

Tax readiness: Maximizing your FDII sense (the proposed Section 250 regulations)

April 2, 2019

In brief

Treasury and the IRS on March 4 released proposed regulations under Section 250, added to the Code by the 2017 tax reform legislation. The proposed regulations provide guidance regarding the deduction allowed under Section 250(a), which is equal to the sum of (i) 37.5% of a domestic corporation's foreign-derived intangible income (FDII) and (ii) 50% of its global intangible low-taxed income (GILTI) plus Section 78 inclusions, with a limit on the overall deduction amount based on taxable income.

The proposed regulations also define and provide mechanics to calculate several key FDII components, including deduction eligible income (DEI), foreign-derived deduction eligible income (FDDEI), and deemed intangible income (DII).

The proposed regulations raise a number of important issues. PwC on March 14 hosted a webcast featuring PwC specialists who discussed some of these issues. This Insight highlights those discussions. [Watch](#) the webcast replay and register for future webcasts in PwC's Tax Readiness series, which addresses other important current tax topics.

In detail

Overview

Applicability

The proposed regulations generally are proposed to apply to tax years ending on or after March 4, 2019. It is unclear whether the proposed regulations will be finalized by June 22, 2019. Pursuant to Section 7805(b)(2), regulations filed or issued within 18 months of the date a statute is enacted can be made retroactive to the date

of enactment, which in this case is December 22, 2017.

The preamble states that taxpayers may rely on the proposed regulations for tax years ending before March 4, 2019. For tax years beginning on or before March 4, 2019, taxpayers may use "any reasonable documentation maintained in the ordinary course of [its] business" to satisfy documentation requirements relating to the foreign person, foreign use,

and location (of persons or property) requirements, including the documentation described in the 'small business' and 'small transaction' rules, as specified in the regulations.

Prop. Reg. sec. 1.1502 would apply to consolidated return years ending on or after the date final regulations are published. The preamble states that taxpayers may rely on such proposed

regulations for tax years ending before that date.

Interaction of Sections 163(j), 172, and 250

The Section 250 deduction is subject to a taxable income limitation. Multiple Code provisions simultaneously limit the availability of a deduction based upon a taxpayer's taxable income, including Section 163(j) limiting business interest deductions and Section 172 limiting net operating loss (NOL) deductions.

The proposed regulations, consistent with the proposed regulations under Section 163(j), mandate a five-step ordering process for addressing the interaction of the Section 163(j) interest deduction limitations, the Section 172 NOL rules, and Section 250;

- *Step 1:* Calculate tentative Section 250 deduction without regard to Sections 163(j) and 250(a)(2) (the taxable income limitation)
- *Step 2:* Calculate disallowance under Section 163(j)(1), taking into account the tentative Section 250 deduction, but without regard to Section 172(a)
- *Step 3:* Calculate NOL under Section 172(a), taking into account deductions allowed after application of Section 163(j) but without regard to Section 250(a)
- *Step 4:* Calculate FDII, taking into account deductions allowed after application of Sections 163(j) and 172(a)
- *Step 5:* Calculate Section 250 deduction after application of the Section 250(a)(2) taxable income limitation, which itself is determined taking into account deductions allowed under Sections 163(j) and 172(a).

FDII computation

$FDII = DII \times (FDDEI / DEI)$ (this ratio is known as the "foreign-derived ratio")

DII is 'deemed intangible income,' which is 'deduction-eligible income' (DEI) minus the 'deemed tangible income return' (DTIR).

DEI in turn means gross income (excluding Subpart F income, GILTI, CFC dividends, financial services income, domestic oil and gas income, and foreign branch income) less allocable deductions, including taxes.

The taxpayer's DTIR equals 10% of the taxpayer's qualified business asset investment (QBAI), which is the average of a US company's aggregate adjusted tax bases, as of the close of each quarter, in 'specified tangible property' (tangible property that is used in a trade or business of the US company and is depreciable under Section 167).

FDDEI is 'foreign derived deduction eligible income,' comprised of DEI from an 'FDDEI transaction' (i.e., FDDEI sale or FDDEI service, both discussed below).

Documentation

Taxpayers must provide documentation regarding whether a purchaser is a foreign person, whether property is sold for a foreign use, and the location of persons to whom (or property with respect to which) the taxpayer provides services is outside the United States. **Note:** Specific documentation requirements vary depending on the type of property sale or services as prescribed by proposed regulations.

All documentation must meet the following reliability requirements:

- As of the FDII filing date (i.e., the tax return due date, including extensions, on which the related

income will be reported), the seller or renderer "does not know and does not have reason to know" that the documentation is "unreliable or incorrect"

- The documentation must be obtained by the seller or renderer by the FDII filing date
- The documentation must be obtained by the seller or renderer no earlier than one year before the date of the sale or service.

