Report No. 1399

New York State Bar Association Tax Section

Report on Foreign Derived Intangible Income

September 4, 2018

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I. INTRODUCTION

A. Background

This Report[1] discusses the "FDII" provisions of the Code added by the legislation informally known as the Tax Cuts and Jobs Act (the "**Act**").[2] The FDII provisions are contained in new Code Section 250.[3] In general, the FDII provisions reduce the effective tax rate imposed on the income of domestic corporations derived from sales of goods to, and performance of services for, non-U.S. persons. Together with the "GILTI" provisions, the FDII provisions form part of a new international tax system for the United States that is a hybrid between a territorial system and a world-wide system.[4] Specifically, sales and services income derived from non-U.S. customers can be taxed in the United States, but at a lower rate than domestic income. The apparent aim is to minimize the role of U.S. tax considerations in determining where income from intangibles is earned or reported.

Part I of this Report presents a brief overview of the FDII rules. Part II provides a summary of our principal recommendations. Part III sets out our comments and recommendations. This Report discusses the issues under the FDII rules that we have identified so far and that we consider most significant. As a consequence, there are many issues that are beyond the scope of the Report. Throughout, we have sought to find solutions to the fundamental question of what should or should not be "foreign-derived" in a manner that is administrable for taxpayers and consistent with the policy of the FDII rules.

B. Overview of the Deduction for FDII

Section 250(a) provides a deduction ("**FDII deduction**") to domestic corporations equal to 37.5% of a domestic corporation's "foreign-derived intangible income" ("**FDII**") for any taxable year beginning after December 31, 2017, and 21.875% of FDII for any taxable year beginning after December 31, 2025. FDII is calculated by multiplying the "deemed intangible income" of the domestic corporation by the ratio of the domestic corporation's "foreign-derived deduction eligible income" over all of its "deduction eligible income" ("**DEI**").[5] The "foreign-

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[1] The principal authors of this report are Peter Furci and Shane Kiggen, with substantial assistance from Shanna Adler, Lilly Aston, Samuel Krawiecz, Margo Watson and Kristie Withrow. Helpful comments were received from Andy Braiterman, Peter Connors, Karen Gilbreath Sowell, Stephen Land, Jeff Maddrey, Richard Nugent, Yaron Reich, Michael Schler, Stephen Shay, Andy Solomon, Shun Tosaka and Dana L. Trier. This report reflects solely the views of the Tax Section of the New York State Bar Association (**"NYSBA"**) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] The Act is formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*", P.L. 115-97.

[3] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

[4] *See* New York State Bar Association Tax Section Report No. 1394, *Report on the GILTI Provisions of the Code* (May 4, 2018) (the "**GILTI Report**").

[5] Section 250(b)(1). DEI is gross income, modified to exclude certain types of income (for example, subpart F inclusions under Section 951(a)(1), GILTI, dividends from controlled foreign corporations, and foreign branch income). Deemed intangible income is the excess of DEI over a 10% yearly return on tangible investment, referred

derived" portion of DEI is derived from the following sources: (1) a sale of property by the taxpayer to a non-U.S. person if the taxpayer establishes to the satisfaction of the Secretary that the property is for a foreign use, and (2) provision of services by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are to any person, or with respect to property, not located within the United States.[6] The term "sale" includes any lease, license, exchange or other disposition.[7] Consistent with the apparent legislative intent to limit the application of this reduced rate of tax to income from exported goods and services, "foreign use" is defined as "any use, consumption, or disposition which is not within the United States."[8]

Special rules apply to transactions with non-end users and between related parties. Property sold to a non-related person for further manufacture or other modification within the United States will not be considered for a foreign use even if the property is subsequently used for a foreign use.[9] Similarly, if a taxpayer provides services to a non-related person located within the United States, such services will not be foreign-derived even if such other person uses the services in providing foreign-derived services.[10]

If property is sold to a related foreign person, the property will not be treated as for a foreign use unless eventually sold, or used in connection with property which is sold or the provision of services, to an unrelated foreign person and the taxpayer establishes that the property is for a foreign use.[11] Similarly, if a service is provided to a related party not located in the United States, such service will not be foreign-derived unless the taxpayer establishes that such service is not substantially similar to services provided by the related party to persons within the United States.[12] These rules are apparently intended to prevent taxpayers from improperly obtaining an FDII deduction by "round-tripping" goods and services through related foreign entities.

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

A. Determination of Foreign Branch Income

1. Guidance should clarify the applicable method for determining the amount of business profits attributable to a qualified business unit ("**QBU**") for purposes of determining foreign branch income. We recommend adopting rules similar to those set forth in Treas. Reg. § 1.987-2, under which items of income, gain,

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to as the "deemed tangible income return". Section 250(b)(2), (3). For a detailed discussion of the issues surrounding the determination of the deemed tangible income return, which is a relevant concept for GILTI as well, see the GILTI Report.

[6] Section 250(b)(4).

[7] Section 250(b)(5)(E).

[8] Section 250(b)(5)(A).

[9] Section 250(b)(5)(B)(i).

[10] Section 250(b)(5)(B)(ii).

[11] Section 250(b)(5)(C)(i).

[12] Section 250(b)(5)(C)(ii).

deduction and loss would generally be attributed to a QBU to the extent they are reflected on the QBU's separate books and records, as adjusted to conform to U.S. tax principles. However, we recommend modifying the rules of Treas. Reg. § 1.987-2, so that items from otherwise disregarded transactions, such as transactions between a QBU and its owner or between two QBUs of the same owner, are taken into account in determining foreign branch income.

B. Allocation of Costs

1. Guidance should clarify that in computing foreign-derived DEI ("**FDDEI**"), cost of goods sold should be allocated to gross receipts under a method that is reasonable taking into account all facts and circumstances.

2. Guidance should provide that in determining DEI and FDDEI, deductions should be allocated and apportioned to items of gross income in accordance with the principles of Section 861.

C. Foreign-Derived Income from Sales of Property

1. Guidance on when property is sold for a foreign use should, where possible, adopt principles of existing regulations in analogous areas, and should take into account the practical limitations on domestic sellers in obtaining information about end users.

2. Guidance should treat sales of property to foreign retailers (related or unrelated) that resell exclusively through physical locations outside the United States as for a foreign use. For sales to foreign retailers that also have locations in the United States, a presumption of foreign use should apply unless the domestic seller has reason to know that a material amount of goods is intended for U.S. resale.

3. Sales of property to foreign online retailers present more difficult issues that are not addressed by existing analogous guidance. To the extent that guidance requires a domestic seller to evidence that resales are for a foreign use, this should be based on objective and reasonably available information.

4. Sales of property to unrelated foreign parties for further manufacture, assembly or processing should be conclusively presumed for foreign use, subject to anti-abuse rules for "round tripping" transactions.

5. Domestic sellers should be permitted to determine the location of sale of fungible goods on the basis of the overall proportion of goods sold.

6. Sales of goods to end users that are delivered outside the United States should be presumed for foreign use absent knowledge by the domestic seller that the use will be in United States or that the user is a United States person.

D. Foreign-Derived Income from Services

1. In developing standards for determining whether income from services is foreign-derived, the Department of the Treasury and the Internal Revenue Service (referred to collectively as "**Treasury**") should give due consideration to both accuracy and administrability. In theory, income from services should be treated as foreign-derived if and only the services are actually consumed or used in a business outside the United States. However, the actual location of consumption or business use is not always readily observable, and so in such cases, proxies for the location of consumption or business use, based on information readily available to the taxpayer, should be used. Other sources of law, such as the OECD International VAT/GST Guidelines (the "**OECD Guidelines**"),[13] may be instructive in developing appropriate proxies.

2. Consistent with the OECD Guidelines, guidance on determining the destination of business-to-consumer services should differentiate between services consumed "on the spot" and services capable of being provided remotely. The destination of "on-the-spot" services should be determined by reference to the place of physical performance. The destination of remotely performed services should be determined by reference to the location of the customer's usual residence, based on information routinely collected from the customer during the sales process.

3. The destination of business-to-business services should generally be determined by reference to the location of the customer's relevant place of business. In general, taxpayers should be allowed to identify the customer on the basis of the applicable business agreement. However, if the taxpayer knows or has reason to believe that a substantial amount (for example, 20%) of the value of the services is provided for the benefit of one or more related persons that are not party to that agreement, guidance should require the taxpayer to treat each user as a customer and to allocate a portion of the services to them. Similarly, if a taxpayer provides services to a single customer with business establishments in multiple locations, guidance should require the taxpayer to attribute the services to the establishments that actually use the services, subject to a *de minimis* rule.

4. We recommend that guidance clarify that income from services is generally foreign-derived if either (i) the services are provided to any person not located in the United States or (ii) the services are provided with respect to property not located in the United States.

5. With respect to income from services provided with respect to property used in multiple locations, we recommend that Treasury provide guidance on the proper allocation method to determine which portion, if any, of the DEI is foreign-

[13] *OECD International VAT/GST Guidelines* (2015). The OECD Guidelines were incorporated in the *Recommendation on the Application of Value Added Tax/Goods and Services Tax to the International Trade in Services*, adopted by the Council of the OECD on September 27, 2016.

derived. Wherever possible, analogous principles of existing areas of law should be used as a reference.

