the proposed regs prescribe different types of documentation that would be required for each type of transaction.

For example, in the case of a sale of property, the seller would have to obtain proof that establishes the recipient's status as a foreign person. The proposed regs provide that, for any documentation described in the proposed regs to be relied upon:

- The seller or renderer must obtain it by the FDII filing date,
- The documentation must be obtained no earlier than one year before the sale or service, and
- The seller or renderer must not know or have reason to know that the documentation is incorrect or unreliable.

Transactions consisting of both sales and services

Under the tax code and the proposed regs, the criteria for establishing that a transaction is foreign-derived is different for sales and services. For example, a transaction with a U.S. person located outside of the United States may qualify as a FDDEI service, but it cannot qualify as a FDDEI sale. Because a transaction might include elements of both a sale and a service, the proposed regs clarify that a transaction is classified according to the overall predominant character of the transaction.

Certain loss transactions

The IRS concluded that it would be inappropriate to allow taxpayers to elect to exclude losses related to sales to foreign persons for a foreign use and services to persons located outside the United States by merely failing the documentation requirements.

Accordingly, the proposed regs provide that, if a seller or renderer 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 U.S. — but the seller or renderer doesn’t satisfy the documentation requirements applicable to such sale or service — the sale of property or provision of a service is nonetheless deemed a FDDEI transaction if treating the sale or service as a FDDEI transaction would reduce a domestic corporation’s FDDEI.

This special loss transaction rule wouldn’t apply to proximate services, property services and transportation services, as defined in the proposed regs. This is because they don’t require documentation with respect to such services.

FDDEI services

Under the proposed regs, whether a service is provided to a person or property located outside the United States would depend on the type of service provided and, in the case of a general service, the type of recipient. The proposed regs distinguish between:

- Services where the provider (or renderer) and the recipient are in physical proximity when the service is performed (proximate services),
- Property services with respect to tangible property,
- Transportation services to transport people or property, and
- All other general services.

For purposes of determining whether a service constitutes a FDDEI service, the proposed regs look to the location or origin of the above services.

Domestic intermediary rules

Sec. 250(b)(5)(B)(i) provides that, if a taxpayer sells property to another person (other than a related party) for further manufacture or other modification in the United States, the property isn’t treated as sold for a foreign use even if the other person subsequently uses such property for a foreign use. With respect to property sales, the proposed regs provide that general property isn’t for a foreign use if, before being subject to manufacture, assembly or other processing outside the United States, the property is subject to a domestic use.

For this purpose, domestic use would include manufacture, assembly or other processing within the United States. In addition, a sale of property to a U.S. person can't qualify as a FDDEI sale under any circumstance. Therefore, a property sale to a foreign person for further manufacture in the United States or to a U.S. person wouldn't qualify for a FDDEI sale, regardless of the ultimate use of the property.

With respect to services, the proposed regs provide that a service is a FDDEI service only if the recipient, or the property to which the service relates, is located outside the United States. Accordingly, a service provided to a person or property located in the United States wouldn't be a FDDEI service, regardless of the ultimate use of the service.

Related party transactions

A property sale or a provision of a service may qualify as a FDDEI transaction, regardless of whether the recipient of such service is a related party of the seller or renderer. However, in the case of a general property sale or a provision of a general service to a related party, additional requirements must be satisfied for the transaction to qualify as a FDDEI sale or FDDEI service.

These requirements must be satisfied in addition to the general requirements that apply to such sales and services as provided in Prop. Reg. Sec. 1.250(b)-3 through Prop. Reg. Sec. 1.250(b)-5. The proposed regulations would define a related party with respect to any person as any member of a modified affiliated group that includes such person. A modified affiliated group would be defined as an affiliated group as provided in Sec. 1504(a) by substituting "more than 50%" for "at least 80%" each place it appears, and without regard to Sec. 1504(b)(2) and (3). A modified affiliated group would also include any person other than a corporation who's controlled by one or more members of a modified affiliated group or that controls such a member.

Related party sales

The tax code provides that property sold to a related party that is not a U.S. person "shall not be treated as for a foreign use unless (I) such property is ultimately sold by a related party, or used by a related party in connection with property which is sold or the provision of services, to another person who is an unrelated party who is not a United States person, and (II) the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use."

