Final FDII and GILTI Regulations Significantly Relax Documentation Requirements

Tax Alert
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On July 9, 2020, Treasury and the IRS released final regulations under section 250, which provides a deduction for a domestic corporation's foreign derived intangible income (FDII) and global intangible low-taxed income (GILTI).[1] Proposed regulations had been issued in March 2019 (which we previously covered here). While the final regulations retain the basic approach and structure of the proposed regulations, Treasury and the IRS made key revisions, which we review below. In particular, the final regulations eliminate the prescriptive documentation requirements for taxpayers to show that they are entitled to the FDII deduction and adopt a more relaxed approach.

The section 250 deduction reduces the effective tax rate on "intangible" income – income in excess of a 10 percent return on tangible assets – that domestic companies earn from foreign sales and services. This reduced effective rate is achieved through a deduction equal to the sum of (1) 37.5 percent of the domestic corporation's FDII, plus (2) 50 percent of the domestic corporation's (a) GILTI and (b) dividends received under section 78 attributable to GILTI. A taxpayer's FDII amount is determined through a multistep process in which the taxpayer must calculate (1) deduction eligible income (DEI), (2) foreign derived DEI (FDDEI), (3) qualified business asset investment (QBAI), and (4) deemed intangible income (DII). For a detailed overview of section 250 and the rules in the proposed regulations for computing a taxpayer's section 250 deduction, review our alert covering the proposed regulations.

The final regulations are generally applicable for tax years beginning on or after January 1, 2021. For tax years beginning before January 1, 2021, taxpayers may apply the final regulations or rely on the proposed regulations.[2] Taxpayers may rely on the transition rule for documentation for all tax years before January 1, 2021, regardless of whether they otherwise are generally relying on the proposed regulations or the final regulations.

I. Documentation and Substantiation Requirements

Treasury and the IRS made significant revisions to the documentation requirements under section 250, generally either abandoning those requirements or replacing them with more flexible substantiation requirements. The proposed regulations provided prescriptive rules for documenting that transactions generated FDDEI. The proposed rules generally provided a list of acceptable documents taxpayers could obtain to establish that a recipient is a foreign person, property is for a foreign use, and that a recipient of a general service is located outside the United States.[3] Further, under the proposed regulations, the documentation obtained by the taxpayer had to comply with additional requirements intended to corroborate the reliability of the documentation, including that the taxpayer obtained the documentation no later than the "FDII filing date" and no earlier than one year before the date of the relevant sale or service.[4] The proposed regulations included several exceptions to the general documentation requirements[5] and provided a transition rule under which taxpayers could use any reasonable documentation maintained in the ordinary course of business for tax years beginning on or before March 4, 2019.[6]

The proposed documentation requirements were criticized in many of the public comments submitted in response to the proposed regulations. Comments remarked, for example, that the types of acceptable documents per the proposed regulations are not documents taxpayers can reasonably expect customers to provide in the ordinary course of business or would be difficult, if not impossible, to obtain.[7]

The final regulations adopt a much more relaxed and flexible approach. In general, the documentation requirements are eliminated for all transactions. For some types of transactions, specific substantiation requirements are provided. For all other transactions, no specific rules are provided. Taxpayers generally bear the burden of demonstrating entitlement to the section 250 deduction, as they do with any other deduction.

A. Transactions Subject to Specific Substantiation Requirements

The final regulations include specific substantiation requirements to establish the requisite foreign use/location with respect to the following types of transactions:

- Sales of general property to resellers and manufacturers;
- Sales of intangible property; and
- The provision of general services to business recipients. [8]

Treasury and the IRS explain in the Preamble to the final regulations that specific rules were needed for these transactions "to ensure that taxpayers make sufficient efforts to determine whether the regulatory requirement is met."[9] Under the specific substantiation rules applicable to those transactions, taxpayers must maintain at least one of the documents listed in the final regulations, which generally fall in one of the following categories:

