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Final FDII Rules Reduce Burden, Delay Applicability: Tax Insight

By Amanda Varma and Lauren Azebu | August 3, 2020 3:01AM ET

On July 9, 2020, Treasury and the IRS released final regulations under tax code Section 250, providing guidance on the deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).

The final regulations (T.D. 9901, 85 Fed. Reg. 43042), which were published in the Federal Register on July 15, generally reduce certain documentation burdens. The regulations also provide greater flexibility in other areas, such as with respect to the taxable income limitation, and certain helpful clarifications. Through a delayed applicability date of 2021, the final regulations also provide some additional time to implement policies and procedures as compared to the proposed regulations (which were proposed to apply to taxable years ending on or after March 4, 2019). However, the regulations also add certain new rules, such as with respect to advertising services and electronically supplied services, that may raise questions for impacted taxpayers.

Overall, the more flexible approach is responsive to concerns that the documentation requirements of the proposed regulations could require significant changes to business processes and potentially impair customer relationships. However, certain types of transactions (sales of general property to resellers and manufacturers, sales of intangible property, and the provision of general services to business recipients) are still subject to specific substantiation requirements that may require contractual changes or information from customers.

This article contains an overview of some of the most significant changes made by the final regulations and certain practical implications for taxpayers. Taxpayers need to assess the revised substantiation requirements and operative rules and determine whether changes to existing processes are needed. In addition, given the delayed applicability date, taxpayers should assess their pre-2021 positions to determine whether to apply a reasonable interpretation of the statute or, as permitted by the preamble to the final regulations, rely on the proposed or final regulations. Taxpayers potentially impacted by the taxable income limitation should evaluate the opportunity to use a reasonable method to coordinate various tax code provisions. In addition, taxpayers should monitor the expected upcoming final regulations under Treasury Regulation Section 1.861-17 regarding allocation and apportionment of R&E expenses given the potential interaction of those rules and the FDII and GILTI regimes.

OVERVIEW OF SECTION 250 AND THE PROPOSED REGULATIONS

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Section 250 was enacted in 2017 as part of the Tax Cuts and Jobs Act (TCJA). Subject to a taxable income limitation, Section 250 allows a domestic C corporation to deduct an amount equal to the sum of 37.5% of its FDII, plus 50% of its GILTI inclusion (as computed under tax code Section 951A). For taxable years beginning after Dec. 31, 2025, the deduction for FDII is reduced to 21.875% and the deduction for GILTI is reduced to 37.5%.

The general formula for the FDII deduction can be summarized as follows:

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\textit{Foreign–Derived Deduction Eligible Income}}{\textit{Deduction Eligible Income}}$$

In general terms, "deemed intangible income" is equal to the excess of deduction eligible income (DEI) over deemed tangible income return (DTIR), which is a fixed return of 10% on "qualified business asset investment" (QBAI). DEI is gross income without regard to excluded income (Subpart F and GILTI inclusions, financial services income, controlled foreign corporation dividends, domestic oil and gas extraction income, and foreign branch income), minus properly allocable deductions. QBAI is determined as the average of the adjusted U.S. tax basis (determined at the end of each quarter of a tax year) in specified tangible property that is used in a trade or business and is subject to U.S. tax depreciation. "Foreign-derived deduction eligible income" (FDDEI) is equal to gross FDDEI over properly allocable deductions, with gross FDDEI being the portion of gross DEI derived from foreign-derived sales and services.

Proposed regulations released on March 4, 2019, addressed numerous issues, including computational rules for the determination of FDII and general rules for identifying FDDEI sales and FDDEI services. The proposed regulations were to apply to taxable years ending on or after March 4, 2019.

The proposed regulations required taxpayers to obtain certain specified documentation with respect to FDDEI sales and certain services referred to as "general services." For FDDEI sales, taxpayers were required to obtain documentation establishing both foreign use and the recipient's status as a foreign person. For general services to consumers or business recipients, taxpayers were required to obtain documentation to establish that the recipient was located outside of the U.S. The proposed regulations also imposed additional requirements with respect to the "reliability" of the documentation. Under a transition rule for tax years beginning on or before March 4, 2019, taxpayers could satisfy the documentation requirements with any reasonable documentation maintained in the ordinary course of the taxpayer's business, provided that such documentation met certain requirements.