6. Guidance should clarify that income from the provision of services to an unrelated foreign intermediary that uses such services to produce consumer goods outside the United States or incorporates such services into the provision of additional services outside the United States is conclusively presumed to be foreign-derived.

E. Consolidated Return Issues

1. Consistent with our recommendation in the GILTI Report, guidance should confirm that members of a consolidated group are treated as a single corporation for purposes of computing the FDII deduction.

2. Guidance should confirm that in the case of an intercompany transaction (as defined in Treas. Reg. § 1.1502-13(b)(1)), Treas. Reg. § 1.1502-13 can redetermine a selling member's intercompany gain to be eligible for the FDII deduction.

F. Income Earned through Partnerships

1. Guidance should clarify that income earned by a domestic corporation through a domestic or foreign partnership can qualify as foreign-derived in appropriate cases.

2. Consistent with our recommendation in the GILTI Report, guidance should clarify that the FDII deduction is determined at the partner level.

G. Interaction of the FDII Deduction with Other Provisions of the Code

1. Guidance should clarify the interaction between the FDII deduction and the rules of new Section 163(j) and Section 172(d)(9).

III. DISCUSSION AND RECOMMENDATIONS

A. Determination of Foreign Branch Income

The first step in determining the FDII of a domestic corporation is to determine the corporation's DEI. DEI is defined in Section 250(b)(3) as the excess (if any) of the gross income of a domestic corporation, determined without regard to certain exceptions,[14] over the deductions (including taxes) properly allocable to that gross income.

[14] The exceptions to gross income are: (i) any amount included in gross income under Section 951(a)(1); (ii) GILTI included in gross income under Section 951A; (iii) financial services income; (iv) any dividend received from a controlled foreign corporation; (v) domestic oil and gas extraction income; and (vi) any foreign branch income. *See* Section 250(b)(3)(A)(i).

Foreign branch income is among the types of income that are excluded from DEI. Foreign branch income consists of business profits which are attributable to one or more QBUs, as determined under Section 989(a), in one or more foreign countries.[15] The statute provides that the business profits of a QBU are to be determined under rules established by the Secretary.[16] The business profits of a QBU, however, do not include any income that is passive category income.[17]

1. Method of Attributing Income

We recommend that Treasury provide guidance clarifying the applicable method for determining the amount of business profits attributable to a QBU. One approach would be to follow rules similar to those set forth in Treas. Reg. § 1.987-2, which attribute items to a QBU for purposes of determining Section 987 taxable income of the QBU and its owner. In general, under these rules, items of income, gain, deduction, and loss are attributed to a QBU to the extent they are reflected on the QBU's separate books and records, as adjusted to conform to U.S. tax principles.[18] However, exceptions apply for non-portfolio stock, partnership interests, certain acquisition indebtedness, and certain items that were included on or excluded from the QBU's books and records with a principal purpose of avoiding taxation under Section 987.[19] If rules similar to Treas. Reg. § 1.987-2 were to apply for purposes of computing foreign branch income, the list of exceptions would have to be broadened to include any asset of a type that would generate passive category income.[20]

An alternative would be to follow rules similar to those forth in Treas. Reg. § 1.1503(d)-5, which attribute items of a domestic corporation to its foreign branch for purposes of the dual consolidated loss provisions. Under these rules, different attribution methods apply in the case of a "true" foreign branch (known as a "foreign-branch separate unit") and a hybrid entity (known as a "hybrid entity separate unit"). In the case of a true foreign branch, the rules incorporate principles similar to those used to determine the income of a foreign person that is effectively connected with a U.S. trade or business. Thus, the domestic corporation of the foreign branch is treated as if it were a foreign corporation, the foreign branch is treated as if it were a trade or business within the United States, and the principles of Section 864(c)(2), (c)(4), and (c)(5) apply, with certain modifications, to determine the items of income, gain, loss, and deduction attributable to the foreign branch. In the case of a hybrid entity, by comparison, items are attributed to a hybrid entity separate unit to the extent they are reflected on the books and

[15] Section 904(d)(2)(J)(i), added by the Act.

[16] *Id.*

[17] Section 904(d)(2)(J)(ii).

[18] Treas. Reg. § 1.987-2(b)(1).

[19] Treas. Reg. § 1.987-2(b)(2).

[20] Treas. Reg. § 1.987-2(b)(1) provides that its attribution rules apply solely for purposes of Section 987. However, given that the regulations predate Section 904(d)(2)(J), it does not appear intended to prevent these attribution rules from applying to the determination of foreign branch income.

records of the hybrid entity, as applicable, as adjusted to conform to U.S. tax principles—similar to the approach in Treas. Reg. § 1.987-2.[21]

As between the two models, we believe that the Section 987 model is the more suitable approach for determining foreign branch income, for several reasons. First, the fact that Congress incorporated the concept of a QBU in defining foreign branch income naturally suggests importing the existing rules applicable to attributing income to a QBU. Second, attributing income to a branch on the basis of the branch's books and records generally yields a fair presentation of the financial results of a foreign branch.[22] Attribution of income under the principles of Section 864(c)(2), (c)(4), and (c)(5), by contrast, is formulaic, and can lead to results that do not accord with the economic income resulting from branch activities. Finally, attributing income on the basis of the branch's books and records is generally more administrable than allocating income under Section 864, which can be quite complex.[23]

2. Treatment of Otherwise Disregarded Transactions

An important issue in determining the amount of profits attributable to a foreign branch is how to treat items from transactions that are generally disregarded for U.S. tax purposes, such as transactions between a branch and its owner and transactions between two branches of the same owner. There are at least two alternative approaches to the treatment of such transactions: (i) follow the books and records of the branch and take into account the resulting items in computing foreign branch income; or (ii) treat the transaction as disregarded and compute foreign branch income without regard to the transaction.

The amount of a taxpayer's foreign branch income, and hence DEI, can vary depending on whether disregarded transactions are taken into account, as the following example shows:

Example 1: Transaction between Foreign Branch and its Owner

DC, a domestic corporation, wholly owns FB, a foreign branch that qualifies as a QBU. During the taxable year, FB generates $100 of revenue and incurs $50 of expense. The expense relates to a payment to DC for services rendered by DC to FB.

If the transactions between DC and FB are given effect in computing DEI, then DC's foreign branch income with respect to FB is only $50 ($100 of revenue minus $50 of expense), and DC includes in its gross income the $50 payment received from FB. However, if those transactions are disregarded in computing DEI, then DC's foreign branch income is $100. Thus, the effect of regarding transactions between DC and the branch in this example is to increase the

[21] *See* Treas. Reg. § 1.1503(d)-5(c)(1)(ii); Treas. Reg. § 1.1503(d)-7(c), Examples 23 through 26.

[22] Treas. Reg. § 1.987-2(b)(3) provides broad anti-abuse rules preventing a QBU from including or excluding an item on its books and records if the principal purpose is the avoidance of U.S. federal income tax.

[23] We note that attributing income to a foreign branch on the basis of the branch's books and records could be more favorable to certain taxpayers than attributing income to a branch under the dual consolidated loss provisions, which import the principles of Section 864. However, this approach may not always be taxpayer favorable because foreign branch income is a new separate limitation category under Section 904(d)(2)(J), and minimizing foreign branch income could maximize FDII but could also reduce the amount of a taxpayer's foreign tax credit.

amount of DC's DEI relative to the scenario in which the transactions between DC and the branch are disregarded.

In general, items from otherwise disregarded transactions are not taken into account under the Section 987 regulations or under the dual consolidated loss regulations.[24] Nevertheless, we believe that such transactions should be taken into account for purposes of determining foreign branch income, in order to promote clear reflection of foreign branch income, and to create parity between the treatment of foreign branches and controlled foreign corporations.

Example 2: Transaction between Foreign Branch, its Owner, and Unrelated Foreign Person

DC, a domestic corporation, wholly owns FB, a foreign branch that qualifies as a QBU. DC sells property with basis of $0 to FB for $60, and FB sells the property to an unrelated foreign person for use outside the United States for $100.

If the transactions between DC and FB are regarded, then solely in the case where FB resells the property to an unrelated foreign person, DC's gain of $60 on the sale to FB would qualify as FDDEI. This reflects the amount of value added by DC with respect to the transferred property. Further, this would be the result if FB was a foreign subsidiary, and it is not obvious why the underlying policy of FDII should favor the shifting of income from a domestic corporation to a foreign subsidiary rather than to a foreign branch. Moreover, even if FB is treated as a U.S. regarded entity, the scenario where FB resells to an unrelated foreign person seems analogous to the rules in the consolidated return context that we propose in Part III.E.2 below.[25] Under similar rules, the gain on the sale between DC and FB should be treated as FDDEI if FB resells the property to an unrelated foreign person.