1. Credible evidence from the recipient obtained or created in the ordinary course of business establishing the requisite factors.[10]
2. A written statement prepared by the taxpayer containing the information described in the final regulations (*e.g.*, name and address of recipient, description of the property or services, etc.), which statement is corroborated by credible and sufficient evidence (the taxpayer chooses the type of corroborating evidence).[11]
3. For sales of general property to resellers and manufacturers and sales of intangible property, other specific documents set forth in the final regulations (*e.g.*, a binding contract providing that the property at issue is for resale or exploitation (in the case of intangible property) only outside the United States).[12]

The substantiating documents must be in existence as of the "FDII filing date" [13] and generally must be provided to the IRS within 30 days of a request.[14] Unlike the proposed regulations, the final regulations do not impose additional requirements with respect to the timing of obtaining the substantiating documents.[15]

B. Factors Subject to General Rules for Claiming Deductions

The final regulations do not provide any specific documentation or substantiation rules to establish the following factors: (1) that the recipient of property is a foreign person; (2) foreign use with respect to sales of certain general property that are made directly to end users; and (3) location of consumers that received general services from the taxpayer. For those factors, Treasury and the IRS determined that "requiring specific documentation ... is difficult given the variations in industry practices and is not necessary to achieve the purpose of the statute."[16] Taxpayers, however, bear the burden of demonstrating that they are entitled to the section 250 deduction, as they do with any other deduction.[17] Treasury and the IRS note in the Preamble that they are considering issuing additional administrative guidance on acceptable documentation to substantiate the section 250 deduction.[18]

C. Small Business Exception

The final regulations expanded the small business exception from the documentation requirements in the proposed regulations, which generally applied to a seller of general property or renderer of services that received less than $10 million in gross receipts during the prior tax year.[19] Under the final regulations, the specific substantiation requirements described in Section I.A above do not apply if the taxpayer and all related parties of the taxpayer, in the aggregate, (as opposed to an individual seller/renderer) receive less than $25 million in gross receipts during the prior tax year.[20]

D. "Reasonable Documentation" Transition Rule Extended Through 2020

Finally, for tax years beginning before January 1, 2021 (the general applicability date of the final regulations), taxpayers generally may apply the final regulations or rely on the proposed regulations. Taxpayers applying the final regulations need not apply the specific substantiation rules in the final regulations. Taxpayers applying the final regulations or the proposed regulations may rely on the transition rule in the proposed regulations under which taxpayers could use any reasonable documentation maintained in the ordinary course of business for tax years beginning before January 1, 2021.[21]

II. "FDDEI Sales" and "FDDEI Services"

A. Software and Other Digital Transactions

The final regulations include new guidance for taxpayers in the software industry or otherwise involved in digital transactions. First, in response to comments requesting further guidance for sales or leases of copyrighted articles, the final regulations (1) clarify that for purposes of section 250, a copyrighted article is not "intangible property"[22] (and thus should be analyzed under the rules applicable to general property) and (2) provide a new rule for determining foreign use in the case of sales of general property that primarily contain "digital content."[23] Under that new rule, a digital content sale that is transferred electronically is for a foreign use if the end user downloads, installs, receives, or accesses the purchased digital content on the end user's device outside the United States.[24]

Second, the final regulations also provide new guidance for those involved in the provision of digital services, creating two new subcategories of general services: electronically supplied services and advertising services.[25] Similar to the new rules on digital content sales, electronically supplied services are FDDEI services if the location of the device used to receive the service is outside the United States (which could be determinable, for example, based on the service recipient's IP address).[26] Whether advertising services qualify as FDDEI services depends on where the advertisements are viewed by individuals.[27]

B. General Property Sold for Foreign Use, Including Foreign Processing

The final regulations relax the rules around whether general property is sold for a foreign use. Under the proposed regulations, a sale of general property is for a foreign use if either the property is not subject to domestic use within three years of sale or the property is subject to manufacture, assembly, or other processing outside the United States before any domestic use.[28] General property is considered to have been processed outside the United States if (1) there is a physical and material change to the property under the facts and circumstances or (2) the property is incorporated as a component in a second product and the value of the property constitutes no more than 20 percent of the value of the second product.[29] Further, under the proposed regulations, the taxpayer could not have known or "have [had] reason to know" that the property is not for a foreign use.[30] Comments noted that these requirements (coupled with the strict documentation requirements in the proposed regulations) made it difficult for taxpayers to satisfy the foreign use requirement.