FINAL REGULATIONS

Transition Rules and Applicability Dates (Treas. Reg. Section 1.250-1)

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The final regulations are generally applicable to tax years beginning on or after Jan. 1, 2021, giving taxpayers additional time to develop systems and procedures for complying with the regulations. The preamble to the final regulations states that taxpayers may choose to apply the final regulations to tax years beginning before Jan. 1, 2021, provided that taxpayers apply the final regulations in their entirety (with the exception of certain substantiation requirements). The preamble also states that taxpayers are permitted to rely on the proposed regulations in their entirety for tax years beginning before Jan. 1, 2021, except that taxpayers relying on the proposed regulations may rely on the transition rule for documentation for all taxable years beginning before Jan. 1, 2021 (rather than only for taxable years beginning on or before March 4, 2019).

Thus, taxpayers have some flexibility for tax years beginning before Jan. 1, 2021, and should consider positions that apply a reasonable interpretation of the statute, the proposed regulations, or the final regulations as described above.

Computation of FDII

- **Taxable Income Limitation (Treas. Reg. Section 1.250(a)-1(c))**

Like several other tax code provisions, the Section 250 deduction is subject to a taxable income limitation. The proposed regulations provided an ordering rule stating that a taxpayer's taxable income for purposes of applying the Section 250(a)(2) limitation is determined after all other deductions are taken into account (with no distinction between pre-TCJA and post-TCJA net operating losses). The final regulations continue not to distinguish between pre- and post-TCJA losses.

With respect to ordering, Treasury and the IRS determined that further study was required. The preamble states that Treasury and the IRS are considering a separate guidance project to address the interaction of tax code Sections 163(j), 172, 250(a)(2), and other tax code sections that refer to taxable income and that such guidance may include the use of simultaneous equations rather than an ordering rule. Until guidance is issued, taxpayers may choose any reasonable method as long as it is applied consistently for all taxable years beginning on or after Jan. 1, 2021. Thus, taxpayers that may be subject to limitation under other tax code provisions that have a taxable income limitation should consider the impact of different methods.

- **Cost of Goods Sold Allocation (Treas. Reg. Section 1.250(b)-1(d)(1))**

Under the proposed regulations, for purposes of determining the gross income included in gross DEI and gross FDDEI, cost of goods sold is attributed to gross receipts with respect to gross DEI or gross FDDEI under any reasonable method. The final regulations retain this approach and clarify that the method chosen by the taxpayer must be consistently applied.

- **Deductions Properly Allocable to Gross DEI and Gross FDDEI (Treas. Reg. Section 1.250(b)-1(d)(2))**

Like the proposed regulations, the final regulations treat Section 250(b) as an operative section under the allocation and apportionment rules in the tax code Section 861 regulations. Gross FDDEI and gross residual deduction eligible income ("RDEI," renamed from the term "gross non-FDDEI" used in the proposed regulations) are treated as separate statutory groupings. However, the final regulations remove the provision in the proposed regulations stating that the exclusive apportionment rules in Treas. Reg. Section 1.861-17(b) do not apply for purposes of apportioning research and experimentation (R&E) expenses to gross DEI and gross FDDEI. Under Treas. Reg. Section 1.861-17(b), "where an apportionment based upon geographic sources of income" of R&E expenditures is needed, an exclusive apportionment of R&E expenditures is made if activities representing more than 50% of the R&E

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expenditures were performed in a particular geographic location, such as the U.S.