In addition, from a policy perspective, it is unclear why the transaction between DC and FB should be disregarded in the case where FB resells to an unrelated foreign person. The results are less favorable to DC than either (1) a sale by DC to a foreign subsidiary for resale, or (2) as discussed in Part III.E.2 below, a sale by DC to a domestic consolidated affiliate for resale. We do note, however, that regarding a transaction with one's own foreign branch (which can produce FDDEI if the branch resells to an unrelated foreign party) produces a different result than if the sale were made to an unrelated domestic party's foreign branch (which would not produce FDDEI).

[24] *See* Treas. Reg. § 1.987-2(c)(2)(i); Treas. Reg. § 1.1503(d)-5(c)(1)(ii).

[25] In Part III.E.2, we request that guidance confirm that in the case of an intercompany transaction, the matching rule of Treas. Reg. § 1.1502-13(c) can apply to treat the seller's income as foreign-derived, when the buyer subsequently sells the property to an unrelated foreign person for foreign use.

If the transactions between DC and FB are instead disregarded, then FB has a carryover basis of $0 in the property and $100 of income on the sale to the unrelated foreign person. All $100 of income accrues to FB and is excluded from DC's DEI as foreign branch income.[26]

We also believe that transfer pricing rules should be taken into account in determining foreign branch income, including in respect of interbranch transactions. The Authorized OECD Approach for determining the profits of permanent establishments provide one possible framework.

We observe that the rules for determining foreign branch income are relevant not only for computing the FDII deduction but also for computing the foreign tax credit limitation under Section 904. Specifically, foreign branch income is a new foreign tax credit limitation basket. Our recommendation that items from otherwise disregarded transactions be taken into account in determining foreign branch income is also intended to apply for purposes of applying Section 904.

B. Allocation of Costs

1. Allocation of Cost of Goods Sold

a. In general

To compute its FDDEI, a taxpayer must allocate cost of goods sold between gross receipts from domestic sales and exports. However, the statute does not specify the applicable method of allocation.

We recommend that Treasury issue guidance modeled on the principles of Treas. Reg. § 1.199-4(b)(2), relating to the allocation of cost of goods sold between domestic production gross receipts ("**DPGR**") and non-DPGR for purposes of former Section 199. In general, Treas. Reg. § 1.199-4 requires a taxpayer to use a reasonable method.[27] Whether an allocation method is reasonable is based on all of the facts and circumstances. Among the factors bearing on the reasonableness of a given method are:

- whether the taxpayer uses the most accurate information available;
- the relationship between cost of goods sold and the method used;
- the accuracy of the method chosen as compared with other possible methods;
- whether the method is used by the taxpayer for internal management or other business purposes;
- whether the method is used for other federal or state income tax purposes;

[26] Example 2 is a case where disregarding transactions between a foreign branch and its domestic owner decreases DEI. However, we note that under different facts, disregarding such transactions could have the effect of increasing DEI.

[27] Treas. Reg. § 1.199-2(b)(2)(i).

- the time, burden, and cost of using alternative methods; and
- whether the taxpayer applies the method consistently from year to year.[28]

Moreover, the regulation provides that a taxpayer that does not have information readily available to specifically identify cost of goods sold allocable to DPGR and that cannot, without undue burden or expense, specifically identify that amount is not required to use a method that specifically identifies cost of goods sold allocable to DPGR.

In this latter respect, the rules of Treas. Reg. § 1.199-4(b)(2)(i) resemble the DISC rules, which permit taxpayers to elect to determine qualifying income either "on a transaction-by-transaction basis" or "on the basis of groups consisting of products or product lines."[29] Under these rules, the taxpayer's product or product line grouping is acceptable if it conforms to either a recognized industry or trade usage, or the two-digit code set forth in the Standard Industrial Classification Manual published by the Office of Management and Budget (*i.e.*, SIC codes).[30] A choice by the taxpayer to group transactions for a tax year on a product or product line basis applies to all transactions for that product or product line consummated during the tax year.[31] However, for transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis.[32] For example, the taxpayer may choose a product grouping for one product and use the transaction-by-transaction method for another product within the same tax year.[33]

b. Treatment of Gross Losses

Guidance is needed on the treatment of gross losses in the computation of DEI and FDDEI.

Example 3: Gross Loss

DM is a U.S. manufacturer of industrial turbines. During the year, DM engages in four transactions, the results of which are as follows:

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[28] *Id.*

[29] Treas. Reg. § 1.994-1(c)(7)(i). The foreign sales corporation provisions, which were enacted in 1984 and repealed in 2000, and the extraterritorial income exclusion provisions, which were enacted in 2000 and repealed in 2006, likewise allowed taxpayers to elect to compute income on a transaction-by-transaction basis or an aggregate basis.

We understand that the DISC legislation was passed in 1971, and the ability of taxpayers to track sales on a transaction-by-transaction basis has evolved since then. However, as discussed below, we believe that as a practical matter, taxpayers should be allowed to elect whether to compute DEI and FDDEI on a transaction-by-transaction or aggregate basis.

[30] Treas. Reg. § 1.994-1(c)(7)(ii).

[31] Treas. Reg. § 1.994-1(c)(7)(iii).

[32] Treas. Reg. § 1.994-1(c)(7)(iv).

[33] *Id.*

	Export Sales		Domestic Sales		Total
	T1	T2	T3	T4	
Sales	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 4,000
Cost of Goods Sold	(800)	(1,200)	(1,000)	(1,000)	(4,000)
Gross Income/(Loss)	200	(200)	-	-	-

DEI is the excess (if any) of gross income determined without regard to certain exceptions, over the deductions properly allocable to that income. In the case of a manufacturing business, gross income means total sales less the cost of goods sold.[34] Here, the cost of goods sold in T2 exceeds the sales price, and so DM has no gross income from T2. Thus, it could be argued that, applying a transaction-by-transaction analysis, DM has $200 of DEI and FDDEI (*i.e.*, the gross income from the T1 export sale).

However, we believe that the better interpretation of the statute is that if a taxpayer realizes a gross loss from an asset that is of a type that would have given rise to DEI or FDDEI, the gross loss should be treated as a reduction to that class of income. Thus, DM's gross loss on T2 should be allocated to the gross income from T1, reducing DM's DEI and FDDEI to zero.

Moreover, the contrary view would produce incongruous results. Suppose that in Example 3, DM has no QBAI, and its only item of income, gain, loss and deduction for the year other than the items from the transactions described above is $150 of subpart F income. If DM's gross loss on the domestic sale were not allocated against its gross income on the export sale, DM would have $200 of DEI, $200 of FDDEI, and $200 of FDII. DM would therefore be allowed an FDII deduction of $37.50. The taxable income limitation contained in Section 250(a)(2) would not apply because the FDII deduction would not create or increase an NOL. Because DM does not have any net DEI, the effect is to tax DM's subpart F income at an effective tax rate of 10.5%—a result that seems hard to justify.

2. Allocation of Deductions

To compute its DEI and FDDEI, a taxpayer must allocate its deductions among its various items of gross income. However, the statute does not provide rules for identifying which deductions are properly allocable to DEI or FDDEI.

The Senate bill (the "**Senate Bill**")[35] provided that in determining DEI, gross DEI is reduced by deductions "properly allocable to such income under rules similar to the rules of Section 954(b)(5)."[36] The rules of Section 954(b)(5), in turn, incorporate the rules of Treas. Reg. § 1.861-8, which govern the allocation and apportionment of deductions to income from specific sources and activities for purposes of various provisions of the Code.[37] The reference to the

[34] Treas. Reg. § 1.61-3(a).

[35] S.1, 115th Cong. (2017).

[36] *Id.* at 437.

[37] Treas. Reg. §1.954-1(c)(1)(i)(B).

rules of Section 954(b)(5) was dropped from the legislation in Conference Committee, without explanation.[38]

We note that with respect to the GILTI provisions, both the Senate bill[39] and the final statutory language of Section 951A include a reference to Section 954(b)(5) as relates to calculating the tested income of a controlled foreign corporation for GILTI purposes. The statute provides that "tested income" means the excess (if any) of a controlled foreign corporation's gross income (determined without regard to certain exceptions) over the deductions (including taxes) "properly allocable to such gross income under rules similar to the rules of Section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)."

We urge Treasury to prescribe a specific methodology for allocating and apportioning deductions for purposes of calculating both DEI and FDDEI. In our view, the logical starting point would be to incorporate the principles of Section 861, as set forth in Treas. Reg. § 1.861-8, for several reasons. First, incorporating the Section 861 regulations will promote the clear reflection of DEI and FDDEI. Because the Section 861 regulations are based on "the factual relationship of deductions to gross income",[40] they are adaptable to a range of different statutory contexts. A statutory scheme that can be viewed in some sense as the forerunner to the FDII rules—the Domestic International Sales Corporation ("**DISC**") rules—require a DISC to allocate its deductions in accordance with the Section 861 regulations in determining income from export sales.