The final regulations adopt a more flexible approach by (1) clarifying the meaning of "foreign use" for sales of general property, [31] (2) eliminating the requirement that the taxpayer have no "reason to know" of some domestic use of the property, and (3) relaxing the

rules for meeting the foreign use requirement when property is exported for manufacture, assembly, or other processing.[32] With regard to general property exported for incorporation into a second product, the final regulations provide a new substantive rule and retain the 20 percent threshold as a safe harbor.[33] Under the substantive component rule, general property is a component incorporated into another product if the process of incorporation involves activities that are substantial in nature and generally considered to constitute the manufacture, assembly, or other processing of property under all the relevant facts and circumstances.[34] This standard is consistent with standards in the subpart F context and allows both taxpayers and the IRS to refer to the attendant case law and other guidance in the FDII context.

C. Services Related to Property Temporarily in the United States

Another takeaway of interest relates to an exception added in the final regulations to the general rule that a property service is a FDDEI service only if provided with respect to property located outside the United States during the entire period the service is performed.[35] Under the new exception, property services still qualify as FDDEI services when the property is temporarily located within the United States for the purpose of receiving the service (and several other regulatory conditions are met).[36] The final regulations specify that manufacturing services are considered property services (and not general services) and therefore may qualify as FDDEI services even if performed within the United States if the conditions of the new exception are satisfied.[37] Accordingly, services provided in the United States as part of a tolling arrangement may qualify as FDDEI services if the property produced is owned by a foreign person and the property will be primarily used outside the United States.

D. Intangible Property

The final regulations relax the foreign use requirement for process intangibles licensed to unrelated foreign manufacturers. The proposed regulations generally provide that the location of use of an intangible is based on the location of end-user customers licensing the intangible property or purchasing products for which the intangible property was used in development, manufacture, sale, or distribution.[38] Comments noted that these rules were more restrictive than the comparable rules for tangible property, in particular general property that is subject to further manufacturing or incorporated into a second product. In response to these comments, the final regulations generally provide that an unrelated manufacturer that uses intangible property consisting of a manufacturing method or process is the end user of the intangible property.[39]

III. Related-Party Rules

The final regulations also made some key changes to the rules applicable to related-party transactions. Under the proposed regulations, a taxpayer that sold property to a related party for resale to an unrelated party could treat the related-party sale as a FDDEI sale only if the unrelated-party transaction took place by the filing date of the tax return that includes the related-party sale (*i.e.*, by the FDII filing date).[40] If the unrelated-party transaction did *not* take place by the FDII filing date, the taxpayer would have had to file an amended return in the year the unrelated-party transaction occurred for the prior tax year to report the related-party sale as a FDDEI sale (assuming the period of limitations was still open at that point in time).[41] In response to comments citing the administrative burdens associated with this rule, Treasury and the IRS modified it in the final regulations to allow taxpayers to treat a related-party sale as a FDDEI sale in the year the related-party sale occurs so long as an unrelated-party transaction already occurred or will occur in the ordinary course of business with respect to the property at issue (at any time in the future).[42]

A related-party sale also may qualify as a FDDEI sale when the related party uses the property either to produce other property sold to an unrelated party or in the provision of a service to an unrelated party.[43] The final regulations eliminate the rule in the proposed regulations requiring that to qualify as a FDDEI sale in these circumstances, the taxpayer had to reasonably expect that more than 80 percent of the revenue of the related party, with respect to the property, would be from unrelated-party transactions.[44] Instead, the final regulations require the taxpayer that sells property to a related party to allocate the related party's

revenues ratably between related-party and unrelated-party transactions based on revenues reasonably expected to be earned as of the FDII filing date.[45] This modification avoids the potential cliff effect of the proposed 80 percent rule, described in a comment to Treasury and the IRS, whereby a taxpayer would derive no FDII benefit if the revenues fell below the proposed threshold.