The preamble notes that Treasury and the IRS will consider the issues raised regarding the application of exclusive apportionment for purposes of Section 250, as well as comments regarding the applicability of the gross income method of allocating R&E expenses, as part of finalizing the proposed regulations under Treas. Reg. Section 1.861-17, issued on Dec. 17, 2019. Those regulations may be finalized this year, and were proposed to apply to taxable years beginning after Dec. 31, 2019. Under Prop. Treas. Reg. Section 1.861-17, R&E expenditures would not be assigned to the Section 951A (GILTI) foreign tax credit basket. Because Section 951A inclusions are excluded from DEI, the approach of the proposed regulations would generally lead to greater amounts of R&E expenses being allocated to FDII. Some commentators have argued that, to achieve parity between GILTI and FDII, R&E expenses should not be allocated to DEI, or other rules should be adopted to mitigate the impact, such as providing in the final regulations that exclusive apportionment applies to FDII.

The final regulations also clarify that for purposes of determining the deductions of a domestic corporation for a taxable year properly allocable to gross DEI and gross FDDEI, the deductions are determined without regard to Sections 163(j), 170(b)(2), 172, 246(b), and 250.

- **Consolidated Groups and Partnerships (Treas. Reg. Sections 1.250(a)-1(e), 1.250(b)-1(e) and -3(e))**

Like the proposed regulations, the final regulations require aggregation of consolidated group members' amounts of DEI, FDDEI, DTIR, and GILTI for Section 250 purposes. These amounts then are used to calculate the group's FDII and Section 250 deduction. Such amounts are then allocated to group members based on respective contribution of consolidated FDDEI and GILTI. The preamble to the final regulations requests comments on the application of the Section 250 deduction in the life-nonlife consolidated group context.

The final regulations also retain an entity approach for purposes of determining whether a sale of property to or by a partnership or a provision of a service to or by a partnership is a FDDEI transaction. Like the proposed regulations, the final regulations require a partnership that has one or more direct partners that are domestic corporations to furnish on Schedules K-1 the partners' shares of the partnership's gross DEI, gross FDDEI, deductions properly allocable to the partnership's gross DEI and gross FEDDI, and partnership QBAI for each taxable year. In the case of tiered partnerships in which one or more partners of the upper-tier partnership are domestic corporations, the lower-tier partnership must report the required information to the upper-tier partnership to allow reporting of the information to any partner that is a domestic corporation.

FDDEI Transactions

As stated above, a taxpayer's FDDEI is equal to gross FDDEI over properly allocable deductions, with gross FDDEI being the portion of gross DEI derived from FDDEI transactions, *i.e.*, FDDEI sales and FDDEI services. The regulations make several important changes with respect to the scope of FDDEI sales and FDDEI services, as well as with respect to the substantiation or documentation required to establish qualification as a FDDEI sale or service.

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- **Foreign Military Sales and Services (Treas. Reg. Section 1.250-3(c))**

The statute does not specifically address the treatment of foreign military sales and services, *i.e.*, sales or services that ultimately for the benefit of a foreign government but are technically provided to the U.S. government by the taxpayer as required by certain statutes, including the Arms Export Control Act. The proposed regulations provided that, for purposes of Section 250, a sale of property or provision of service to the U.S. government under the Arms Export Control Act is treated as a sale or provision of service to a foreign government, subject to certain conditions.

The final regulations make several helpful changes in response to comments. The regulations remove the requirement in the proposed regulations that the resale or on-service to a foreign government must be made "on commercial terms," a phrase that commentators had argued was ambiguous and something that the taxpayer may not be able to assess. The regulations also remove the requirement that the contract between the taxpayer and the U.S. government specifically refer to the resale or on-service to the foreign government.

In response to comments noting that there is not necessarily one particular type of documentation that would always indicate that a sale is a foreign military sale, the final regulations do not require any particular documentation to substantiate that a transaction qualifies as foreign military sale or service.

- **Documentation Relief (Treas. Reg. Section 1.250-3(f))**

In response to comments noting the difficulties of requiring specific documentation given variations in industry practices, the final regulations eliminate specific documentation requirements to establish foreign person status and foreign use with respect to certain sales of general property and the location of a consumer of a general service.