Second, incorporating the Section 861 regulations will ensure that taxpayers consistently apply the same method of allocating deductions for purposes of different provisions of the Code.[41] In particular, we believe that there are strong reasons for using the same method to allocate deductions for purposes of calculating DEI for FDII and for purposes of calculating tested income for GILTI, given that FDII and GILTI are apparently intended to work in tandem to achieve the policy objectives of the new international tax regime.

Finally, taxpayers are familiar with the rules of Section 861, and we believe that building on existing allocation methods is a sound approach.

Special rules may be needed to coordinate the application of the rules governing the allocation and apportionment of deductions with the rules governing the determination of foreign branch income. Specifically, if, for purposes of determining foreign branch income, business profits are attributed to a foreign branch on the basis of the branch's separate books and records under rules similar to Treas. Reg. § 1.987-2, guidance will be needed to address the treatment of items that are not definitely related to any particular class of gross income. In our view, the most

[38] It is possible that the reference to Section 954(b)(5) was removed for fear of creating uncertainty regarding the allocation of expenses not expressly described in Treas. Reg. § 1.861-8, such as interest expense and research and experimental expenditures, which are covered by Treas. Reg. § 1.861-9T through -13T and -8T(e)(2), respectively.

[39] Senate Bill at 424.

[40] Treas. Reg. § 1.861-8(a)(2).

[41] *See* Treas. Reg. § 1.861-8(f)(2) (requiring a taxpayer to use the same method of allocating deductions for all applicable operative Code sections).

sensible approach would be to follow the books and records of the foreign branch, subject to a special rule for interest expense, under which the branch's and the owner's interest expense would be aggregated and allocated under Section 861 principles. This approach generally would be consistent with current rules for allocating interest expense for foreign tax credit limitation purposes for taxpayers with foreign branches.

However, other approaches are possible. For example, a foreign branch could be allocated those deductions recorded on its books and records, as well as a share of the deductions of the domestic corporate owner. Thus, if a foreign branch incurs deductible interest expense, which is reflected on its books and records, then the entire amount of that expense would be treated as reducing foreign branch income. In addition, an allocable portion of any interest expense incurred by the domestic corporation would be allocated and apportioned to the foreign branch under Section 861 principles based upon the net assets of the foreign branch, further reducing foreign branch income. This approach is broadly consistent with the allocation and apportionment of expenses relating to investments in controlled foreign corporations ("**CFCs**") for foreign tax credit purposes, where the CFC's own interest expense ultimately reduces the U.S. shareholder's foreign source income and foreign source income is further reduced by an allocable portion of the U.S. shareholder's interest expense based upon the adjusted basis or (under rules in effect prior to the Act) the fair market value of the stock of the CFC.

C. Foreign-Derived Income from Sales of Property

As discussed above, a key component of a domestic corporation's FDII is its DEI from the sale of property to a non-U.S. person that the taxpayer "establishes to the satisfaction of the Secretary is for a foreign use." Foreign use is defined in Section 250(b)(5)(A) as "any use, consumption, or disposition which is not within the United States."

The statute does not provide specific guidance as to what constitutes use, consumption or disposition. However, the Conference Report accompanying the Act clarifies that "manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States" is a foreign use.[42] This interpretation of foreign use is supported by the statute itself, which excludes from the definition of foreign use any property sold to an unrelated party "for further manufacture or other modification within the United States . . . even if such other person subsequently uses such property for a foreign use."

Section 250(b) treats transactions involving related and unrelated parties differently.[43] When a taxpayer sells property to an unrelated foreign intermediary, the statute does not explicitly require the taxpayer to determine to whom the intermediary ultimately sells the property.[44] By contrast, when property is sold to a related foreign party, the sale will not be for a

[42] H.R. Rep. No. 115-466 (the "**Conference Report**"), p. 625 n. 1522.

[43] For this purpose, parties are related if they are part of an "affiliated group" as defined in Section 1504(a), substituting "more than 50%" for "at least 80%". Section 250(b)(5)(D).

[44] The general rule is that a taxpayer must show property is for a foreign use, but for sales to a related party, it must also show that the related party does not sell to a U.S. person.

foreign use until the property is sold or used in connection with transactions with unrelated foreign parties. We believe that applying different standards to related party transactions is sensible, not only as a matter of policing abuse but also as a matter of practicality, since the ability of taxpayers to obtain information about the ultimate use of property is meaningfully higher in the related party context. However, as noted below, we also believe that there are some cases where the rules should be the same for related and unrelated sales, where either the potential for abuse is not present, or the ability to determine the end user is limited.

We believe that guidance clarifying when property is sold for a foreign use is of paramount importance to taxpayers. Furthermore, we believe that it would be sensible for any FDII guidance to provide rules similar to those in existing regulations under other provisions of the Code governing when property is sold for foreign use, consumption or disposition. In developing the requirements that taxpayers must satisfy in demonstrating foreign use, any FDII guidance should reflect the practical limitations on a selling domestic corporation in obtaining information to determine the purpose for which property is purchased.

1. Demonstrating Foreign Use under Other Code Provisions.

The "use, consumption, or disposition" terminology in the context of FDII is similar to terminology used in other provisions of the Code, such as in the definition of export income for a DISC (the "**DISC rules**") and in the definition of "foreign base company sales income" ("**FBC Sales Income**") for a CFC. Like the FDII rules, these provisions contain special rules for sales to related parties. The regulations for these rules identify transactions for which taxpayers generally lack sufficient information to determine the location of eventual use of property, even in transactions with related parties, and instead allow taxpayers to make assumptions or benefit from rebuttable presumptions.

a. DISC Rules

The DISC rules' definition of "export property" requires that the property be "held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a DISC, for direct use, consumption, or disposition outside the United States."[45] The regulations promulgated thereunder provide a three-part test to determine whether property is sold or leased for direct use, consumption or disposition outside of the United States. The property must be sent outside the United States (the "**destination test**"), the taxpayer must furnish certain documents as proof that the destination test has been satisfied (the "**proof of compliance requirements**"), and the property must ultimately be used outside the United States (the "**use test**").[46]

[45] Section 993(c)(1).

[46] Treas. Reg. § 1.993-3(d).

The most important factor relevant to the destination test is generally the place of ultimate delivery or use of the property.[47] If delivered from within the United States, property must generally be delivered either to the purchaser or lessor outside the United States, or from within the United States to a purchaser or lessor that will be delivered, used, or consumed outside of the United States within one year. If delivered from outside the United States to the purchaser or lessor, the property must have previously been delivered from within the United States to a warehouse, storage facility or assembly site outside the United States from which it is then delivered to the purchaser or lessor, unless certain other exceptions apply.[48] Similar to the FDII rules, the DISC rules' destination test for export property is not satisfied with respect to a sale if, before ultimate delivery or use outside the United States, the property "is subject to any use (other than resale or sublease), manufacture, assembly, or other processing (other than packaging)."[49]

Like the FDII rules, the "use" test in the DISC rules includes special rules for transactions with related parties.[50] A sale of property that satisfies the delivery test and proof of compliance requirements generally satisfies the use test unless either: (1) the parties are related and, within the three years following the sale, the property (or other property into which the sold property has been incorporated as a component) is ultimately used in the United States; (2) there is an agreement at the time of sale that the purchaser will use the property (or other property into which the sold property has been incorporated as a component) in the United States, including an indication by the purchaser prior to or at the time of the transaction that it intends to incorporate the property into a product designed principally for sale into the United States; or (3) "[a]t the time of the sale, a reasonable person would have believed that the property or such [other property into which the sold property has been incorporated as a component] would be" ultimately used in the United States, unless the property is a component part with a value less than twenty percent of that of the final product into which it is incorporated.[51] Sales to retailers whose principal business is selling inventory to retail customers at retail outlets outside the United States are conclusively treated as sold for ultimate use outside the United States.[52]

b. FBC Sales Rules

Similarly, the FBC Sales Income rules provide a developed set of rules for demonstrating that property is purchased or sold "for use, consumption, or disposition" in the country where the

[47] Treas. Reg. § 1.993-3(d)(2)(i). However, the destination test may also be satisfied if the property is sold and delivered to a DISC that is not a member of the same controlled group, regardless of the destination. Treas. Reg. § 1.993-3(d)(2)(i)(c).

[48] Treas. Reg. § 1.993-3(d)(2)(i).

[49] Treas. Reg. § 1.993-3(d)(2)(iii).

[50] For this purpose, the definition of "related party" is somewhat broader than that used in the context of determining FDII. Treas. Reg. § 1.993-3(d)(4)(ii)(a) (related parties, for purposes of the "use" test under the DISC rules, includes related parties under Section 267 or 707(b) or members of a "controlled group of corporations" under Section 1563(a), substituting "more than 50%" for "at least 80%" where it appears).

[51] Treas. Reg. § 1.993-3(d)(4)(ii)–(iii).

[52] Treas. Reg. § 1.993-3(d)(4)(iv).