Under the proposed regs, if a foreign related party resells the purchased property (such as where the foreign related party is a distributor or a manufacturer of a product that incorporates the purchased property as a component), the sale to the foreign related party qualifies as a FDDEI sale only if an unrelated party transaction with respect to such sale occurs and the unrelated party transaction is a FDDEI sale. An unrelated party transaction would generally be a transaction between the foreign related party and an unrelated foreign person in which the property purchased by the foreign related party is sold or used.

The unrelated party sale generally would have to occur on or before the FDII filing date; otherwise, the gross income from the related party sale would be included in the domestic corporation's gross DEI for the taxable year of the related party sale, but wouldn't be included in its gross FDDEI.

For transactions other than the resale of purchased property, the property sale wouldn't qualify as a FDDEI sale unless, as of the FDII filing date, the seller reasonably expects that more than 80% of the revenue earned by the foreign related party from the use of the property in all transactions will be earned from unrelated party transactions that are FDDEI.

The rules applicable to related party sales would apply only to determine whether sales of general property qualify as FDDEI sales. Sales of intangible property, whether to a related or an unrelated party, would be for a foreign use only to the extent that the intangible property generated revenue from exploitation outside the United States.

Related party services

The tax code provides that a service provided to a related party not located in the United States “shall not be treated [as a FDDEI service] unless the taxpayer establishe[s] to the satisfaction of the Secretary that such service is not substantially similar to services provided by such related party to persons located within the United States.”

Accordingly, the proposed regs generally provide that a provision of a general service to a business recipient that’s a related party would qualify as a FDDEI service only if the service isn’t substantially like one provided by the related party to persons located within the United States. The proposed regulations stipulate that the related party services rule applies only to determine whether a general service provided to a business recipient that is a related party is a FDDEI service.

A service provided by a renderer to a related party would be “substantially similar” to one provided by the related party to a person located within the United States if the renderer’s service (or “related party service”) is used by the related party to provide a service to a person located within the United States and either a “benefit test” or a “price test” is satisfied.

The benefit test would be satisfied if 60% or more of the benefits conferred by the related party service were to persons located within the United States. Therefore, a related party service would provide a benefit to a customer of the related party if it provided “a reasonably identifiable increment of economic or commercial value” to the customer, rather than an indirect or remote benefit.

Under the price test, a service provided by a renderer to a related party would be “substantially similar” to one provided by the related party to a person located within the United States if:

- The renderer’s service was used by the related party to provide a service to a person located within the United States, and
- 60% or more of the price that persons located within the United States pay for the service provided by the related party was attributable to the renderer’s service.

If a related party service is treated as substantially similar to one provided by the related party to a person located within the United States solely because of the price test, the general rule that wholly disqualifies the related party service as a FDDEI service wouldn’t apply. Rather, a portion of the gross income from the related party service would be treated as a FDDEI service corresponding to the ratio of benefits conferred by the related party service to persons not located within the United States to the sum of all benefits conferred by the related party service.

Applicability dates

Prop. Reg. Sec. 1.250(b)(1) through Prop. Reg. Sec. 1.250(b)(6) are proposed to apply to tax years ending on or after March 4, 2019. However, the IRS recognizes that rules may apply to transactions that have occurred before the filing of the proposed regulations and that taxpayers may not be able to obtain the documentation required for already-complete transactions.

Accordingly, for taxable years beginning on or before March 4, 2019, taxpayers may use any reasonable documentation maintained in the ordinary course of the taxpayer’s business that establishes that:

- A recipient is a foreign person,
- Property is for a foreign use under the proposed regs, or

- A recipient of a general service is located outside the United States within the meaning of the applicable proposed regs and in lieu of the documentation required by the proposed regs, provided that such documentation meets the reliability requirements.

Reasonable documentation includes, but isn't limited to, documents described in or similar to those described in the applicable proposed regs. For this purpose, reasonable proof also includes the documentation described in the special rules for small businesses and small transactions in the proposed regs — even if the taxpayer wouldn't otherwise qualify for the special rules. Taxpayers may rely on Prop. Reg. Sec. 1.250(b)-1 through Prop. Reg. Sec. 1.250(b)-6 for taxable years ending before March 4, 2019.

Important development

The FDII and GILTI deduction is an important development for the corporations and, in some cases, individuals who may be able to claim it. Consult your CPA on whether and how it may apply to you. •