As discussed below, in the case of foreign use with respect to sales of general property to resellers and manufacturers, foreign use with respect to sales of intangible property, whether services are performed for business recipients located outside the U.S., the regulations require specific "substantiation" in lieu of specific documentation requirements. Substantiating documents must be in existence as of the FDII filing date provided to the IRS upon request, generally within 30 days or some other period agreed upon by the IRS and the taxpayer.

To the extent that the rules in the final FDII regulations do not contain specific substantiation requirements with respect to a transaction, a taxpayer still will be required to substantiate that it is entitled to a deduction as required under tax code Section 6001.

The proposed regulations provided that the seller or renderer must not know or

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have reason to know that the documentation is incorrect or unreliable. The knowledge or reason to know standard is retained in the final regulations with respect to the treatment of certain loss transactions, the foreign person requirement, general property incorporated into a product as a component, a sale of intangible property consisting of a manufacturing method or process to a foreign unrelated party, and general services provided to consumers. The final regulations generally provide that a taxpayer has reason to know that a transaction fails to satisfy a substantiation requirement if the information that the taxpayer receives as part of the sales process contains information that indicates that the substantive requirement is not met and, after making reasonable efforts, the taxpayer cannot establish that the substantive requirement is met.

FDDEI Sales

Under the final regulations, a FDDEI sale is generally defined as a sale of general property or intangible property to a recipient that is a foreign person and that is for a foreign use. As stated above, while the proposed regulations generally required certain documentation to establish that the foreign person and foreign use requirements are satisfied, the final regulations take a more flexible approach, including providing certain presumptions and providing specific substantiation requirements only in certain cases.

- **Definitions of “General Property” and “Intangible Property” (Treas. Reg. Section 1.250(b)-3(b))**

Under the final regulations, the term general property means any property other than intangible property, a security (as defined in tax code Section 475(c)(2)), an interest in a partnership, trust, or estate, a commodity described in Section 475(e)(2)(A) that is not a physical commodity, or a commodity described in Section 475(e)(2)(B) through (D).

Under the proposed regulations, any commodity described in Section 475(e)(2)(B) through (D) was excluded from the definition of “general property.” The final regulations modify the definition of “general property” to clarify that physical commodities described in Section 475(e)(2)(A) are treated as general property, including if they are sold pursuant to a forward or option contract (but not a tax code Section 1256 contract or similar contract that is traded and cleared like a Section 1256 contract) that is physically settled by delivery of the commodity, provided that the taxpayer physically settled the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances.

An interest in a corporation is a security under Section 475(c)(2)(A) and therefore is excluded from the definition of “general property.” The final regulations further provide that an interest in a partnership, estate, or trust is not general property. The preamble states that partnership interests are not the type of property that can be subject to “any use, consumption, or disposition outside the United States,” and a look-through approach would be inconsistent with the fact that title to the partnership’s property does not change upon the sale of a partnership interest.

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Like the proposed regulations, the final regulations define "intangible property" by cross-reference to tax code Section 367(d)(4), but clarify that "intangible property" for purposes of Section 250 does not include a copyrighted article as defined in Treas. Reg. Section 1.861-18(c)(3). The preamble provides that determination of whether the transfer of a copyrighted article is characterized as a sale or service for purposes of Section 250 is based on general U.S. tax principles, taking into account the Section 861 proposed regulations released in August 2019 on the classification of cloud transactions and transactions involving digital content.

- **Presumptions as to "Foreign Person" (Treas. Reg. Section 1.250-4(c))**

The proposed regulations generally required a seller to establish that the recipient is a foreign person by obtaining certain documentation. Under the final regulations, a sale of property is presumed made to a foreign person if:

1. It is a foreign retail sale (*i.e.*, a sale of general property to a recipient that acquires general property at a physical retail location outside the U.S.);

2. In the case of general property that is not sold in a foreign retail sale and is delivered to the recipient or end user, the shipping address of the recipient or end user is outside the U.S.;

3. In the case of general property that is not sold in a foreign retail sale or delivered overseas, the billing address of the recipient is outside the U.S.; or

4. In the case of sales of intangible property, the billing address of the recipient is outside the U.S.

The presumption as to foreign person status does not apply if the seller knows or has reason to know that the sale is to a recipient other than a foreign person. A seller knows or has reason to know that a sale is to a recipient other than a foreign person if the information received as part of the sales process contains information that indicates that 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. Information that indicates that a recipient is not a foreign person includes, but is not limited to, a U.S. phone number, billing address, shipping address, place of residence, or evidence that the entity was organized in the U.S.