CFC is created or organized.[53] Under the rules for determining the FBC Sales Income of a CFC, income derived from either the purchase from, or the sale of personal property to, or on behalf of, a related party is generally included in the FBC Sales Income of the CFC unless it is either (a) manufactured or (b) purchased or sold for use, consumption or disposition, in the country of creation or organization of the CFC.[54] The regulations under the FBC Sales Income rules provide a general rebuttable presumption that sales of personal property to unrelated parties will be presumed for use, consumption or disposition in the country of destination.[55] This presumption is rebutted if the CFC knew or should have known that the country of destination was likely not where the property would be used, consumed or disposed of, in which case the income therefrom will be treated as FBC Sales Income unless the CFC determines that the ultimate country of use is the country where the CFC is organized.[56]

Sales of personal property to related parties do not benefit from the general presumption that the place of destination is the place of use.[57] Instead, any such sale to a related party is presumed to be for use outside of the country where the CFC is created or incorporated unless the CFC can identify where the related party uses the property.[58] If the related party eventually sells the purchased property to an unrelated party, then the CFC may use the general presumption for sales to unrelated parties to show that the eventual sale was for use, consumption or disposition in the CFC's country of creation or formation.[59]

In addition, other presumptions are provided, which apply regardless of whether the sales are to related or unrelated parties, for sales to retailers and sales of fungible goods. Similar to the rules for defining export property sold to retailers in the context of DISCs, a CFC may treat personal property sold to a retailer (regardless of whether it is related) who sells inventory to retail customers at retail outlets all within one country as sold for use, consumption, or disposition in such country.[60] A CFC may also treat fungible personal property as being sold for use, consumption, or disposition in a given country in the same proportion that such fungible property is ultimately sold by the purchaser for use, consumption, or disposition in that country.[61]

2. Sale of Goods to a Foreign Retailer

The sale of goods to a foreign retailer presents a number of variations that may merit clarification in regulations. As outlined in the examples below, we believe that it is important to

[53] Section 954(d)(1)(B).

[54] *Id.*

[55] Treas. Reg. § 1.954-3(a)(3)(ii).

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] Treas. Reg. § 1.954-3(a)(3)(iii).

balance the practical concerns of administering these rules with the overall policy of only allowing the FDII deduction for foreign-derived income.

Example 4: Sale to an Unrelated Foreign Retailer

DS is a U.S. wholesaler. FR is a foreign retailer incorporated in Country Z. DS and FR are unrelated parties. DS sells goods to FR, who sells to customers through stores located in Country Z. FR has no actual knowledge of which sales are to U.S. persons.

We believe that it is clear that the sales in this case are for a foreign use. The taxpayer is a domestic seller that has sold property to an unrelated foreign person, and DS's access to information ends when it sells to FR. There does not appear to be any practical way for DS to know whether any property may be sold by FR to a domestic person in a store in country Z. Treating the sale of goods for resale at stores outside the United States as a foreign use for FDII purposes is consistent with the approach taken by the DISC and the FBC Sales Income rules, and consistent with the economic substance of such sales as exports.

Example 5: Sale of Inventory to a Related Foreign Retailer

DS is a U.S. wholesaler. FR is a foreign retailer incorporated in Country Z. DS and FR are related parties – FR is a foreign subsidiary of DS. DS sells inventory to FR, who sells to customers through stores located in Country Z. FR has no actual knowledge of which sales are to U.S. persons.

We note that Section 250 provides that sales to related foreign parties do not qualify as for a foreign use unless the property is ultimately sold, or used in connection with property that is sold or the provision of services, to an unrelated foreign person, and the taxpayer establishes to the satisfaction of the Secretary that the property is for a foreign use.[62] However, even though FR is a related party, we believe that guidance should provide that the sales by DS to FR for resale to customers through stores located outside the United States should satisfy the requirement that the property is "ultimately sold . . . to another person who is an unrelated party who is not a United States person."[63] While FR is a related party and DS may have more access to information than if FR were unrelated, it would be administratively unworkable for FR to trace the sale of goods to specific customers and to determine whether the customers are United States persons. In light of the broad grant of regulatory authority under Section 250(c), we believe that there would be sufficient authority to provide for a presumption that property sold to foreign retailers (whether or not related) is ultimately sold to unrelated foreign persons for a foreign use, notwithstanding the statutory language which appears to require tracing the ultimate users of property in the case of sales to related foreign persons.

There may be circumstances where it is not appropriate to treat all sales to foreign retailers (including unrelated parties) as for a foreign use. For example, in the case of a foreign retailer with stores located in the United States as well as outside the United States, the presumption of foreign use could be rebutted to the extent that the domestic seller knew, or had

[62] Section 250(b)(5)(C)(i); Conference Report p. 625.

[63] Section 250(b)(5)(C)(i)(I).

reason to know, that a material amount of the goods was intended for resale in the United States. Sales to online retailers pose even more difficult issues, as online sales are more susceptible to sale to United States persons. And it would be contrary to the policy underlying the FDII rules to obtain a FDII deduction by, in the starkest case, shipping goods to an offshore warehouse of a foreign online retailer that made all of its sales to United States customers.

Although line drawing in this area will be difficult, there are some possible alternatives. For example, sales to unrelated foreign online retailers whose primary business is selling to non-United States customers should still qualify for the basic presumption. Such a determination could be made by publicly available information, from information provided by the retailer, or from objective evidence such as the language, address, currency and other elements of the retailer's website that indicate its primary intended audience. Similarly, additional documentation could be required for sales to unrelated foreign online retailers that are affiliated with domestic retailers. However, due to the likely difficulty in obtaining actual end user sale information from unrelated retailers, we recommend that any additional documentation requirements be carefully crafted to allow compliance. For example, it may suffice to receive written confirmation from an unrelated foreign retailer that the goods are intended for sale on websites that are not United States-facing or substantially all of the sales on which are to non-United States persons. In cases that are not so clear, it may be possible to make some apportionment based on average sales to United States persons via the website (if the retailer is willing to provide) or through publicly available segment sale information. Finally, in the case of sales to related foreign online retailers, it may be appropriate in light of the statutory rules on related party sales to require documentation of the end purchaser's location to validate foreign use.

3. Sale of Intermediate Goods to Foreign Manufacturers

The sale of an intermediate good (e.g., a part) to a foreign manufacturer constitutes a different fact pattern than the sale to a foreign retailer. The Code specifically provides that if a taxpayer sells property (other than to a related person) for further manufacture or other modification in the United States, such property is per se not sold by the taxpayer for a foreign use, even if it is ultimately sold for a foreign use.[64] By contrast, the Conference Report states that "manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States" is a foreign use.[65]

Example 6: Sale of Intermediate Good to an Unrelated Foreign Manufacturer

DS is a U.S. wholesaler of automobile engine parts. FM is an unrelated foreign automobile manufacturer incorporated in Country Z. DS sells parts to FM, who uses the parts in creating cars.

[64] Section 250(b)(5)(B)(i).

[65] Conference Report p. 625, n. 1522.

Based on the Conference Report, we believe that guidance should provide that the sale of an intermediate good to an unrelated foreign manufacturer (at least where there are no facts indicating a round-tripping abuse potential, as discussed below) is conclusively presumed to be for foreign use. In this case, the final destination of the finished product should not matter.

If FM is related to DS, a conclusive presumption of foreign use appears not to be appropriate in light of the related party sale rule in Section 250(b)(5)(C)(i). Although the Conference Report states the principle that using goods in manufacture, assembly or processing outside the United States is itself a foreign use, Section 250(b)(5)(C) provides that for purposes of the related party sale rule, a sale of property shall be treated as a sale of each of the components thereof. This can be read to require that a sale of components to a related foreign manufacturer will not be for a foreign use unless the finished good is sold to an unrelated foreign person. In light of the wording of Section 250(b)(5)(C), it may be appropriate to require documentation of the destination of the end user of the finished good in cases where the foreign manufacturer is related.

We also believe that it would be appropriate to have anti-abuse rules to avoid use of contract manufacturers or other intermediaries to improperly obtain an FDII deduction. The FDII deduction should be *per se* unavailable for property sold to intermediaries that is repurchased by DS or its affiliates. For example, if DS were a manufacturer of cellular phones that are sold primarily to customers in the United States, DS should not be able to obtain an FDII deduction by shipping parts to an unrelated contract manufacturer that completes finished goods that are then purchased by DS or an affiliate for resale in the United States.

4. Sales of Fungible Goods

A similar fact pattern involves a sale by DS of fungible goods (goods that because of their fungible nature cannot be traced to particular end purchasers) to a foreign buyer ("FB"). FB purchases such goods from other sources as well, and then sells them globally, including into the United States. We believe that where FB is unrelated to DS, rules similar to those discussed above for sales to unrelated foreign retailers should apply. Specifically, a general presumption of foreign use should apply, with exceptions for cases where DS knows or has reason to know that a material amount of the goods were intended for resale in the United States, or where FB sells online through platforms that reach more than a *de minimis* number of United States customers. By contrast, if FB is related, DS would be required by Section 250(b)(5)(C)(i) to determine where its goods were resold to establish whether they were sold for a foreign use.