QBAI anti-abuse rule

The proposed regulations include anti-avoidance rules that disregard certain transfers of specified tangible property by a domestic corporation where the corporation continues to use the property in production of gross DEI.

Specifically, with regard to related-party transactions, a transfer of property by a domestic corporation to a related party whose QBAI would not be taken into account in calculating the corporation's DTIR may be disregarded if, within a two-year period beginning one year before the transfer, the domestic corporation (or a related party whose QBAI would be taken into account in calculating the corporation's DTIR) leases the same or substantially similar property from a related party and such transfer and lease occur pursuant to a principal purpose of reducing the domestic corporation's DTIR. A transfer is treated as 'per se' made pursuant to such a principal purpose if both the transfer and leaseback occur within a six-month period.

With regard to unrelated-party transactions, the anti-avoidance rule will not apply to a transfer to or lease from an unrelated party unless the transaction is pursuant to 'structured arrangements' — i.e., certain transfer and leaseback transactions in which a reduction in the domestic

corporation's DTIR is a material factor in the pricing of the arrangement or such reduction is a principal purpose of the arrangement.

FDDEI sales

An FDDEI sale is a sale of 'general property' or 'intangible property' to a 'foreign person' for a 'foreign use.' The term 'sale' includes a lease, license, exchange, or other disposition. A sale also includes any transfer of property in which gain or income is recognized under Section 367, including a transfer of intangible property subject to Section 367(d).

A different set of rules (discussed below) applies to general property and intangible property to determine and document that the property is sold for a foreign use.

Sales to foreign related parties can qualify as FDDEI sales if certain conditions are satisfied. Essentially, the related party either must sell the property to an unrelated party or must use the property in a sale to an unrelated party, in a transaction that qualifies as an FDDEI sale.

Note: Foreign military sales (sales to the US government for resale or on-service to a foreign government under the Arms Export Control Act of 1976, as amended (22 U.S.C. 2751 et seq.)) qualify for the deduction.

Foreign person determination (for sales of general and intangible property): A recipient is a foreign person if the seller establishes that the recipient is a foreign person by obtaining documentation and, as of the FDII filing date, the seller does not know or have reason to know that the recipient is not a foreign person.

Foreign person documentation: A seller generally establishes the status of a recipient as a foreign person by obtaining one or more enumerated

types of documentation, including a written statement by the recipient that the recipient is a foreign person. A seller that is a 'small business' or that engages in 'small transaction' establishes the recipient's status as a foreign person if the recipient's shipping address is outside the United States.

Foreign use determination (for sales of most types of general property): The sale of general property is for a foreign use if either (i) the property is not subject to domestic use within three years of delivery or (ii) the property is subject to manufacture, assembly, or other processing outside of the United States before any domestic use of the property. In addition, the seller must not know or have reason to know that the property is not for foreign use. Special rules exist for specific types of general property sales, such as sales of fungible property and sales of international transportation property.

Activities that qualify as 'manufacturing, assembly, or other processing' are determined based on the detailed rules in the proposed regulations. These rules follow an approach similar to determination of 'manufacturing' in the Subpart F regulations. The proposed regulations provide that general property is subject to manufacturing, assembly, or other processing only if (i) there is a physical and material change to the property or (ii) the property is incorporated as a component into a second product. A physical and material change does not include 'minor assembly, packaging, or labeling.' The proposed regulations prescribe thresholds of comparative values of components and final product for purposes of the second requirement.

Foreign use determination (for sales of intangible property): Intangible

property generally is considered sold for a foreign use in proportion to the revenue generated by the property from exploitation outside the United States. If property is used both within and outside the United States, foreign use is determined in proportion to the revenue generated from exploitation within and outside the United States.

For intangible property used in the development, manufacture, sale, or distribution of a product, the intangible property is treated as exploited at the location of the end user when the product is sold to the end user. Specific rules apply depending on whether the sale results in a series of payments or one lump-sum payment. Finally, the seller must not know or have reason to know that the property is not for foreign use.

Foreign use documentation (for general property sales): A seller establishes that general property, or a portion of a particular class of fungible general property, is for a foreign use only if the seller obtains one or more enumerated types of documentation, including a written statement from the recipient or a related party of the recipient that the recipient's use or intended use of the property is for a foreign use. Small business and small transaction sales document foreign use based on the recipient's shipping address.

Foreign use documentation (for intangible property sales): A seller establishes the extent to which a sale of intangible property is for a foreign use by obtaining one or more enumerated types of documentation, including a written statement from the recipient providing the amount of the annual revenue from sales or sublicenses of the intangible property or sales of products with respect to which the intangible property is used that is generated as a result of exploitation of the intangible property

outside the United States and the total amount of revenue from such sales or sublicenses worldwide.