Other than the special rule for foreign military sales, which is appropriate given that U.S. law requires that such sales be made to the U.S. government, the final regulations do not provide special rules for sales or licenses made through a U.S. person that may be treated as an intermediary.

- **"Foreign Use" (Treas. Reg. Section 1.250-4(d))**

The proposed regulations provided that a sale of general property is for foreign use if the property is not subject to domestic use within three years of delivery or the property is subject to manufacture, assembly, or other processing outside the U.S. before being subject to a domestic use. Certain documentation was generally required to establish foreign use.

The final regulations provide that sale of general property is for a foreign use if the seller determines that the sale is to an end user in one of the following categories:

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1. A sale (including a sale of digital content transferred in a physical medium) to a recipient that is delivered by a freight forwarder or carrier to an end user if the end user receives delivery of the general property outside the U.S. (subject to an anti-abuse rule);

2. Where a sale is not delivered through a carrier or freight forwarder, a sale (including a sale of digital content transferred in a physical medium) to an end user where the property is located outside the U.S. at the time of the sale (including a foreign retail sale);

3. A sale (including a sale of digital content transferred in a physical medium) to a recipient such as a distributor or retailer that will resell the general property, if the seller determines that the general property will ultimately be sold to end users outside the U.S. (and such sales to end users outside the U.S. are substantiated);

4. A sale of digital content that is transferred electronically if sold to an end user that downloads, installs, receives, or accesses the digital content on the end user's device outside of the U.S.; and

5. A sale of international transportation property if, in the case of property used for compensation or hire, the end user registers the property in a foreign jurisdiction, or, in the case of property not used for compensation or hire, if the end user registers the property in a foreign jurisdiction and hangars or stores the property primarily outside the U.S.

In addition, a sale of general property is for foreign use if the sale is to a foreign unrelated party that subjects the property to manufacture, assembly, or other processing outside the U.S. and certain substantiation requirements are satisfied. Property is subject to manufacture, assembly, or other processing only if the property is physically and materially changed or the property is incorporated as a component into another product.

The final regulations state that whether general property is subject to a physical and material change is determined based on all the relevant facts and circumstances. The regulations further provide that general 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."

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General property is considered a component incorporated into another product if the incorporation of the general property into the other product involves activities that are "substantial in nature and generally considered to constitute the manufacture, assembly, or processing of property based on all the relevant facts and circumstances." However, general property is not considered a component incorporated into another product if it is subject only to packaging, repackaging, labeling, or minor assembly operations. In addition to the general component standard, the final regulations also contain a safe harbor using a numerical threshold. General property is treated as a component if the seller expects, using reliable estimates, that the fair market value of the property when it is delivered to the recipient will constitute no more than 20% of the fair market value of the finished good into which the general property is directly or indirectly incorporated when the finished good is sold to end users. If the property could be incorporated into a number of different finished goods, a reliable estimate of the fair market value of the finished good may include the average fair market value of a representative range of such goods.

Where a seller sells general property to a recipient (other than a related party) for manufacturing, assembly, or other processing within the U.S., the final regulations provide that such property is not sold for a foreign use even if the requirements described above are subsequently satisfied. (As described below, a separate set of rules applies to sales of general property to related foreign persons.)

- **"Foreign Use" of Intangible Property (Treas. Reg. Section 1.250-4(d))**

The proposed regulations provided that a sale of intangible property is for a foreign use to the extent the intangible property generates revenue from exploitation outside the U.S., which is generally determined based on the location of end users purchasing products for which the intangible property was used in development, manufacture, sale or distribution. The final regulations clarify that the end user is the person that ultimately uses or consumes the property, or the person that acquires the property in a foreign retail sale. A person who acquires the property for resale or otherwise as an intermediary is not an end user. The final regulations also incorporate the concept of an end user into the rules for determining whether a sale of general property, in addition to intangible property, is for a foreign use.