IV. Changes to Rules for Determining DEI and FDDEI

A. Foreign Branch Income

The final regulations conform the definition of "foreign branch income," which is excluded from DEI and FDDEI, to the definition of that term in the context of the foreign tax credit.[46] This definition, which is consistent with the statutory text of section 250(b)(3)(A)(i)(VI), is a welcome change from the definition in the proposed regulations. Under the proposed regulations, the definition of foreign branch income contained in the foreign tax credit rules was expanded for purposes of FDII to include any income from the sale of an asset that produces income attributable to a foreign branch. As a result, under the proposed regulations, gain from the sale of a disregarded entity that is not reflected on the books and records of a branch would potentially have been treated as foreign branch income and excluded from DEI, even though such gain would not have been foreign branch income for foreign tax credit purposes. By adopting a consistent definition of foreign branch income for purposes of FDII and the foreign tax credit, the final regulations permit gain from such a sale of a disregarded entity to be included in DEI and FDDEI, if the other requirements for FDDEI treatment are met.[47] This modification may permit taxpayers more flexibility in restructuring foreign branch operations.

B. Partnership Interests

In contrast, the final regulations provide that a sale of a partnership interest cannot be a FDDEI sale because a partnership interest is not general property.[48] The proposed regulations did not address the treatment of a sale of a partnership interest. The Preamble discusses this rule and states that Treasury and the IRS considered adopting a "look-through" approach to partnership interests but rejected such an approach because a partnership interest is "not the type of property" that can be subject to foreign use and because a look-through approach would be inconsistent with the fact that title to partnership property does not change upon a sale of a partnership interest and would be difficult to administer.[49]

C. R&E Expense Apportionment

DEI and FDDEI are determined by considering properly allocable deductions and the final regulations continue the general approach of the proposed regulations that the expense allocation and apportionment regulations under section 861 apply for this purpose. One key modification in the final regulations, however, pertains to the rules for apportioning research and experimentation (R&E) expenditures and the applicability of the "exclusive apportionment" rule for purposes of FDII. The exclusive apportionment rule provides that 50 percent of R&E expenditures are apportioned exclusively to the geographic location where R&E activity predominantly occurs.[50] The proposed regulations provided that this exclusive apportionment does not apply for purposes of FDII, but Treasury and the IRS have reconsidered that approach in light of comments, and the final regulations remove this provision.

Treasury and the IRS have been engaged in a regulatory process to update the rules for R&E expense allocation and apportionment and issued proposed regulations in December 2019.[51] The Preamble to the final regulations observes that Treasury and the IRS continue to study the exclusive apportionment and other issues raised by commenters in connection with the application of these R&E expense allocation and apportionment rules to FDII.[52]

V. Future Guidance and Developments

The Preamble to the final regulations notes several issues under consideration by Treasury and the IRS and to be addressed in future guidance. For example, Treasury and the IRS are considering issuing additional administrative guidance on acceptable documentation to substantiate the section 250 deduction.[53] In addition, as noted above, the expense apportionment rules related to R&E are the subject of a separate regulation project, and Treasury and the IRS are continuing to study those rules in the context of FDII and more generally.[54] Treasury and the IRS also are studying the coordination of the section 250 deduction with other deductions that are limited, directly or indirectly, by the taxpayer's taxable income. Guidance on this issue in the proposed regulations was eliminated, and taxpayers may use any reasonable method, consistently applied, for tax years beginning on or after January 1, 2021.[55]

Finally, note that U.S. trading partners have suggested that the FDII rules may run afoul of international standards. The FDII rules are under review by the OECD as a potential harmful preferential regime and the European Union has suggested that the FDII rules may violate international trade law. The FDII rules, enacted in 2017, are intended to "neutralize the role that tax considerations play when a [domestic corporation] chooses the location of intangible income attributable to foreign-market activity" by conforming the U.S. tax burden on such income without regard to whether such income is earned directly by a U.S. corporation, or indirectly through a controlled foreign corporation.[56] The finalization of regulations under section 250 may spur action internationally.