If it is necessary to determine the end user of goods (whether in a related or unrelated party context), given the potential administrative difficulty with establishing the ultimate destination of fungible goods, we believe that a method other than actual tracing is needed. Similar to rules provided in the FBC Sales Income area, DS should be able to treat a proportionate amount of the goods sold to FB as for a foreign use based on FB's overall

proportion of U.S. sales to total global sales.[66] However, DS should be permitted to actually trace if it can in fact substantiate the ultimate destination of its goods.

5. Sales of Goods for Final Consumption

In the case of a sale of goods to an unrelated person that is the final user of the goods, we believe that it would be appropriate for guidance to provide a rebuttable presumption (similar to the DISC rules and the FBC Sales Income rules) that goods delivered outside of the United States are sold to a foreign person for a foreign use. The presumption could be rebutted if the seller knew or reasonably should have known that the final user of the goods was a United States person or that the intended use of the goods would occur in the United States.

6. Sales or Licenses of Intangible Property

The availability of the FDII deduction is not limited to sales of tangible property. The definition of "sale" in Section 250(b)(5)(E) includes any lease or license, and thus the statutory framework is broad enough to encompass sales or licenses of intellectual property or other intangibles as potentially eligible for the FDII deduction.

In the case of intangible property that is sold or licensed to an unrelated foreign party for use in business operations conducted outside the United States, whether manufacturing, performance of services or other activities, we believe that it would be appropriate to have a presumption of foreign use that does not depend on whether the unrelated foreign party resells goods or performs services for United States persons (consistent with the Conference Report and the rules proposed above for sales of goods to unrelated foreign parties).[67] Guidance could provide an anti-abuse rule in cases where the license is to an intermediary that resells goods created using the intellectual property to the domestic licensor or its affiliates, similar to the round-tripping contract manufacturing case discussed above.

In the case of intangible property that is sold or licensed to a related foreign party, we believe that the statutory framework requires a determination of the destination of the end use. Intangible property used in connection with the creation of tangible property for resale would be for a foreign use to the extent of property sold to unrelated foreign persons, while intangible property used in connection with the performance of services would be for a foreign use to the extent the services are performed for an unrelated foreign person.

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[66] *See* Treas. Reg. § 1.954-3(a)(3)(iii) (in the case of a sale of fungible goods to a purchaser, a CFC can treat such property as having been resold to those countries in the same proportions in which property from the fungible mass is sold in the ordinary course of business by the purchaser.)

[67] *See supra* note 65.

D. Foreign-Derived Income from Services

FDDEI can be derived not just from the sale of property for foreign use, but also from the provision of services by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are "to any person, or with respect to property, not located within the United States."[68]

Neither the statute nor the legislative history provides any specific guidance as to what it means to provide services to a person not located in the United States or with respect to property not located in the United States. The overall structure of the statute, however, suggests that the rules for determining foreign use are intended to apply consistently to both sales and services. For example, there is a special rule for services provided to certain domestic intermediaries, similar to the corresponding rule for sales, under a common subsection titled "Rules relating to foreign use property or services".[69] Further, there is a special rule for services provided to related parties, which tracks a similar rule for sales to related parties, and again both related-party rules appear under the same subsection.[70] In light of the similarity of the rules defining foreign-derived income from sales and those defining foreign-derived income from services, the statute suggests that both sets of rules are aimed at the same target—*viz.*, foreign consumption or use.

We believe that guidance clarifying when services are provided for foreign consumption or use is equally important to taxpayers as guidance relating to sales. Furthermore, as in the case of sales, we believe that it would be sensible for Treasury to look to existing sources of law in developing the requirements that taxpayers must satisfy in demonstrating foreign consumption or use. Unlike in the sales context, there is scant guidance in the Code governing when services are provided for foreign use or consumption. However, consumption taxes, such as value-added taxes ("**VAT**"), normally tax services on a destination basis, and so the rules developed under these systems may serve as a potential guide. In particular, we believe that the OECD Guidelines, which set forth "internationally agreed principles and standards for the value added tax treatment of the most common types of international transactions, with a particular focus on trade in services and intangibles",[71] may be instructive in certain situations.

1. Summary of OECD Guidelines

The OECD Guidelines are animated by the "destination principle"—the norm that "for consumption tax purposes internationally traded services and intangibles should be taxed

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[68] Section 250(b)(4)(B).

[69] Specifically, income from services provided to unrelated persons located in the United States is not treated as foreign-derived, even if the unrelated person uses the services in providing services to another person, or with respect to property, not located in the United States. Section 250(b)(5)(B)(ii).

[70] Under this rule, if a service is provided to a related party who is not located in the United States, such service is not treated as foreign-derived unless the taxpayer establishes 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. Section 250(b)(5)(C)(ii).

[71] *Id.*

according to the rules of the jurisdiction of consumption."[72] In implementing the destination principle, the OECD Guidelines differentiate between business-to-consumer services, which involve the provision of services for final consumption, and business-to-business services, which involve the provision of services for use in business operations.

According to the OECD Guidelines, in theory, the rules should aim to identify the actual place of final consumption for business-to-consumer services and the actual place of business use for business-to-business services.[73] Yet, in practice, the rules do not aim squarely at these targets. In many cases, the service provider will not know or be able to ascertain where final consumption or business use will actually occur.[74] The rules therefore "generally use proxies for the place of final consumption or business use … based on features of the [service] that are known or knowable" to the service provider.[75] Thus, the rules reflect the need to take into account practical considerations in identifying the jurisdiction of final consumption or the jurisdiction of business use.

Business-to-consumer transactions are subject to one of two general rules, depending on the nature of the services involved. The first rule applies to so-called "on-the-spot" services—services that are "normally physically performed at a readily identifiable place and are ordinarily consumed at the same time and place where they are physically performed, and that ordinarily require the presence of both the person performing the [service] and the person consuming it."[76] The destination of such services is determined by reference to the physical location where performance occurs. The second rule applies to all services other than on-the-spot services. The destination of services falling into this residual category is determined by reference to the jurisdiction in which the customer has his or her "usual residence", on the assumption that the customer's usual residence is a reasonable proxy for the jurisdiction of final consumption.

In the case of business-to-business transactions, the OECD Guidelines adopt the jurisdiction in which the customer is located as a proxy for the jurisdiction of business use. In general, determining the location of the customer is a two-step process: first, the identity of the customer is determined on the basis of the business agreement between the parties; and second, the services are attributed to the customer's relevant business operations. As discussed below, the OECD Guidelines provide specific rules applicable to cases where the customer has operations in multiple jurisdictions.

Finally, the OECD Guidelines provide exceptions to the rules above for certain types of services provided with respect to property.

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[72] *Id.* Guideline 3.1, at 27.

[73] *Id.* para. 3.6, at 28.

[74] *Id.* at 28-29.

[75] *Id.*

[76] *Id.* para. 3.116, at 47.

2. Business-to-Consumer Services

We believe that the OECD Guidelines for on-the-spot services are an appropriate approach for FDII purposes as well, which provide that the destination of such services is determined by reference to the physical location where performance occurs. In the case of business-to-consumer services other than on-the-spot services, the OECD Guidelines look to the location of the customer's usual residence to determine the destination of the services, on the theory that the customer is most likely to consume a service in its country of usual residence.

However, in many cases, service providers will often have limited interaction with customers, and therefore limited information as to the customer's place of usual residence. Recognizing this, the Guidelines suggest that the rules should permit service providers "to rely, as much as possible on information they routinely collect from their customers in the course of their normal business activity, as long as such information provides reasonably reliable evidence of the place of usual residence of the customers."[77] As the OECD Guidelines note, this could include information collected through the ordering process, such as the customer's telephone number, address, bank account, or credit card information, or, in the case of digital content, the IP address of the device used to access the content.[78]

We recommend that Treasury adopt a similarly pragmatic approach, and allow taxpayers to determine the destination of business-to-consumer services on the basis of the customer's usual residence, as determined by reference to information routinely collected from the customer during the sales process. In particular, if this information provides indicia that the customer resides abroad and no indicia to the contrary, the income from the services should be conclusively presumed to be foreign-derived.

3. Determining the Location of Recipients of Business-to-Business Services

As discussed above, the theoretical lodestar for determining the destination of business-to-business services under the OECD Guidelines is the location of business use. Yet, rather than focusing directly on where services are *actually* used, the OECD Guidelines employ a proxy that effectively identifies the location of business use with the location of the customer's relevant business operations. Overall, we believe that this approach is sound, and we recommend that Treasury generally look to the OECD Guidelines in developing rules for determining whether income from business-to-business services is foreign-derived. However, we discuss below selected issues arising from this approach, and in certain instances we recommend guidance that departs from the OECD Guidelines.

a. Identifying the Customer

Under the OECD Guidelines, the first step in determining the destination of business-to-business services is to identify the customer. For this purpose, the OECD Guidelines look to the

[77] *Id*. para. 3.126 at 49.

[78] *Id*. para. 3.127 at 49.

business agreement between the parties. We believe, however, that rigidly adhering to the business agreement to identify the customer can lead to incongruous results when one entity pays for services for the specific benefit of a related entity that is not a party to the agreement.