The final regulations provide guidance on determining where revenue is earned from end users of the intangible property, including rules for intangible property embedded in general property or used in connection with the sale of general property, intangible property used to provide services, and intangible property used in research and development. The final regulations generally place the location of use of the intangible property with the location of the end user, who is generally the person who ultimately uses the general property in which the intangible property is embedded or associated with, or, if the intangible property is used to provide a service, the service recipient.

- **Foreign Use Substantiation for Certain Sales of Property (Treas. Reg. Section 1.250(b)-4(d)(3))**

As discussed above, the final regulations remove the specific documentation requirements of the proposed regulations. However, the final regulations contain specific substantiation requirements for certain situations.

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With respect to property sold for resale, a seller satisfies the substantiation requirements only if the seller maintains one of the following items:

1. A binding contract that specifically limits subsequent sales to sales outside the U.S.;

2. Proof that property is specifically designed, labeled, or adapted for a foreign market;

3. Proof that the cost of shipping the property back to the U.S. relative to the value of the property makes it impractical that the property will be resold in the U.S.;

4. Credible evidence obtained or created in the ordinary course of business from the recipient evidencing that property will be sold to an end user outside the U.S. (or, in the case of fungible mass property, stating what portion of the property will be sold to end users outside the U.S.); or

5. A written statement prepared by the seller containing certain specified information corroborated by "credible and sufficient" evidence.

With respect to property sold to manufacturers, the substantiation requirements are met if a taxpayer maintains credible evidence that the property has been sold to a foreign unrelated party that is a manufacturer and such property generally cannot be sold to end users without being subject to a physical and material change, credible evidence obtained or created in the ordinary course of business from the recipient to support that the product purchased will be subject to manufacture, assembly, or other processing outside the U.S., or a written statement prepared by the seller containing certain specified information corroborated by credible and sufficient evidence.

The final regulations also require a taxpayer to substantiate foreign use for sales of intangible property. A taxpayer may satisfy the substantiation requirement by maintaining a binding contract that specifically provides that the intangible property can be exploited solely outside the U.S., credible evidence obtained or created in the ordinary course of business from the recipient establishing the portion of its revenue for a taxable year that was derived from exploiting the intangible property outside the U.S., or a written statement prepared by the seller containing certain specified information corroborated by credible and sufficient evidence.

Given these substantiation requirements, taxpayers selling property in the above categories may need to modify their current business practices in order to satisfy the substantiation requirement, such as by amending contractual language or obtaining certain information or statements from the counterparties.

- **FDDEI Services**

Like the proposed regulations, the final regulations provide five categories of services that are considered FDDEI services. Under the final regulations, a FDDEI service is the provision of one of the following:

1. A general service to a consumer located outside the U.S.;

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2. A general service to a business recipient located outside the U.S.;

3. A proximate service to a recipient located outside the U.S.;

4. A property service with respect to tangible property located outside the U.S.; or

5. A transportation service to a recipient, or with respect to property, located outside the U.S.

As is the case with respect to FDDEI sales, the final regulations impose less onerous documentation requirements than the proposed regulations as discussed below.

a. General Services to Consumers (Treas. Reg. Section 1.250(b)-5(d))
Under the final regulations, a general service is provided to a consumer located outside the U.S. if the consumer of a general service resides outside of the U.S. when the service is provided. Unlike the proposed regulations, the final regulations do not include specific documentation requirements for general services to consumers. The final regulations provide that if the renderer does not have (or cannot after reasonable efforts obtain) the consumer's location of residence when the service is provided, the consumer of a general service is treated as residing outside the U.S. if the consumer's billing address is outside of the U.S. However, this rule does not apply if the renderer knows or has reason to know that the consumer does not reside outside the U.S.