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[1]85 Fed. Reg. 43042 (July 15, 2020). All "section" references are to the Internal Revenue Code of 1986, as amended and currently in effect.

[2]Treas. Reg. § 1.250-1(b).

[3]*See, e.g.*, Prop. Treas. Reg. §§ 1.250(b)-4(c)(2) (documentation requirements for establishing foreign person status), 1.250(b)-4(d)(3) (documentation requirements for establishing foreign use of general property), 1.250(b)-4(e)(3) (documentation requirements for establishing foreign use of intangible property), 1.250(b)-5(d)(3) (documentation requirements for establishing that general services are provided to consumers located abroad), 1.250(b)-5(e)(3) (documentation requirements for establishing that general services are provided to business recipients located abroad).

[4]Prop. Treas. Reg. § 1.250(b)-3(d). The "FDII filing date" is the date, including extensions, by which the taxpayer is required to file an income tax return for the tax year in which the gross income from the sale of property or provision of a service is included in the taxpayer's gross income. Prop. Treas. Reg. § 1.250(b)-3(b)(1). That definition remained the same in the final regulations. *See* Treas. Reg. § 1.250(b)-3(b)(3).

[5]For example, the small business (less than $10 million in gross receipts in a prior tax year) and small transaction (less than $5,000 in gross receipts in a tax year from a single recipient) exceptions were two of the exceptions from the general documentation requirements in the proposed regulations. *See, e.g.*, Prop. Treas. Reg. § 1.250(b)-4(c)(2)(ii) (providing the small business and small transaction exceptions for establishing foreign person status and in those cases, allowing the taxpayer to rely on a recipient's address in making the requisite showing).

[6]Prop. Treas. Reg. § 1.250-1(b). The documentation used by the taxpayer still had to comply with the general reliability requirements in Prop. Treas. Reg. § 1.250(b)-3(d).

[7]For example, foreign government-issued IDs and documents reflecting the customer's U.S.-foreign revenue splits were among the documents taxpayers could obtain to establish foreign person status or foreign use. *See, e.g.*, Prop. Treas. Reg. §§ 1.250(b)-4(c)(2)(i), -4(e)(3)(i), -5(d)(3)(i); *see also* 85 Fed. Reg. at 43042 (reviewing some of the comments received with respect to the proposed documentation requirements).

[8] *See* Treas. Reg. §§ 1.250(b)-3(f)(1) (general substantiation rules), -4(d)(3) (substantiation of foreign use for certain sales of property), -5(e)(4) (substantiation of foreign location of business recipients of general services).

[9] 85 Fed. Reg. at 43043.

[10] *See* Treas. Reg. §§ 1.250(b)-4(d)(3)(ii)(D), -4(d)(3)(iii)(B), -4(d)(3)(iv)(B), -5(e)(4)(i).

[11] *See* Treas. Reg. §§ 1.250(b)-4(d)(3)(ii)(E), -4(d)(3)(iii)(C), -4(d)(3)(iv)(C), -5(e)(4)(ii). Commercial invoices issued pursuant to the taxpayer's terms and conditions of sales were deemed sufficient corroborating evidence in one of the regulatory examples illustrating the substantiation requirements. Treas. Reg. § 1.250(b)-4(d)(3)(v)(B)(1), Example 1.

[12] *See* Treas. Reg. §§ 1.250(b)-4(d)(3)(ii)(A)–(C), -4(d)(3)(iii)(A), -4(d)(3)(iv)(A).

[13] *See supra* note 4.

[14] Treas. Reg. § 1.250(b)-3(f)(1).

[15] *See* 85 Fed. Reg. at 43043 (noting that the timing of when substantiating documents are created may affect the credibility of those documents).

[16] 85 Fed. Reg. at 43043.