Example 7: Service for Specific Benefit of Related Entity

DC is a U.S. consultancy. FP is an unrelated corporation organized in Country Z and the parent of a multinational group that includes domestic subsidiary DS. DS recently acquired a business in the United States, and DC provides consulting services to FP relating to integration of the newly acquired business operations with FP's existing operations. The engagement letter is between DC and FP, and DC bills FP for its services.

Here, the business agreement indicates that the customer is FP. But the "true" customer—the entity that actually uses the services in its business operations—is DS. Accordingly, we believe that DC's income should not qualify as foreign-derived. Treating income derived from services that are, in substance, provided to a U.S. person as foreign-derived is inconsistent with the purpose of the FDII rules. Moreover, inflexibly following the business agreement to isolate the customer could lead to inappropriate planning opportunities. Although there is considerable practical value to determining the identity of the customer by reference to the applicable business agreement in general, we believe that guidance should depart from this approach when the applicable business agreement plainly fails to reflect the economic substance of the transaction.

The same principles would apply if the contract is instead with DP, a U.S. corporation that is the parent of a multinational group that includes foreign subsidiary FS, and FS recently acquired a business abroad. The entity using the services in its business operations is FS, and we believe that DC's income should qualify as foreign-derived.

In the simplified facts of Example 7, the place of business use is stipulated to occur in a single jurisdiction. In real life, however, the facts are apt to be less stark. To illustrate, contrast Example 7, where services were provided for the benefit of a specific entity, with the following example, where services are provide to a foreign multinational for the joint benefit of multiple entities.

Example 8: Service for Joint Benefit of Multiple Entities

DC is a U.S. information technology firm. FP is an unrelated corporation organized in Country Z and the parent of a multinational group that includes domestic subsidiary DS. DC provides IT services to FP for the joint benefit of its various subsidiaries. The engagement letter is between DC and FP, and DC bills FP for its services.

In a case such as Example 8, the destination of the services can be determined in one of two ways: allocate the services among the various users in some manner, or fall back on the location of the customer identified in the applicable business agreement. For services that are not physically performed at the place where they are used, allocating services among the entities may present conceptual and practical problems: it may be unclear that there is a suitable basis for making the allocation, and a service provider may not be able to obtain the detailed information about an unrelated customer's business enterprise required to determine it. However,

determining the destination of the services by reference to the nominal customer is not wholly satisfactory; as discussed above, it can both lead to results that are arguably inconsistent with the purposes of the FDII rules, as well as incentivize inappropriate planning opportunities. On balance, we recommend an allocation approach, subject to a *de minimis* rule providing that a U.S. service provider may rely on the customer as the party to the agreement if the U.S. service provider reasonably believes that the customer allocates less than a substantial amount (for example, 20%) of the services to or for the benefit of a U.S. user. Such belief may be established by information obtained from the customer, or from information that is publicly available (e.g., publicly available financial statements with geographic segment reporting).

b. Determining Where the Customer is Located

Once the customer has been identified, the next step in determining the destination of business-to-business services is to attribute the services to the relevant business establishment of the customer. Where the customer operates out of a single location, the analysis is straightforward. However, guidance is needed for cases in which the customer operates in multiple jurisdictions.

Example 9: Customer Operates in Multiple Jurisdictions

The facts are the same as Example 8, except that FP directly conducts business operations in the United States (as opposed to through a separate subsidiary), and the business services are provided to FP solely with respect to its U.S. business.

Under the general principles discussed above, the destination of the services would be determined by reference to the location of FP's business operations. But here FP has multiple establishments, and so the application of the general rule does not yield a determinate outcome. Accordingly, we recommend that Treasury issue guidance that sets forth principles for attributing the services to the customer's relevant business establishment. In our view, the principles should be geared toward identifying the establishment that actually uses the business services. Applying this standard in Example 9, DC's income from providing services to FP would not qualify as foreign-derived, because the services are actually used in FP's U.S. business operations.

Similar to Example 8 above, in many cases services will benefit multiple business establishments of a single customer. When some establishments are located within the United States and some are located abroad, taxpayers should be required to demonstrate that the business establishment that uses the services is outside the United States. However, similar to the rule discussed above, we recommend a *de minimis* rule providing that a customer will be presumed to be located in the jurisdiction in which it has its primary place of business, unless the service provider knows or has reason to believe that a substantial amount (for example, 20%) of the services are performed for the benefit of a different jurisdiction. As in the case with Example 8, the information necessary to make this determination should be of a type that is reasonably obtained from the customer or publicly available.

4. Location of Serviced Property

a. Location of Service Recipient Differs from Location of Serviced Property

Guidance is needed clarifying what it means to provide services "to any person, or with respect to property, not located within the United States." At present, it is unclear how this standard is to be applied when the location of the customer differs from the location of the serviced property. To illustrate, compare the following three scenarios.

Scenario A: Both Person and Property Located Outside the United States

DC, a domestic corporation, provides services to a person located outside the United States with respect to property located outside the United States.

Scenario B: Only Person Located Outside the United States

A foreign person located outside the United States ships moveable property to the United States for servicing by DC, a domestic corporation, and then DC ships the moveable property back to that foreign person outside the United States.

Scenario C: Only Property Located Outside the United States

DC, a domestic corporation, provides services to a person located inside the United States with respect to property located outside the United States.

In Scenario A, DC's provision of services to a foreign person with respect to foreign property clearly qualifies as foreign-derived. The result is less clear in Scenario B, however. Although services are provided to a foreign person, the services are provided with respect to property located in the United States temporarily. However, it appears consistent with the purposes of the FDII rules to allow persons outside the United States to send property to the United States on a temporary basis for servicing, as the substance of this transaction is an export of services.

In Scenario C, the results are murkier still. There, although the services are provided with respect to foreign property, the services are provided to a person located in the United States. It is possible that the drafters intended for the phrase "or with respect to property" to apply only where property is serviced, and to look to the location of the recipient of the services if services are not provided with respect to property. Section 250(b)(5)(B)(ii), while it is aimed at transactions involving domestic intermediaries, states that services to another person (other than a related party) located within the United States do not qualify as foreign-derived. We note that Section 250(b)(5)(B)(ii) can be read to disqualify any services provided to a person within the United States, even if with respect to property located outside the United States,[79] or it can be

[79] If Section 250(b)(5)(B)(ii) is read to disqualify services provided to a person located within the U.S. with respect to property located outside the U.S., then this provision would eliminate any content to the clause "or with respect to property" in Section 250(b)(4)(B), which defines FDDEI. We believe the statute should be read to give some content to that clause.

read to apply only to services provided specifically to a person and not the provision of services with respect to property.

In our view, the better interpretation of the statute is that it sets out a disjunctive test. Accordingly, we recommend that guidance clarify that services are generally foreign-derived if either of the following two conditions are met: (i) the services are provided to any person not located in the United States or (ii) the services are provided with respect to property not located in the United States. However, we do not believe that services income should be viewed as foreign-derived to the extent that services are provided to a person not located in the United States with respect to business activities within the United States that effectively constitute a United States branch, or with respect to immovable property within the United States. Such services are not, in substance, the kind of export contemplated by the FDII rules.

b. Property Used in Multiple Locations

Special rules are needed to identify the destination of services provided with respect to property in multiple locations.

Example 10: Property Used in Multiple Locations

DS, a domestic corporation, provides logistics services to another domestic corporation relating to the transport of high-risk chemicals from the port of Hong Kong to the port of Los Angeles.

In Example 10, DS is providing services with respect to property; however, it is unclear whether, and to what extent, that property is "not located in the United States" within the meaning of the statute. It is therefore unclear whether all, none, or a portion of DS's income qualifies as foreign-derived. We believe that some allocable portion of DS's income should be treated as foreign-derived. We recommend that Treasury provide guidance on the proper allocation method to use to determine which portion, if any, of the DEI is foreign-derived. Wherever possible, analogous principles of existing areas of law should be used as a reference. For example, in the case above where services are provided with respect to property that is transported from a location outside the United States to a location inside the United States, the principles of Section 863(c) could apply to determine the portion of the services income that is derived from the time when the property was located outside the United States.

5. Intermediate Services

Section 250(b)(5)(B)(ii) provides that if a taxpayer provides services to another person (other than to a related person) located within the United States, such services are not treated as foreign-derived, even if the other person ultimately uses such services to provide services that generate FDDEI.

However, Section 250(b)(5)(B)(ii) does not address when services are provided to an unrelated person not located within the United States. Where the unrelated foreign person uses such services to produce consumer goods outside the United States, or incorporates such services into the provision of additional services outside the United States, such scenario is analogous to the language in the Conference Report regarding the sale of intermediate goods to foreign

unrelated manufacturers, which states that the "manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States" is a foreign use.[80]

In the case of an unrelated foreign intermediary that uses or incorporates services in the production of goods or the provision of additional services, the same principles discussed above regarding the sale of intermediate goods to foreign unrelated manufacturers should apply.[81] We believe that guidance should provide that the provision of services to an unrelated foreign intermediary that uses such services to produce consumer goods outside the United States or incorporates such services into the provision of additional services outside the United States is conclusively presumed to be foreign-derived. The location of the ultimate recipient of such services or finished goods should not matter.