As discussed below, the final regulations also provide a new rule for electronically supplied services. The final regulations state that the consumer of an electronically supplied service is deemed to reside at the location of the device used to receive the service, which may be determined based on the location of the IP address when the service is provided. If the renderer does not have or cannot after reasonable efforts obtain the consumer's device location, the location of the device is determined based on the renderer's billing address for the consumer, unless the renderer has knowledge or reason to know otherwise.

b. General Services to Business Recipients (Treas. Reg. Section 1.250(b)-5(e))
The final regulations provide that a general service is provided to a business recipient located outside the U.S. to the extent that the service confers a benefit on the business

recipient's operations outside the U.S. The location of residence, incorporation, or

formation of a business recipient is not relevant to determining the location of the business recipient's operations that benefit from a general service.

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A business recipient is generally treated as having operations in any location where it maintains an office or other fixed place of business. The final regulations clarify that an office or other fixed place of business is generally a fixed facility through which the business recipient engages in a trade or business. If the business recipient does not have an identifiable office or fixed place of business, the business recipient is deemed to be located at its primary billing address.

The determination of which operations of the business recipient located outside the U.S. benefit from a general service, and the extent to which such operations benefit, is made under the principles of Treas. Reg. Section 1.482-9, which governs transfer pricing of controlled services transactions, a term defined as including any activity that results in a "benefit," by treating the taxpayer as one controlled taxpayer, the portions of the business recipient's operations within the U.S. (if any) that may benefit from the service as one or more controlled taxpayers, and the portions of the business recipient's operations outside the U.S. (if any) that may benefit from the service each as one or more controlled taxpayers. The determination of the amount of the benefit conferred on the business recipient's operations is determined under a reasonable method consistent with the principles of Section 1.482–9(k).

In response to a comment arguing that transfer pricing rules should not be incorporated into the FDII regime, the preamble states that Treasury and the IRS do not intend that the use of tax code Section 482 regulations be interpreted "as suggesting that taxpayers are required to perform a transfer pricing-like analysis of the recipient's operations" but rather decided to use an existing tax concept to clarify that a service confers a benefit only if an uncontrolled party with similar operations would pay for the service under comparable circumstances.

The final regulations provide for two sub-categories of general services that may be provided by business recipients—advertising services and electronically supplied services—and provide rules on where the operations of the business recipient that benefit from advertising are deemed to be located. Given that these categories were not included in the proposed regulations, taxpayers supplying these types of services need to consider the new operative rules, whether the rules change their ability to treat certain income as foreign-derived, and whether the new rules would compel taxpayers to make operational changes to, for example, determine where services are "accessed" in the case of electronically supplied services.

With respect to advertising services, which are defined as general services that consist primarily of transmitting or displaying content to consumers with a purpose to generate revenue based on the promotion of a product or services, operations that benefit are deemed to be located where the advertisements are viewed by individuals, essentially using place of viewing as a proxy for the location(s) of the business recipient benefiting from the service. If the advertisements are displayed on the internet, the services are viewed at the location of the device on which the advertisements are viewed.

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As is the case with respect to general services provided to consumers, there is a special rule for general services that are electronically supplied. Electronically supplied services are defined as general services (other than advertising services) that are delivered primarily over the internet or an electronic network. The operations of the business recipient that benefit from the service are generally deemed to be located where the business recipient (including employees, contractors, or agents) accesses the services.

The final regulations replace the documentation requirements for general services provided to business recipients with the requirement that the taxpayer substantiate its determination of the extent to which the service benefits a business recipient's operations outside the U.S. A renderer satisfies the requirements if the renderer maintains credible evidence obtained or created in the ordinary course of business from the business recipient establishing the extent to which operations of the business recipient outside the U.S. benefit from the service or a written statement prepared by the renderer containing certain specified information that is corroborated by credible and sufficient evidence. The preamble indicates credible evidence obtained or created in the ordinary course of business could include statements made by the recipient regarding the need for the service or data on the sales of the business recipient's operations or the taxpayer's own records. Alternatively, the substantiation requirements may be satisfied by a written statement prepared by the seller containing certain information corroborated by credible and sufficient evidence. In contrast with the proposed regulations, the final regulations do not explicitly permit taxpayers to rely on publicly available information to substantiate the location of a business recipient's operations.