[17] 85 Fed. Reg. at 43043 (explaining that under section 6001, taxpayers are required to make returns, render statements, and keep the necessary records to show whether such person is liable for tax under the Code).

[18] 85 Fed. Reg. at 43043–44.

[19] *See* Prop. Treas. Reg. §§ 1.250(b)-4(c)(2)(ii)(A), -4(d)(3)(ii)(A), -5(d)(3)(ii)(A), -5(e)(3)(ii)(A).

[20] Treas. Reg. § 1.250(b)-3(f)(2). Treasury and the IRS note in the Preamble that small businesses have to nonetheless comply with the general substantiation rules under section 6001. 85 Fed. Reg. at 43044.

[21] *See* Treas. Reg. § 1.250-1(b); 85 Fed. Reg. at 43044.

[22] *See* Treas. Reg. § 1.250(b)-3(b)(11).

[23] "Digital content" is defined as a computer program or any other content in digital format (*e.g.*, books, movies, and music in digital format). Treas. Reg. § 1.250(b)-3(b)(1).

[24] Treas. Reg. § 1.250(b)-4(d)(1)(ii)(D).

[25] *See* Treas. Reg. § 1.250(b)-5(c)(1), (5) (defining "advertising service" and "electronically supplied service").

[26] Treas. Reg. §§ 1.250(b)-5(d)(2), (e)(2)(iii).

[27] Treas. Reg. § 1.250(b)-5(e)(2)(ii).

[28] Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i).

[29] Prop. Treas. Reg. § 1.250(b)-4(d)(2)(iii).

[30] Prop. Treas. Reg. § 1.250(b)-4(d)(1).

[31] *See* Treas. Reg. § 1.250(b)-4(d)(1)(ii)–(iii).

[32] *See* Treas. Reg. § 1.250(b)-4(d)(1)(iii).

[33] *See* Treas. Reg. § 1.250(b)-4(d)(1)(iii)(C).

[34] *See* Treas. Reg. § 1.250(b)-4(d)(1)(iii)(C).

[35] *See* Treas. Reg. § 1.250(b)-5(g)(1).

[36] Treas. Reg. § 1.250(b)-5(g)(2).

[37] Treas. Reg. § 1.250(b)-5(c)(7), (g)(2).

[38] Prop. Treas. Reg. § 1.250(b)-4(e)(2).

[39] Treas. Reg. § 1.250(b)-4(d)(2)(ii)(C).

[40] Prop. Treas. Reg. § 1.250(b)-6(c)(1)(i).

[41] Prop. Treas. Reg. § 1.250(b)-6(c)(1)(i).

[42] Treas. Reg. § 1.250(b)-6(c)(1)(i); *see* 85 Fed. Reg. at 43067. The final regulations also include guidance on how taxpayers can establish that the unrelated-party transaction will occur later in time. *See* Treas. Reg. § 1.250(b)-6(c)(1)(i).

[43] *See* Treas. Reg. § 1.250(b)-6(c)(1)(ii).

[44] *See* Prop. Treas. Reg. § 1.250(b)-6(c)(1)(ii).

[45] *See* Treas. Reg. § 1.250(b)-6(c)(1)(ii).

[46] Treas. Reg. § 1.250(b)-1(c)(11).

[47] 85 Fed. Reg. at 43045–46.

[48] *See* Treas. Reg. § 1.250(b)-3(b)(10).

[49] 85 Fed. Reg. at 43050.

[50] Treas. Reg. § 1.861-17(b).

[51] *See* Prop. Treas. Reg. § 1.861-17, 84 Fed. Reg. 69124 (Dec. 17, 2019).

[52] 85 Fed. Reg. at 43047.

[53] *See* 85 Fed. Reg. at 43044.

[54] *See* 85 Fed. Reg. at 43047.

[55] Treasury and the IRS are considering a separate guidance project to address the interaction of section 250 and other sections that refer to taxable income and request comments on this issue. 85 Fed. Reg. at 43044–45.

[56] 85 Fed. Reg. at 43065.

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