E. Consolidated Return Issues

1. Application of Single-Entity Treatment

In the GILTI Report, we recommended that Treasury issue regulations treating members of a consolidated group as a single corporation for purposes of computing the GILTI deduction.[82] For the reasons stated in the GILTI Report, this Report adopts the same recommendation with respect to the FDII deduction.[83]

2. Application of Attribution Redetermination Rule

Assuming that members of a consolidated group are treated as a single entity for purposes of computing the FDII deduction, we recommend that Treasury issue guidance clarifying the application of the intercompany transaction rules of Treas. Reg. § 1.1502-13 in determining the group's FDII deduction.[84]

Treas. Reg. § 1.1502-13 provides rules for accounting for transactions between members of the same consolidated group. The purpose of the rules is "to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)."[85] To this end, the rules treat the selling member (S) and the buying member (B) in an intercompany transaction as a single entity for certain purposes.[86] The principal rule for

[80] Conference Report p. 625 n. 1522.

[81] Part III.D.3.

[82] *See* the GILTI Report, Part IV.B.2.

[83] There are a number of collateral issues that might arise if regulations provide that the Section 250 deduction applies on a consolidated basis. However, a discussion of such issues is beyond the scope of this Report.

[84] For an extensive discussion of this issue, *see* Manal S. Corwin, Mark R. Hoffenberg, Jeffrey L. Vogel, Michael H. Plowgian, Danielle E. Rolfes, Thomas F. Wessel, & Matthew A. Shaw, *Consolidated Attribute Redetermination to the FDII Rescue*, TAX NOTES TODAY, Mar. 12, 2018.

[85] Treas. Reg. § 1.1502-13(a)(1).

[86] *See* Treas. Reg. § 1.1502-13(a)(2).

achieving single-entity treatment is the matching rule of Treas. Reg. § 1.1502-13(c). Under this rule, the attributes of S's "intercompany items" and B's "corresponding items" from an intercompany transaction, although initially determined on a separate-entity basis, are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions.[87] The attributes of an intercompany item or corresponding item are all of the item's characteristics, except its amount, location and timing, necessary to determine the item's effect on taxable income (and tax liability).[88]

We recommend that guidance clarify that the attributes of S's intercompany item include its status as foreign-derived. Thus, when S transfers property to B and B uses the property to provide services or make sales to an unrelated foreign person, the attributes of S's intercompany items should be redetermined under Treas. Reg. § 1.1502-13(c)(1) to produce the same effect on consolidated tax liability as if S and B were divisions of a single corporation that sold the property to the foreign person. We believe that this result furthers the underlying purpose of the intercompany transaction rules, which is to "to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)."[89]

We note that, in an analogous context, the regulations provide an example that applies the matching rule to determine whether the source of income is within or without the United States for purposes of Section 863.[90] In the example, the regulations determine the source of the income as though S and B were members of a single division. In the first two scenarios, S manufactures inventory in the United States and recognizes $75 of income on sales to B in Year 1. B distributes the inventory in Country Y and recognizes $25 of income on sales to X in Year 1. Title passes from S to B and from B to X in Country Y. In determining the source of income, S and B are treated as divisions of a single corporation, and Section 863 applies as if $100 of income were recognized from producing in the United States and selling in Country Y.[91] In the third scenario, S earns $10 of income performing services in the United States for B. B capitalizes S's fees into the basis of property that B manufactures in the United States and sells to an unrelated person in Year 1 for a $90 profit. Title passes in Country Y. In determining the source of income, S and B are treated as divisions of a single corporation, and Section 863 applies as if $100 were earned from manufacturing in the United States and selling in Country

[87] Treas. Reg. § 1.1502-13(c)(1)(i). S's "intercompany items" are its income, gain, deduction, and loss from an intercompany transaction. Treas. Reg. § 1.1502-13(b)(2)(i). B's "corresponding items" are its income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction. Treas. Reg. § 1.1502-13(b)(3)(i).

[88] Treas. Reg. § 1.1502-13(b)(6). The source of income is included as an example of an attribute.

[89] Treas. Reg. § 1.1502-13(a)(1).

[90] Treas. Reg. § 1.1502-13(c)(7)(ii), Example 14.

[91] Treas. Reg. § 1.1502-13(c)(7)(ii), Example 14(a) and (b).

Y.[92] We believe that the underlying reasoning in this example is consistent with applying the attribute redetermination rule for purposes of determining the FDII deduction.

We note that our recommendation applies to members of a consolidated group and does not apply to members of an affiliated group or to domestic corporations that do not file consolidated returns. Section 250(b)(5) provides restrictions on the qualification of sales and services as FDII with respect to unrelated domestic intermediaries and foreign related parties,[93] but the statute does not provide restrictions with respect to transactions between related domestic parties (presumably under the theory that a sale to a related domestic party simply does not qualify as foreign use on its face).

F. Income Earned through Partnerships

When a domestic corporation owns an interest in a partnership, a number of issues relating to the FDII deduction arise. The threshold issue is whether income earned by the partnership from exporting goods or services can qualify as foreign-derived. The statute provides that the FDII deduction is available only to a domestic corporation that is not a RIC or REIT. Section 250(b)(4) refers to goods and services provided by "the taxpayer". These two provisions could be read together as suggesting that only income earned directly by a domestic corporation from the export of goods and services qualifies as foreign derived.

However, in describing the Senate Bill, the Conference Report suggests that a domestic corporate partner in a domestic partnership is eligible for the Section 250 deduction: "The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for global intangible low-taxed income could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under section 705(a)(1)(B)."[94] Thus, we believe that Congress intended to allow income earned by a partnership to qualify as foreign derived in appropriate cases. Further, we believe that the domicile of a partnership should not impact whether a domestic corporate partner is eligible for the FDII deduction. Consistent with its underlying policies, the definition of FDII requires the economic activity generating such income to generally consist of export activity from the United States. The domestic corporate partner would be eligible for the FDII deduction only if the underlying economic activity of the partnership qualifies as FDII.

The second key issue that arises in the partnership context concerns whether the computations required by the FDII rules should be applied at the partner level or the partnership level. In Part IV.F.1 and Part IV.F.3 of the GILTI Report, we recommended that regulations or legislation should adopt an approach where, if a partnership is a United States shareholder of a CFC, then the CFC's GILTI-related items flow through the partnership directly to the partners and are treated as the partners' *pro rata* shares of such items for purposes of applying the GILTI rules. Each partner would then combine these items with its own partner-level items in determining its own GILTI inclusion under Section 951A and Section 250 deduction. Consistent

[92] Treas. Reg. § 1.1502-13(c)(7)(ii), Example 14(c).

[93] *See* discussion above at Part I.B.

[94] H.R. Rep. No. 115-466, at 494 n. 1517.

with our recommendation in the GILTI Report, we recommend that regulations adopt a similar approach for purposes of the FDII rules.

G. Interaction of the FDII Deduction with Other Provisions of the Code

The interaction between the FDII provisions, Section 163(j), and Section 172 raises questions about ordering. Each provision has calculations that include taxable income as an item, and the ordering of the calculations is unclear.

The limitation under Section 163(j) is computed based on "adjusted taxable income." In our recent report on Section 163(j), we noted that the taxable income limitation under Section 250(a)(2) reduces the Section 250 deduction if the sum of the corporation's FDII and GILTI amounts exceeds its taxable income. We recommended that "Treasury and the IRS should confirm whether simultaneous equations need to be used in order to apply Section 163(j) and 250(a)(2) in tandem."[95] In the GILTI Report, we reiterated that regulations should address the relationship between Section 163(j) and Section 250.[96] For the reasons described in the Report on Section 163(j) and the GILTI Report, this Report adopts the same recommendations.

Furthermore, in the Report on Section 163(j), we noted that in general, DEI is defined as the excess of the corporation's gross income, computed without regard to specified items, over "the deductions (including taxes) properly allocable to such gross income."[97] We recommended that "guidance should be provided regarding whether, for this purpose, 'the deduction' for interest takes into account the limitation on deductibility imposed by Section 163(j)."[98] This Report adopts the same recommendation.

Section 172(a) limits the net operating loss deduction to 80% of taxable income. In the GILTI Report, we noted that Section 172(d)(9) provides that the Section 250 deduction is not allowed in calculating a net operating loss.[99] We recommended that "[r]egulations should clarify the situations where [Section 172(d)(9)] becomes relevant in light of Section 250(a)(2), which limits the combined GILTI/FDII deduction to a percentage of taxable income determined without regard to Section 250."[100] This Report adopts the same recommendation.

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[95] *See* New York State Bar Association Tax Section Report No. 1393, *Report on Section 163(j)* (March 28, 2018) (the "**Report on Section 163(j)**"), Part III.E.3.

[96] *See* the GILTI Report, Part IV.D.3.

[97] *Id. See* Section 250(b)(3)(A)(ii).

[98] *Id.*

[99] *See* the GILTI Report, Part IV.G.4.

[100] *Id*.