c. Property Services Provided With Respect to Property Temporarily in the U.S. (Treas. Reg. Section 1.250(b)-5(g)(2))

The proposed regulations provided that a property service is a FDDEI service only if the tangible property with respect to which the service is performed is located outside the U.S. for the duration of the period of performance. The final regulations provide, however, that a property service is deemed to be provided with respect to tangible property located outside the U.S. if the property is temporarily located in the U.S. for the purpose of receiving the service, after completion of the service, the property will be primarily hangered, docked, stored, or used outside the U.S., the property is not used to generate revenue in the U.S. at any point during the duration of the service, and the property is owned by a foreign person that resides or primarily operates outside the U.S.

- **Related-Party Transactions (Treas. Reg. Section 1.250(b)-6)**

The statute provides that the sale of property to a foreign related person is treated as for a foreign use when the foreign related party resells the property to an unrelated foreign party for foreign use or uses the property in connection with the sale of other property or provision of services to an unrelated foreign party for a foreign use.

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Under the final regulations, a sale to a foreign related party for resale is treated as a FDDEI sale in the year it occurs if a sale to an unrelated party occurs in such year or will occur in the future in the ordinary course of business. The seller in the related party sale may establish that an unrelated party transaction will occur based on contractual terms, past practices of the foreign related party, 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. Unlike the proposed regulations, the final regulations do not require the taxpayer to file an amended return to claim an FDII benefit for an unrelated party sale occurring after the FDII filing date (*i.e.*, the date, including extensions, by which the taxpayer is required to file an income tax return for the taxable year in which gross income from the transaction is included in the taxpayer's income).

When the foreign related party uses the purchased property in connection with the sale of other property or provision of services, the amount treated as a FDDEI sale is proportionate to the amount of revenue reasonably expected to be earned from all qualifying unrelated party transactions relative to the total revenue expected to be earned from all transactions. All related parties are treated as a single foreign related party for purposes of determining whether an unrelated party sale has occurred.

Because a sale of intangible property is a FDDEI transaction only to the extent the intangible property is used outside the U.S., the final regulations do not contain special rules for related party sales of intangible property.

A related party service is a FDDEI service only if the service is not substantially similar to a service that is or will be provided by the related person to a person located in the U.S. The regulations retain two bright-line tests aimed at "round tripping" arrangements where the provision of services primarily benefits persons within the U.S. but a related party located outside the U.S. is interposed. Under these tests, a service is considered substantially similar to a service provided by the related party if either 60% or more of the benefits conferred by the related party service are to persons located within the U.S. (the "benefit test") or if the renderer's service is used by the related party to provide a service to a person located within the U.S. and 60% or more of the price that persons located within the U.S. pay for the service provided by the related party is attributable to the renderer's service (the "price test"). If the benefit test is failed, the transaction does not qualify as a FDDEI transaction. If only the price test is failed, qualifying revenue is reduced based on the benefits provided to persons located in the U.S. The final regulations also clarify that services provided to a related party that only indirectly benefit the related party's service recipients are not "substantially similar" to the services provided by the related party.

CONCLUSION

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The final regulations make several changes that will reduce taxpayer compliance burdens and provide greater certainty, though certain types of transactions are still subject to enhanced substantiation requirements. The transition rule should also be helpful for many taxpayers, providing additional time to refine compliance systems and procedures.

Although the final regulations provide critical foundational guidance, Treasury and the IRS are continuing to study several issues. As noted above, the upcoming final regulations under Treas. Reg. Section 1.861-17 regarding the allocation and apportionment of R&E expenditures will interact with the FDII regime. In addition, the preamble to the final regulations mentions several other issues that may be the subject of future guidance and on which Treasury and the IRS seek comment, namely, the interaction of Sections 163(j), 172, 250(a)(2), and other tax code sections that refer to taxable income, FDDEI sales related to hedging transactions, and the treatment of life-nonlife consolidated groups.

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