Observation: With respect to general property, determination of its foreign use follows an ‘all or nothing’ approach. In comparison, the rules with respect to foreign use of intangible property are more flexible as it is possible to demonstrate a partial foreign use of intangible property, resulting in a partial FDII benefit from the sale.

FDDEI services

Services qualify as FDDEI services only when rendered to a person, or with respect to property, located outside the United States. There are five mutually exclusive categories of services, each of which requires a different method to determine whether this requirement has been satisfied:

- general service to a consumer located outside the United States
- general service to a business recipient located outside the United States
- proximate service to a recipient located outside the United States
- property service with respect to tangible property located outside the United States
- transportation service to a recipient, or with respect to property, located outside the United States.

Specific documentation requirement rules apply for establishing whether general services have been provided outside of the United States. The documentation required for general services is dependent upon whether the recipient is a consumer or a business recipient.

Observation: The statute is unclear whether the ‘or with respect to

property’ rule requires the recipient be a foreign person. The proposed regulations clarify that the recipient of a service with respect to property located outside the United States does not need to be a foreign person. Specifically, a US corporation that provides a service with respect to property owned by an unrelated US person, when such property is located outside the United States, may be entitled to FDDEI treatment for income from such services.

Related-party service rule

Under Section 250, a service provided to a related party not located in the United States is not treated as an FDDEI service unless such service is not substantially similar to services provided by such related party to persons located within the United States. The proposed regulations clarify that services provided by a foreign related party to persons within the United States will be considered ‘substantially similar’ to the services provided by the US person if either the ‘benefit test’ or ‘price test’ is met.

The benefit test is met if 60% or more of the benefits conferred to the related party (the related-party service) are to persons located within the United States. This test applies even if the related party adds significant value to the service through bundling with other high-value services. If the benefit test threshold is met, the transaction is wholly disqualified from FDDEI.

The price test is met if 60% or more of the price charged by the foreign related person to its US customer is attributable to the service such person received from the US related person. Unlike the benefit test, income from services treated as substantially similar only under the price test is not wholly disqualified from FDDEI. Rather, the portion of the gross income that corresponds to the ratio

of benefits conferred by the foreign related party’s services to persons not located within the United States will be treated as FDDEI.

Observations: When participants in the March 14 webcast were asked which aspect of the proposed regulations concerns them the most, 17% said ordering of deductions; 33% said allocation of expenses; 32% said documentation requirements; 7% said rules with respect to sales; and 11% said rules with respect to services.

Application to C corporations, individuals, consolidated groups, and partnerships

The Section 250 deduction is available only to a domestic corporation (excluding RICs, REITs, and subchapter S corporations). Individuals who have made the election under Section 962 may take the portion of the Section 250 deduction related to their GILTI and Section 78 gross-up inclusion.

In determining the Section 250 deduction of a member of a consolidated group, the proposed regulations provide that a member’s Section 250 deduction is determined by reference to the relevant items of all members of the group. The group must aggregate the DEI, FDDEI, DTIR, and GILTI of all consolidated group members. These aggregated numbers and the consolidated group’s consolidated taxable income are then used to calculate the group’s overall deduction. Such overall deduction is then allocated among the members based on each member’s contribution to the consolidated group’s aggregate amounts of FDDEI and GILTI.

With respect to partnerships, the proposed regulations provide an aggregate approach to partnerships for determining a domestic corporate partner’s FDII attributable to the

income and assets of a partnership. The Section 250 deduction is computed and allowed only at the level of a domestic corporate partner.

For purposes of determining whether a sale or a provision of a service to or by a partnership is an FDDEI transaction, the proposed regulations apply an entity approach, i.e., the partnership is treated as a separate person.

The takeaway

The proposed regulations provide needed guidance with respect to the determination of the Section 250 deduction and its various components. This guidance includes

detailed categories of sales and services that are eligible for FDDEI treatment, each with their own rules.

The proposed regulations also impose fairly significant documentation requirements that may prove burdensome for some taxpayers. Other documentation requirements on which taxpayers traditionally have focused -- specifically, for intercompany transactions -- generally have consequences in relation to accuracy-related penalties and protection therefrom. In contrast, the documentation requirements in the proposed regulations constitute necessary conditions that must be met in order for an eligible taxpayer to

include income from the sale of property or provision of a service in FDDEI. Taxpayers should be mindful of these requirements and pay close attention to the technical requirements for FDDEI treatment of the various sale and service categories.

Observations: When participants in the March 14 webcast were asked whether they expect to benefit from the FDII regime, of those that have undertaken the analysis, 30% said significant benefit; 29% said limited or no benefit because of significant QBAI; 15% said limited or no benefit because of documentation requirements; and 26% said limited or no benefit because of expense or computational issues.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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